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FOREWORD

With this first Annual Report of the EMI, which is addressed to the European Parliament, the Council, the Commission and the European Council, the EMI aims to take stock of all aspects relevant to its tasks as set out in the Treaty establishing the European Community and to provide the public at large with a broad account of its views and activities. In accordance with Article 11 of the EMI Statute, the Report covers both monetary and financial conditions in the Community and the activities of the EMI, and presents the Institute's annual accounts. In addition, the Report assesses progress towards convergence, the preparatory work for Stage Three and the institutional features of national central banks, thereby also fulfilling the reporting requirements of Article 7 of the EMI Statute. Finally, this year's Annual Report encompasses the years 1993 and 1994, reflecting the fact that the EMI took over the tasks of the Committee of Governors of the EC central banks with effect from 1st January, 1994 and that no Committee Report for the year 1993 was published. Following standard practice for Annual Reports, the text does not assess developments beyond 31st December 1994; events such as the ERM realignment of early March 1995 thus fall outside the time frame of the Report and are not considered.

Chapter I describes and analyses the major economic, financial and monetary developments in the EU by focusing on their implications for the achievement and maintenance of price stability. On balance, the progress towards price stability achieved during the past two years is notable. Nevertheless, important challenges remain. First, price stability has not yet been achieved in the European Union as a whole, and in the context of the widespread recovery currently under way it may become considerably more difficult to make further progress. Thus monetary policy-makers will have to remain vigilant. Second, public finances in many Member States continue to be a cause for serious concern. Decisive action will be necessary to reduce budget deficits and to restore acceptable levels of public debt. Medium-term consolidation has to proceed at a satisfactory pace, and should be strongly weighted towards expenditure restraint. This is all the more important in those countries where the policy mix implies too heavy a burden for monetary policy in the pursuit of price stability. The period ahead will be particularly important as it will be crucial for the first assessment of convergence under Article 109j(1) of the Treaty, which is to be conducted independently both by the EMI and by the Commission in the course of 1996.

Chapter II presents the role of the EMI in the field of co-operation and co-ordination during Stage Two and in the preparatory work for Stage Three. In Stage Two, the EMI has the task of strengthening the monetary policy co-ordination of Member States with the aim of ensuring price stability. In carrying out its duties, the EMI provides a forum for consultations and exchange of views and information on policy issues, while the conduct of monetary policy remains the exclusive responsibility of the national authorities. Regarding the preparatory work for Stage Three, the Treaty establishing the European Community requires the EMI to prepare and specify by the end of 1996 the regulatory, organisational and logistical framework necessary for the European System of Central

Banks to perform its tasks. In view of the very wide range of issues to be addressed in detail and the limited time available for the preparatory work, the EMI Council has organised its work on the basis of a comprehensive agenda which acts as a guiding instrument for organising, monitoring and assessing the activities of the EMI staff, the Sub-Committees and the Working Groups.

Chapter III deals with the institutional features of national central banks, in particular in respect of the Treaty provisions concerning the implementation of central banking independence and the primary objective of promoting price stability. Institutional changes in 1993 and 1994 are highlighted, current features of EU central banks are described and prospective changes in legislation are indicated. This chapter also addresses the role of the EMI in monitoring compliance of the central banks with the prohibition of monetary financing of the public sector and its privileged access to financial institutions.

The Report addresses a wide range of issues, reflecting the comprehensive range of tasks to be performed and the heavy agenda for the EMI in the years ahead. In order to meet the requirements laid down in the Treaty a great deal of commitment and dedication will be necessary both from the national central banks and their staff members serving on the Sub-Committees and Working Groups of the EMI and from the staff members of the EMI. To all of them, and first and foremost to the members of the EMI Council, I wish to express my gratitude for the work which has been accomplished during the past two years, and in particular during last year's institution-building phase. In November 1994 the EMI moved from its provisional base in Basle to its premises in the "Eurotower" in Frankfurt: following the recruitment of additional personnel, it is now in a position to deal effectively with the tasks entrusted to it by the Treaty establishing the European Community.

A. LAMFALUSSY
President

Frankfurt, 7th March 1995

CHAPTER I

ECONOMIC, MONETARY AND FINANCIAL CONDITIONS IN THE EUROPEAN UNION

SUMMARY AND OVERVIEW

1. Economic, monetary and financial conditions in the EU in 1993-94

1993 witnessed a recession in most - but not all - of the twelve EU Member States, with Union GDP falling by 0.3%, while 1994 saw a recovery to an estimated growth rate of 2.6%. Owing to rapid growth outside the EU, positive contributions from net exports were important in many member countries, mitigating the effects of the recession and providing a significant impetus to growth in 1994. As a consequence, the external balance of the Union improved significantly in 1993, and further smaller improvements took place in 1994. Domestic demand, which had been weak in 1993, recovered in 1994, in line with the cyclical upswing. Besides the general increase in activity, growth rates in EU countries were considerably more synchronised in 1994 than in 1993; economic growth was positive in all Union countries in 1994, for the first time since 1989.

The average rate of increase in consumer prices in the European Union fell from 4.3% in 1992 to 3.1% in 1994, thus continuing the decline that had been observed since 1991; there was also a marked convergence of inflation. While the trends towards lower inflation rates in the Union reflected wage moderation and substantial productivity gains, attention should also be drawn to other factors. In particular, a significant change in economic policy thinking has taken place, and price stability is now considered to be one of the major objectives of economic policy in general, and the primary objective of monetary policy in particular. Furthermore, the progressive completion of the Single Market has enhanced competition, and some structural reforms to improve the flexibility of labour markets have been implemented.

However, though the progress towards price stability achieved in EU countries during the past two years is notable, the result cannot yet be considered wholly satisfactory. Whereas some countries (Belgium, Denmark, France, Ireland, Luxembourg, the Netherlands and the United Kingdom) reached or maintained annual inflation rates below or around 2-2.5% in 1994, Germany recorded a consumer price increase of 3%, and inflation rates in Spain, Italy and Portugal remained in the range of 3.9 to 5.2%. Greece showed an inflation rate of slightly below 11% in 1994.

Unemployment, which usually lags behind developments in activity, peaked in the EU as a whole at almost 12% in 1994, before beginning to decline slowly. Considerable differences remained among individual countries, but a common factor appears to be the existence of substantial structural problems. A wide range of measures have already been implemented in member countries since the late 1980s, but further supply-side measures are needed.

A major cause for concern in 1993-94 was the continued deterioration of fiscal positions in EU countries. After standing at 5.0% in 1992, the general government deficit of the Union as a whole increased in 1993 - partly for cyclical reasons - to 6.0% of GDP, the highest level recorded since the creation of the EEC. In 1994 it fell only marginally to stand at 5.6% despite the cyclical improvement. According to certain estimates, this modest reduction reflects on average cyclical rather than structural effects. Overall, the gross public debt ratio of the Union climbed to almost 69% of GDP in 1994, compared with nearly 61% two years earlier, although deficits and debts continued to vary substantially among Member States.

Monetary expansion, albeit moderate at an EU level, differed significantly in individual countries, sometimes posing problems of interpretation for the monetary authorities. In Germany, where the Bundesbank continued in 1993-94 to be guided by an intermediate money supply target for M3, it was judged on balance that rapid monetary growth could largely be accounted for by exceptional or temporary factors, and monetary developments at the end of 1994 confirmed this assessment.

The conduct of monetary policy by ERM members was complicated by volatility on foreign exchange markets. 1993 in particular was notable for a continuation of the turbulence in the Exchange Rate Mechanism of the EMS which had begun in the late summer of 1992. In August 1993, as a consequence of overwhelming market pressure, the decision was taken by EU Ministers of Finance and central bank Governors to widen the fluctuation bands while confirming the prevailing central rates. Immediately after the widening of the ERM bands, the currencies previously in the narrow band traded below their former lower limits against the Deutsche Mark (the exception was the Dutch guilder, which remains within a narrow margin vis-à-vis the Deutsche Mark) but rather rapidly recovered towards their central parities. The Spanish peseta and the Portuguese escudo (which were devalued in the first half of 1993) stayed above their former limits. Overall, central banks of ERM countries used the flexibility inherent in the new framework prudently to accommodate only short-lived market pressures. At the same time, the wider fluctuation margins proved to be an efficient means of deterring speculative movements, alleviating the related constraints on monetary policy. As a result, from the end of 1993 and during most of 1994 the ERM operated relatively smoothly, without major tensions.

Currencies of EU countries outside the ERM experienced greater volatility. Over the period as a whole, the Italian lira and the Greek drachma weakened vis-à-vis the strongest ERM currencies, reflecting among other factors concerns about the stance of fiscal policy, the outlook for inflation and, in Italy, political uncertainties. At the end of 1994, the sterling/DM rate was similar to the end-1992 level. The monetary policy strategies of these countries' central banks tended to focus directly on domestic inflation, while also taking into account related indicators and not disregarding the importance of exchange rate stability.

While bond markets in 1993 were characterised by optimism, a decline in long-term yields and a compression of differentials, early 1994 witnessed a dramatic revision of expectations. Bond yields rose steeply in all industrialised countries and, despite contrasting cyclical positions, there was a simultaneous movement of US and European bond markets. Within the EU, however, country-specific factors were clearly also important, as indicated by the fact that bond market yield differentials widened considerably in some cases.

The monetary policy implications of bond market developments depend on the extent to which rises in nominal yields are caused by higher (risk-free) real interest rates, increasing inflation expectations and/or rising risk premia. While the overall judgement of the central banks in most EU countries was that there was no risk of an immediate upturn in inflation, the behaviour of long-term bond yields was nevertheless considered to indicate important long-term concerns in the markets, particularly over fiscal positions, as well as an increased focus on countries' long-term records of price and exchange rate stability.

In the context of these real and financial developments, central banks remained aware that it was important to emphasise the steady conduct of anti-inflationary monetary policies, based on a clear statement of objectives and assumptions, and a willingness to act when the fulfilment of the objectives was threatened. Within this framework, central banks in the Union considered it appropriate for most of 1993-94 to continue their policy of gradually lowering official or key interest rates, thus allowing short-term interest rates to decline until the summer of 1994. In the second half of 1994 a few countries started to raise interest rates again, either because prospects for further disinflation had weakened or in response to perceived threats to price stability.

In retrospect, the restoration of exchange rate stability, especially within the ERM, in combination with the continued slowdown in the rate of inflation across the Union and a narrowing of inflation differentials between countries, may be seen as evidence that the course of monetary policies in individual countries was broadly appropriate. Of course, in making this assessment, the prospects for inflation must also be taken into account. In this context, monetary policy again risked becoming overburdened when other economic policies did not contribute sufficiently to the achievement of medium-term price stability, and, consequently, to stability in financial markets. In this respect fiscal policies bore a substantial responsibility.

2. Prospects and challenges

Viewed from the end of 1994, the overall growth perspective for 1995 has clearly brightened further, both for the twelve existing Member States and the three new entrants. Economic activity is growing faster than expected and the rise in unemployment rates has come to an end. At the same time, the external balance of the Union is expected to continue to improve. On a less favourable note, however, high levels of structural unemployment, the pattern of fiscal deficits and levels of public debt continue to constitute major challenges.

The fall in inflation to below 3% expected in 1995 is, to some extent, related to the previous recession, which had opened up significant output gaps in several countries. In addition, wage flexibility may have increased in some countries as a consequence of recent agreements between the social partners and/or labour market reforms. There are, however, risks inherent in the forecast for inflation which call for vigilance on the part of central banks in respect of their interest rate policies, not only to safeguard the progress made thus far in fostering price stability, but also to enable further progress in countries where inflation is still relatively high. Pre-emptive tightening measures have been taken in some Member States.

More generally, continued wage restraint as well as determined structural adjustment measures - including fiscal consolidation - are critical to enhance the durability of a non-inflationary recovery. The scope for wage increases should not be misjudged and fiscal consolidation efforts should be pursued with determination in a period in which the cyclical upswing tends to mask the underlying structural problems. The upturn offers an opportunity to take the necessary steps in fiscal adjustment and at the same time minimises the social costs of fiscal restriction. Without continued efforts to reduce structural fiscal deficits, no lasting progress can be made towards a viable fiscal position in the Union and a more balanced policy mix. In particular, it is essential that the commitments included in convergence programmes be respected, with the emphasis being put on expenditure cuts rather than on increases in revenue. Consolidation will be all the more important in those countries where monetary policy is overburdened. Labour market reforms are also urgently needed. Such reforms could also be expected to lend support to the pursuit of price stability.

The achievement of a high degree of sustainable convergence will be of crucial importance. In particular, in the context of the Maastricht Treaty on European Union, the countries entering Economic and Monetary Union are required to have met the necessary conditions for the adoption of a single currency. The criteria which will be examined focus on price stability, sustainability of government financial positions, exchange rate stability and the convergence of long-term interest rates, although other factors will also be taken into consideration. On balance, whereas progress towards price stability was notable in the past, deficiencies remain, and at present most EU countries would not qualify for Monetary Union, in the majority of cases because of their fiscal positions. If, however, outstanding structural and cyclical challenges are met, convergence within the Union will make further progress.

A. MAJOR DEVELOPMENTS SINCE THE BEGINNING OF 1993

1. Macroeconomic background

1.1 Global patterns in major industrialised economies

Cyclical positions

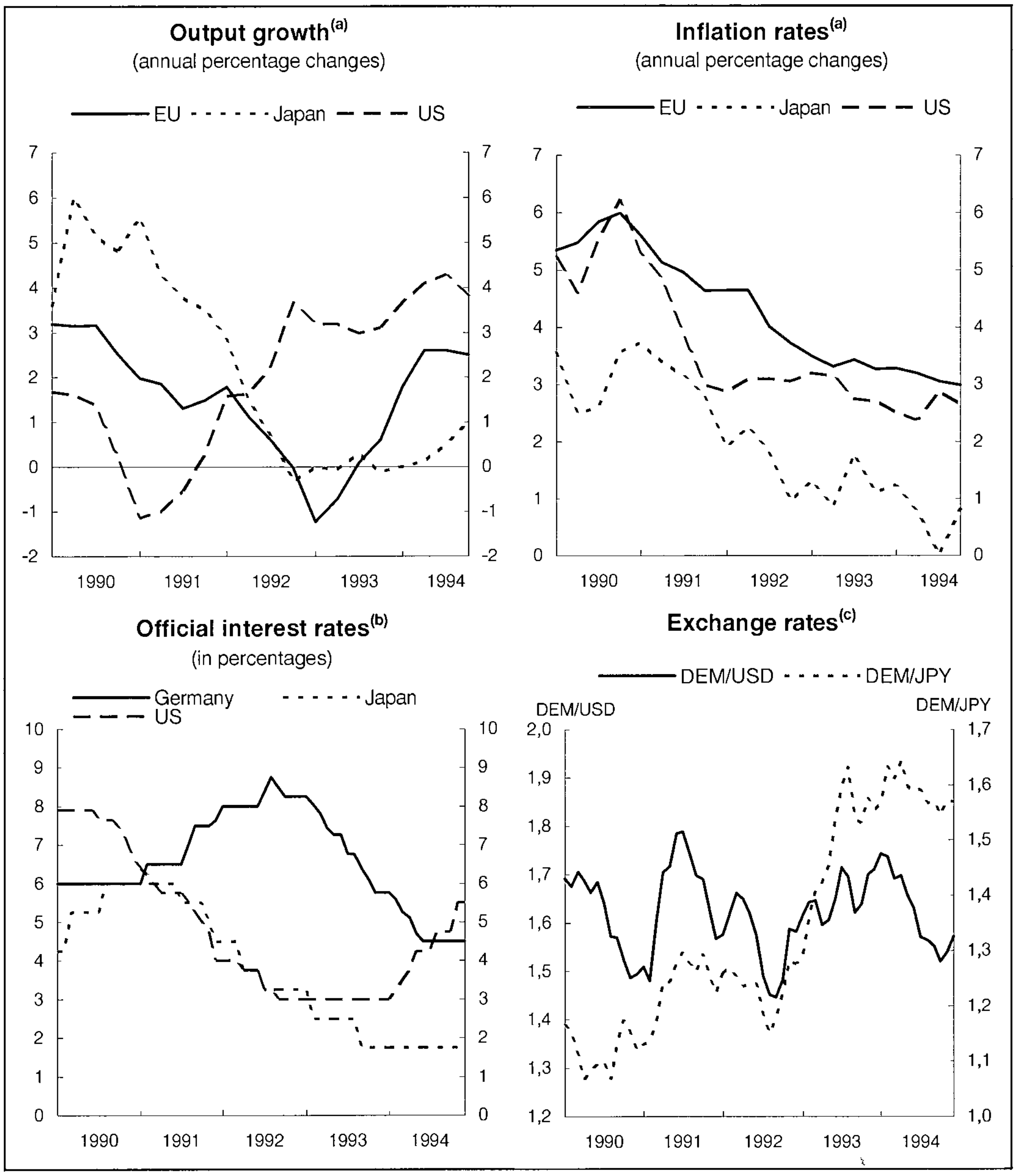
There were marked contrasts in the evolution of the global business cycle between 1993, a year which witnessed a pronounced desynchronisation among major industrial countries, and 1994, during which growth rates tended to converge (see Chart 1). The United States, which was the first country to move into recession, has experienced sustained growth since reaching a trough in 1991. With an increase in GDP of 4.0% in 1994 the US economy is operating close to full capacity. The most dynamic components of the expansion have been private consumption and investment, which have been increasing above historical trend rates, causing the level of imports to rise rapidly and thereby widen the trade deficit.

In the EU as a whole, output growth began to slow in 1990 and reached its low point in early 1993. This reflected contrasting developments. In the United Kingdom, which had experienced two years of falling output from mid-1990 to mid-1992, the economy entered a phase of renewed growth during the course of 1992. In most other EU countries both the timing and the intensity of cyclical developments were strongly influenced by the spillover effects of the German unification boom. As discussed in Section 1.2 below, the contraction in output in 1993 was followed by a stronger than expected recovery in 1994.

Among the last of the major economies to go into recession was Japan. Owing to depressed consumer and business confidence and partly reflecting the real appreciation of the yen, private consumption and investment were very subdued in 1993, with output growing at 1.0% in 1994, still well below the trend rate.

In a number of countries financial fragility was a special feature of the recent recession. In the United States, the United Kingdom, Japan and some other countries, the length and depth of the economic downturn were aggravated by the efforts of households, firms and financial institutions to correct disequilibria in their balance-sheet positions.

Chart 1 Main developments in major industrialised economies



Source: National data.
(a) Quarterly data.
(b) For Germany and Japan discount rate, for the United States federal funds target rate.
(c) Deutsche Mark per dollar and per 100 Yen.

Inflation trends and monetary policies

In 1993 and 1994 annual inflation rates in the major industrialised economies declined. In the United States inflation was below 3% in both 1993 and 1994, one of the lowest rates of price increase of the post-war period, although quarterly rates have shown some fluctuation. The Federal Reserve tightened monetary conditions in February 1994 for the first time in five years in response to concerns about an increase in underlying inflationary pressures. Between February and December 1994 the federal funds rate was raised six times; initially, the Federal Reserve opted for relatively small increases in official rates (of 25 basis points each), but these apparently did not reassure the markets. The increase of 75 basis points in mid-November 1994 brought the federal funds rate to 5.5% (from 3% in early February 1994); this was one of the largest increases of the post-war period and seems to have strengthened the financial markets' confidence in the anti-inflationary stance of the US monetary authorities.

In the EU the average rate of inflation fell continuously; in 1994 it stood close to 3%.

In Japan, monetary easing started in early 1991 and the discount rate was held at 1.75% from September 1993 onwards. Owing to weak domestic demand and the strong appreciation of the yen, the inflation rate stood at 1.3% in 1993 (compared with 1.7% the year before) and declined further in 1994. In order to stimulate economic activity the monetary authorities adopted a very accommodating stance, although the real appreciation of the yen in 1994 partly offset the effects of low nominal interest rates.

Exchange rate developments

A significant feature of the foreign exchange markets throughout the period under review was the relative weakness of the dollar during both years vis-à-vis the yen and in 1994 vis-à-vis all currencies, and the considerable strengthening of the yen. During these two years the dollar depreciated in nominal effective terms by around 5% and the yen appreciated by about 30%; movements in their real effective exchange rates were roughly of the same order. Viewed in a medium-term perspective, this could help to reduce external imbalances between the two countries by increasing the competitiveness of US goods and services. In the short run, however, it had pro-cyclical effects on the US and Japanese economies.

The appreciation of the US dollar vis-à-vis the Deutsche Mark of around 7% in the course of 1993 was followed in 1994 by a depreciation of around 10%. The dollar's initial appreciation was partly related to changing expectations concerning short-term interest rate differentials after the Bundesbank began a series of interest rate reductions, thus generating expectations of a progressive narrowing of the short-term interest rate differential between the two countries. However, the tightening of monetary conditions by the Federal Reserve in February 1994 drew the market's attention to the stronger than anticipated growth and failed to calm increased inflationary expectations. Another important factor was the temporary halt in the bilateral trade talks with Japan, which drew attention to the widening US external imbalance. Finally, the recovery in Europe, which turned out to be stronger than expected, also played a part in the dollar's weakening. A number of central banks intervened on occasion in foreign exchange markets in 1994 to smooth or check the dollar's fall, and there were a few co-ordinated rounds of joint intervention.

The Japanese yen went through two main phases vis-à-vis the Deutsche Mark in 1993 and 1994. Between January and August 1993 the yen appreciated sharply before stabilising with minor fluctuations at around DM 1.60 per Yen 100. Vis-à-vis the dollar the yen experienced a sharp appreciation over the whole period, moving from Yen 125 in January 1993 to around Yen 100 at the end of 1994, notwithstanding heavy intervention purchases of dollars by the Japanese monetary authorities.

1.2 Economic developments in the EU

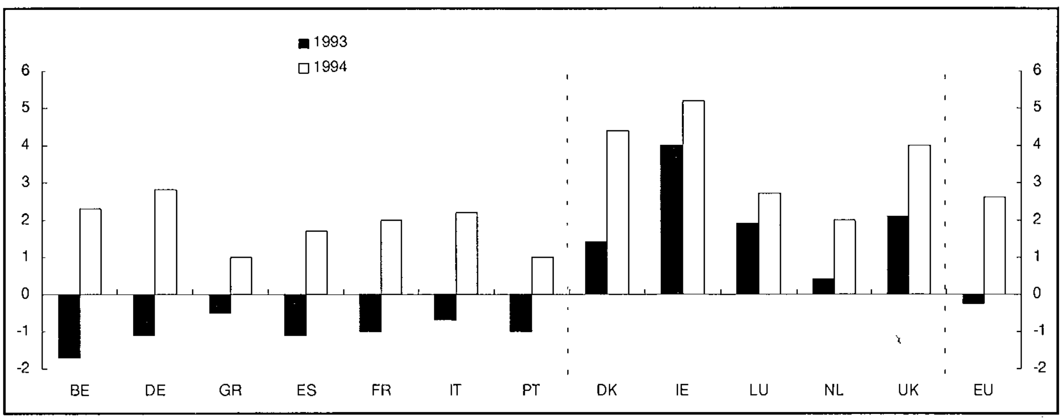
For the EU as a whole, the 1993-94 period was characterised by a return to growth following the recession. Several successive years of declining GDP growth rates in the Member States collectively had been capped by a decline of 0.3% in the real level of economic activity in 1993, the first fall in GDP for twelve years. By contrast, GDP growth in 1994 is estimated to have been around 2.6% for the EU as a whole.

Putting these developments into historical perspective, it is evident that the recent recession in the EU as a whole was not unusually severe when compared with previous recessions, although in some countries it was the deepest in decades. The fall in GDP was 1.3% from peak to trough, with the low point in activity being reached in the spring of 1993. By comparison, GDP in the Union in the early 1980s fell by 1.4%, with an even greater decline amounting to 2.1% in 1974-75. As regards the pace of the current upturn, a growth rate of 2.6% does not appear to be exceptional for the first year of recovery: while growth was sluggish for several years following the recession in the early 1980s, the EU average growth rate was 4.5% in 1976, the first year of recovery following the previous recession.

In most countries cyclical behaviour was quite synchronised, with developments in real GDP reflecting closely those in the EU as a whole. However, some economies showed contrasts either in terms of the amplitude of the cycle, or in terms of its timing (see Chart 2).

Chart 2

GDP growth in EU Member States*
(annual percentage changes)



Source: National data.
* Aggregate EU figures, here and elsewhere in the Annual Report, are generally constructed using purchasing power parity (PPP) exchange rates. However, trade data use actual exchange rates in 1989. Rates and indices (except CPI) are based on 1989 GDP weights.

In Belgium, Germany, Greece, Spain, France, Italy and Portugal overall economic activity declined in 1993 but recovered significantly in 1994. In some countries the positive contribution from net exports was particularly important in determining developments both in 1993 and 1994. In 1993, positive changes in trade balances partly offset the weakness of domestic demand (thus mitigating the severity of the downturn) and in 1994 the strength of net trade provided a significant impetus to growth. In this context, the buoyancy of world trade in 1994 benefited all these countries, while in Spain and Italy export growth in the course of 1993-94 was further strengthened by the gains in competitiveness which had followed the substantial exchange rate depreciations of 1992-93.

Domestic demand, which had been a major source of weakness of real activity in most of these countries in 1993, made a positive, albeit a fairly modest, contribution to growth in 1994. Consumer sentiment, which had been severely affected by the recession and in some countries by the 1992-93 exchange rate crises, recovered gradually over time. This led to a gradual improvement in private consumption and an accompanying decline in the saving ratio. Stock building has also given a significant stimulus to growth in most of these countries, but investment, despite a marked improvement in 1994, provided only a modest stimulus to economic activity. Furthermore, in spite of sizable fiscal deficits, the direct contribution of government consumption to GDP growth remained small or even negative in most of this group (see Section 3.1 for a discussion of fiscal policy).

Growth remained positive in Denmark, Ireland, Luxembourg, the Netherlands and the United Kingdom throughout the two years covered by this Report, although in some countries a slowdown in activity was experienced during the course of 1993. In both 1993 and 1994 GDP growth in Ireland was the highest in the Union and it was above the EU average in Denmark. Domestic demand in Denmark, Ireland and the Netherlands was either broadly unchanged or fell in 1993, but GDP growth was supported by net trade. Rapid growth in Denmark over the period under review was also attributable to an expansionary fiscal stance. In the United Kingdom, GDP growth was positive in both years. However, this followed a prolonged and severe recession between mid-1990 and mid-1992, which had been related to private sector balance-sheet difficulties and the high level of nominal interest rates between 1988 and 1990. The recovery, which began in mid-1992, was principally associated with a turnaround in private consumption and was boosted by the reduction in interest rates, which had begun as early as 1990. Net exports, which had supported the economy during the earlier downturn, had a much less positive influence during the initial stages of the recovery in 1993 since these coincided with the cyclical deterioration in continental Europe. However, as the recovery gathered pace in 1994 net exports provided an increasing contribution to growth as fiscal tightening slowed domestic demand.

1994 also witnessed an increasing convergence of growth rates, with, for the first time since 1989, all Union countries simultaneously experiencing positive economic growth. The standard deviation of growth rates, which stood at 2.3% in 1991, declined to 0.7% in 1994.

As a consequence of the cyclical desynchronisation of the Union vis-à-vis third countries, the external balance of the EU as a whole improved significantly in 1993. A further, smaller improvement also took place in 1994 (see Table 1). Trade balances improved in almost all EU countries in 1993 and the overall EU trade surplus increased in 1994, to reach 1.3% of GDP. Over this period the EU's deficit on invisibles increased slightly from 0.6% to 1% of GDP, but this did not prevent the current account from moving into a surplus of 0.2 and 0.4% of GDP in 1993 and 1994 respectively.

Improvements in the trade balance in 1993 amounted to over 2% of GDP in Spain, Ireland and Italy, both as a result of gains in competitiveness and, particularly in Spain and Italy, as a consequence of the depressed state of domestic demand. In general, the improvements in trade balances in 1994 were on a smaller scale, with improvements of between 0.5 and 1% of GDP in Germany, Italy and Ireland. However, some countries experienced either a deteriorating or a constant trade balance in 1994 due to the strength of domestic activity (although in Denmark the trade balance and the current account remained comfortably in surplus).

Table 1 **Trade and current account balances in the EU***

(as a percentage of GDP)

	Trade balances				Current account balances			
	1991	1992	1993	1994 (a)	1991	1992	1993	1994 (a)
BLEU	0.9	1.5	2.7	2.8	2.4	2.7	5.1	5.1
Denmark	3.2	4.8	5.6	3.5	1.7	3.4	4.1	1.9
Germany	0.8	1.1	2.0	2.6	-1.1	-1.1	-1.0	-1.4
Greece	-14.2	-14.5	-14.0	-14.0	-1.8	-2.2	-0.8	-0.2
Spain	-6.5	-6.0	-3.9	-3.7	-3.0	-3.0	-0.6	-0.6
France	-0.4	0.5	1.3	1.2	-0.5	0.3	0.8	0.8
Ireland	7.0	11.2	15.0	15.6	3.3	4.8	7.6	6.1
Italy	0.0	0.3	3.3	4.0	-2.1	-2.3	1.2	2.0
Netherlands	3.7	3.6	2.8	2.9	2.7	2.3	3.0	3.0
Portugal	-10.0	-9.8	-9.2	...	-0.9	-0.1	-0.2	0.3
United Kingdom	-1.8	-2.2	-2.1	-1.7	-1.4	-1.6	-1.8	-0.4
EU-12 (b)(c)	-0.6	-0.3	0.9	1.3	-1.0	-0.9	0.2	0.4

Source: National data.
* Figures distorted from 1993 onwards by the change in the statistical collection procedure.
(a) Provisional.
(b) See footnote to Chart 2.
(c) Includes intra-EU trade.

Differences in the timing and severity of the recession in the Member States would suggest that, while growth rates may have converged during 1994, the margins of slack existing in individual countries continued to vary considerably. Such a margin can be proxied by the "output gap", which is the difference between actual and potential output where potential output is the level of output that would be sustainable in the economy without putting upward pressure on the inflation rate. Estimates of this are subject to considerable uncertainty but confirm the view that output gaps, although showing some convergence during 1993 and 1994, still varied considerably within Europe.

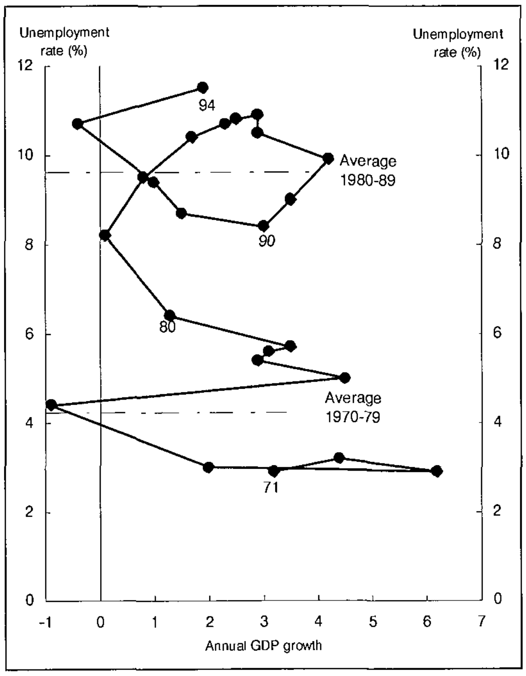
Unemployment, which usually lags behind developments in activity, peaked in the EU as a whole at around 18 million (or close to 12% of the labour force) in 1994, before beginning - albeit slowly - to decline. The unemployment rate in the Union had risen by more than three percentage points during the downturn from a low point of 8.3% during the previous expansionary phase of economic activity in the early 1990s, and had either stabilised or started to decline in most Member States during the second half of last year. However, considerable differences remained among the rates of unemployment in individual countries. At the end of 1994 unemployment was below the 10% level only in Belgium, Germany, Greece, Luxembourg, the Netherlands, Portugal and the United Kingdom.

A sizable part of the recorded increase in unemployment in the Union since the late 1980s was the result of the slowdown in economic activity. However, the recent peak level of unemployment was higher than that reached in previous cycles (the average unemployment rate in the 1970s never exceeded 6%, and the peak rate in the mid-1980s

Box 1 Structural adjustments in labour markets

The high unemployment rates seen in most EU countries in 1993-94, both relative to their own past experience and compared with those in other major countries, represented a considerable waste of resources and an important source of social (as well as budgetary) costs to Member States. As is widely acknowledged, the high levels and rates of unemployment can be attributed primarily to a poor record of employment creation rather than to changes in the labour force. Between 1980 and 1994, for instance, only around 3.5 million additional jobs were created within the EU, far fewer than in either the United States (19.3 million) or Japan (10.5 million). Improving this performance requires structural reforms to the functioning of the labour market. Such reforms could also be expected to lend support to the pursuit of price stability.

EU unemployment rate and annual GDP growth



Source: National data.

Structure of unemployment

	Unemployment rates, 1993 (%)[a]		Share of long-term unemployed 1992[d]
	Total[b]	Youth[c]	
Belgium	9.1	19.6	59.0
Denmark	10.4	11.4	27.0
Germany[e]	5.8	4.9	33.5
Greece	9.8	24.6	49.7
Spain	22.4	43.2	47.4
France	11.6	24.6	36.1
Ireland	15.8	27.9	60.2
Italy	10.2	30.6	58.2
Luxembourg	2.6	6.5	17.6
Netherlands	8.3	15.0	44.0
Portugal	5.5	12.0	30.9
United Kingdom	10.3	16.9	35.4
EU-12[f]	10.6	20.6	42.2
US	6.7	13.3	11.2
Japan	2.1	5.1	15.4

Source: OECD Jobs Study (1994).
(a) OECD standardised unemployment rates except Denmark and Luxembourg. (b) All unemployed as % of total labour force. (c) Youth (those aged under 25), as % of youth labour force. (d) All persons unemployed continuously for one year and over, as % of total unemployed. (e) Western Germany. (f) See footnote to Chart 2.

The specific features of labour markets in individual EU countries vary considerably - as indeed do the precise characteristics of the unemployment problem (see the table) - and consequently the particular policy priorities in terms of reform vary across countries. Moreover, creating more jobs in the EU requires greater competitiveness and implies that policy should also focus on product markets and deregulation more generally.

At the Union level, as well as at the level of individual Member States, attention has been increasingly focused on labour market issues in 1994, and proposals to improve labour market performance were published in a White Paper. Labour market reforms may be considered as falling into two categories: those affecting the terms and conditions of employment and others that focus directly on the unemployed. Factors that have been identified as having an influence on the functioning of the labour market and which may be of particular relevance to the EU include the following: labour costs (including both wage and

Box 1 (Cont'd)

non-wage elements), the degree of real wage flexibility (related to the extent of centralisation of wage bargaining, wage indexation, minimum wage regulation, union density and strike legislation), hiring and firing costs, unemployment insurance schemes and training programmes.

A wide range of labour market reforms have been implemented in Europe since the late 1980s. Changes to unemployment insurance schemes have been widespread, taking the form of changes in the level of net benefits received, the duration of benefit entitlement and/or eligibility. In France, for example, the pattern of payments was revised, so as to decline with unemployment duration. In 1994, the ratio of unemployment benefit to average earnings was reduced in Germany, while in Ireland and Spain unemployment benefits were made taxable. Forms of wage indexation have been changed in several countries. In Belgium the link has been changed to exclude price rises in alcohol, fuel and tobacco, while in Italy the "scala mobile" has been replaced by a system linking wage rises to targeted inflation. In Greece, wage indexation was abolished in 1991. Minimum wages have been frozen in the Netherlands since 1992, and remaining restrictions in a number of industries were abolished from 1993 in the United Kingdom. Progress has also been made in reducing non-wage labour costs, for example in Belgium and in France, where employers' social insurance contributions have been reduced (in Belgium, for low-income earners and when hiring young workers). A number of measures have been taken in Luxembourg, aimed, inter alia, at reducing non-wage labour costs. The introduction of new hiring procedures and the relaxation of restrictions governing redundancies were carried out in Spain, as part of a wide-ranging reform of the labour market in 1994. Finally, training programmes have been extended in many countries, with a particular focus on improving the skills and qualifications of the young and long-term unemployed.

was 11%). It was also significantly above the recent peaks reached in both the United States (7.4% in 1992) and Japan (where the maximum observed to date is around 3.0%).

As shown in Box 1, unemployment in the EU has tended to drift upwards in each cycle since the 1970s, highlighting the existence of substantial structural problems that need to be addressed; the important corollary is that current levels of unemployment are only partly cyclically determined. The most recent trough in unemployment (in 1990) was considerably higher than the average unemployment rate seen in the 1970s. Moreover, an OECD study published in 1994 showed that unemployment in Europe was particularly high for certain categories within the labour force, e.g. for those under 25 years (over 20% of whom were unemployed in 1993) and the long-term unemployed (over 40% of the total in 1992).

Consumer price inflation in EU countries declined on average from 4.3% in 1992 to 3.1% in 1994. There was also a marked convergence of inflation, with the standard deviation of inflation falling from 2.1% in 1992 to 1.5% in 1994. Although the achievement of the past two years cannot be considered wholly satisfactory, it represents notable progress for the Union as a whole. Belgium, Denmark, France, Ireland, Luxembourg, the Netherlands and the United Kingdom reached or maintained inflation rates of, or below, 2-2.5% in 1994, while Germany made headway and recorded an inflation rate of 3%. Further reductions in annual consumer price increases took place in Italy and Portugal, where inflation in 1994 stood at 3.9% and 5.2% respectively, while in Spain the inflation rate rose marginally to 4.7%. Greece showed an inflation rate of slightly below 11% in 1994, compared with almost 16% in 1992. The following paragraphs focus on the major factors accounting for the trend towards lower inflation rates in the Union, with the emphasis on short-term cost elements (see Table 2); other causal factors such as

Table 2 **Prices, wages and productivity in EU Member States**

(annual percentage changes)

		Consumer prices (1)	Nominal unit labour costs [a] (2)	Compensation per employee [a] (3)	Productivity (3)-(2) [a] (4)	Import prices [a] (5)
Belgium	1992	2.4	3.5	6.1	2.6	-2.6
	1993	2.8	4.5	4.4	-0.1	-3.4
	1994	2.4	0.6	4.1	3.5	1.4
Denmark	1992	2.1	1.1	2.8	1.7	-1.3
	1993	1.3	0.3	1.9	1.6	-0.9
	1994	2.0	-0.8	2.8	3.6	2.8
Germany [b][c]	1992	4.0	4.9	5.6	0.7	-1.2
	1993	4.1	3.5	2.9	-0.6	-0.3
	1994	3.0	-1.0	1.8	2.8	0.4
Greece	1992	15.9	11.0	10.3	-0.7	8.4
	1993	14.5	11.1	9.4	-1.7	7.6
	1994	10.8	11.6	12.5	0.9	7.8
Spain	1992	5.9	6.2	9.0	2.8	1.3
	1993	4.6	3.3	6.1	2.8	6.6
	1994	4.7	2.0	4.3	2.3	6.9
France	1992	2.4	2.6	4.4	1.8	-2.3
	1993	2.1	2.2	2.5	0.3	-2.3
	1994	1.6	0.5	3.7	3.2	3.1
Ireland	1992	3.0	-5.9	4.6	10.5	-2.1
	1993	1.5	-0.2	5.8	6.0	5.2
	1994	2.4	-3.4	4.0	7.4	1.4
Italy	1992	5.3	4.0	6.2	2.2	-0.6
	1993	4.3	0.8	3.6	2.8	11.7
	1994	3.9	-0.8	3.0	3.8	3.5
Luxembourg	1992	3.2	5.9	5.9	0.0	-1.7
	1993	3.6	6.4	4.9	-1.5	-0.1
	1994	2.1	3.5	4.2	0.7	3.1
Netherlands	1992	3.2	4.5	5.2	0.7	-2.1
	1993	2.6	2.4	3.2	0.8	-2.8
	1994	2.7	0.4	2.1	1.7	1.1
Portugal	1992	8.9	13.4	13.8	0.4	-4.5
	1993	6.5	5.9	6.9	1.0	3.3
	1994	5.2	2.7	4.0	1.3	5.9
United Kingdom	1992	3.7	4.2	6.3	2.1	0.9
	1993	1.6	0.3	3.6	3.3	8.2
	1994	2.4	0.0	3.9	3.9	3.2
EU-12 [d]	1992	4.3	4.6	6.3	1.7	-0.8 [e]
	1993	3.4	2.4	3.8	1.4	3.4 [e]
	1994	3.1	0.4	3.5	3.1	2.7 [e]

Source: National data.
(a) Provisional for 1994.
(b) Western Germany.
(c) Nominal unit labour costs per unit of real GDP.
(d) See footnote to Chart 2.
(e) Including intra-EU imports.

unemployment, output gaps and the restrictive stance of monetary policy are dealt with elsewhere.

Unit labour cost increases in the EU fell substantially on average over the past two years, from an average of 4.6% in 1992, to 2.4% in 1993 and 0.4% in 1994. Wage restraint was the principal underlying factor in 1993; against the background of the recession and increasing levels of unemployment the rise in nominal wages declined from over 6% in 1992 to 3.8% in 1993. At the same time, and also as a result of the recession, labour productivity growth slowed, but this only partly offset the impact of nominal wage restraint. In 1994 the recovery in activity and a further increase in the level of unemployment in the Union as a whole was associated with a sharp rise in labour productivity. This development, together with continuing wage moderation (with nominal wage increases falling to 3.5%), underlay the further deceleration in unit labour costs overall.

In a number of countries, rises in unit labour costs were kept below 3% in 1993 and below 2% in 1994. In 1994 unit labour costs actually fell in Denmark, Germany, Ireland and Italy. Increases above the EU average were recorded in Spain, Luxembourg and Portugal over 1993-94, although a marked slowdown occurred, and in Greece costs continued to rise very rapidly, exceeding 11% in both years. Other factors - unrelated to cyclical developments - contributed to the favourable inflation performance of EU countries in 1993-94. In some, structural reforms to improve flexibility in the labour markets have been implemented (see Box 1). Furthermore, there are indications of enhanced competition in product markets, partly related to the progressive completion of the Single Market.

Patterns of import prices differed sharply across countries in 1993. In several Member States import prices declined, but sharp increases occurred in Greece, Spain, Italy and in the United Kingdom, and smaller ones in Ireland and Portugal, as a result of intra-EU currency devaluations or depreciations in 1992-93. Nevertheless, the pass-through of these exchange rate changes was not complete in most of the countries concerned as importers accepted a compression of their profit margins and exporters reduced home-currency prices as a result of weak demand. In 1994, import prices were influenced by a partial restoration of margins and rising commodity prices, supplemented in some countries, such as Greece, Spain, Italy and Portugal, by further exchange rate effects. Over the two-year period, however, the impact of weaker exchange rates on overall consumer price inflation has been limited, compared with past experience.

The general tendency towards declining inflation rates in 1993-94 was apparent both in sectors producing goods and services traded on international markets, and in those producing domestic goods and services. While the difference between inflation rates in the sheltered and non-sheltered sectors increased on average in the first two years of this decade, it has declined more recently in most Member States, reflecting the effects on inflation of moderate wage developments and increased competition in the sheltered sector. The further development of the Single Market may lead to a broader range of goods and services being traded among Member States, contributing further to lower inflation rates in traditionally sheltered sectors.

Finally, notwithstanding the above, consumer price rises in the EU were boosted by increases in indirect taxes. Reflecting the state of public finances, such increases were common to most Member States in 1993-94.

2. Financial market developments

Trends in foreign exchange and bond markets differed markedly in 1993 and 1994. 1993 was notable for a continuation of the exchange rate tensions which had arisen in the late summer of 1992, until they were defused by the decision to widen the ERM exchange rate bands in August. Bond markets, meanwhile, experienced a bullish period, with rising prices and historically low yields being attained. In contrast, 1994 was marked by a rapid reversal of these bond market trends, but comparative calm on the foreign exchange markets.

2.1 Developments in foreign exchange markets

Exchange rate developments

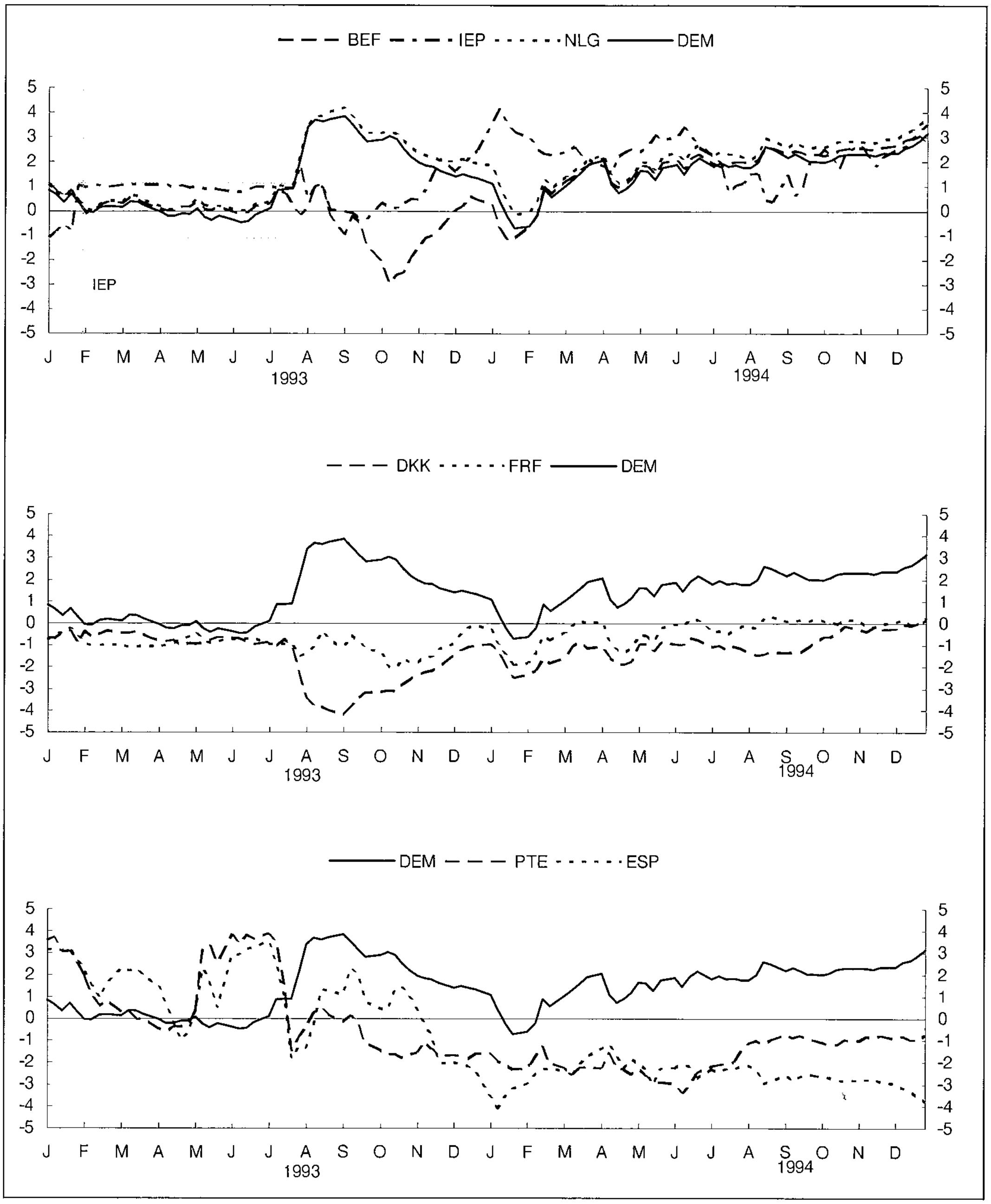
In 1993, exchange rate relations in the EMS experienced substantial strains. In the first half of the year, the persistence of tensions led to two realignments, in addition to the three that had been carried out in the last four months of 1992 and the suspension of their ERM membership by the Italian lira and the pound sterling. In the face of unprecedented speculative pressures, fluctuation margins were widened in August 1993. Thereafter, more stable conditions were re-established in foreign exchange markets, as the new system performed relatively smoothly from the end of 1993 and during most of 1994.

In the first half of 1993, recurrent episodes of speculative tensions affected most currencies. After intense pressure, the Irish pound was devalued by 10% on 1st February. In the days which followed, the tensions affecting the Danish krone were successfully subdued in the wake of a rise in official interest rates, co-ordinated intervention and a reduction in German interest rates. In March, the French franc came under pressure in the run-up to the French legislative elections, but recovered after the new Government re-affirmed its commitment to exchange rate stability. In April, the Spanish peseta was affected by the announcement of early legislative elections in Spain. As tensions grew, spilling over onto the Portuguese escudo, the Spanish authorities requested a realignment on 13th May; the Spanish peseta and Portuguese escudo were devalued by 8% and 6.5% respectively from 14th May.

In July 1993, after a short period of relative stability, intense market pressure re-emerged, focusing in particular on the French franc. The turnaround in market sentiment was intensified by expectations of diverging paces of economic activity in the member countries, combined with uncertainties about the future stance of monetary policies. After substantial co-ordinated intervention in the foreign exchange markets, official rates were raised in France and Denmark. Speculative capital flows were temporarily contained, following a joint public statement by the Banque de France and the Bundesbank and additional policy measures in France. The Bundesbank decided on 29th July to reduce the lombard rate and announced a further lowering of the rate on repurchase agreements while leaving the discount rate unchanged. This was followed by renewed market pressure, which in the end could not be resisted despite massive intervention by all the central banks involved and the announcement by the Bundesbank that it would allow short-term market rates to fall below the discount rate. Ministers and Governors confirmed the prevailing central rates and took the decision to widen the ERM fluctuation bands to ±15% on 2nd August 1993. As a result of a bilateral agreement, the former

Chart 3

Position of currencies in the ERM
(in percentage points)



Source: EMI
Vertical lines show realignments of IEP, PTE and ESP. Horizontal lines show fluctuation limits for former narrow band currencies.
The position of a currency in the fluctuation band is determined by its deviation with respect to the strongest and weakest currencies in the ERM. The deviation between two currencies represents the percentage difference between their market exchange rate and their bilateral central parity.

fluctuation limits of ±2.25% continue to apply between the Dutch guilder and the Deutsche Mark.

In the wake of the widening of the ERM bands, the currencies previously in the narrow band, with the exception of the Dutch guilder, started to trade below their former lower limits against the Deutsche Mark, reflecting expectations that the greater scope for monetary differentiation allowed by the wider ERM bands would be used by the member countries concerned to ease monetary policy. Between August and mid-October 1993, the bilateral deviations vis-à-vis their Deutsche Mark central rates ranged from 4% to 8.5% for the Irish pound, the French franc, the Belgian franc and the Danish krone. For the currencies previously in the wide band, the impact of the decision was less marked, as the Spanish peseta and the Portuguese escudo fluctuated within their former limits vis-à-vis the Deutsche Mark. From mid-October, bilateral deviations of exchange rates started to narrow in response to growing market awareness that the room for manoeuvre allowed by the new ERM margins would only be used to absorb self-reversing market movements. Interest rate policies were implemented accordingly.

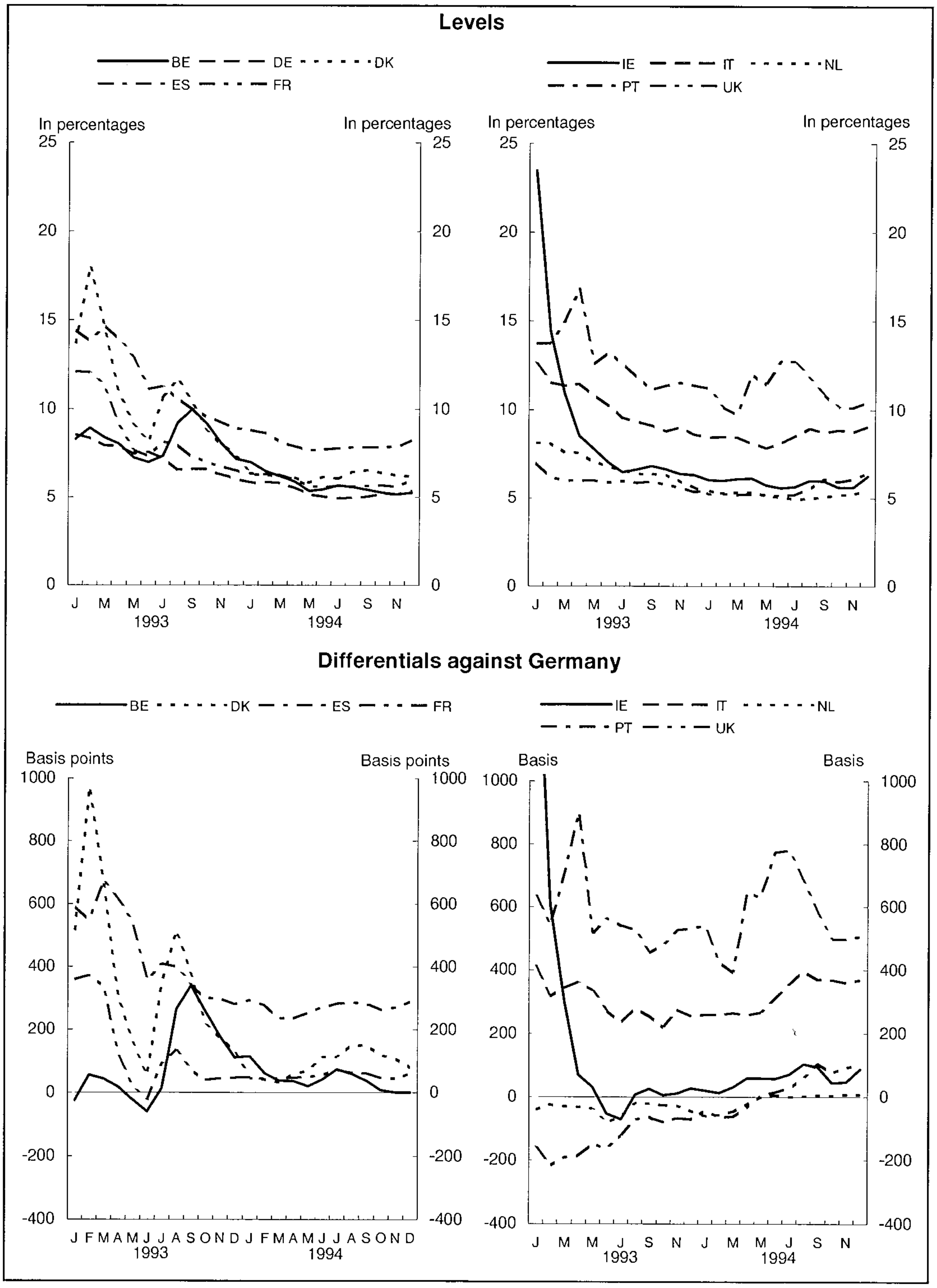
During most of 1994, the bilateral deviation between the strongest and the weakest participating currencies remained close to 6%, except for three episodes (in January, June and December 1994) when it reached 8%. The Dutch guilder, the Irish pound and the Belgian franc were the strongest of the former narrow band currencies. Vis-à-vis the Deutsche Mark, in 1994, the French franc and the Danish krone remained stable, on average, around their former lower bilateral limits and the Spanish peseta and the Portuguese escudo stayed above their former limits. The latter experienced temporary tensions in May and June 1994, leading the Banco de Portugal to resort to intervention sales and higher official and market interest rates. In December 1994, the Spanish peseta weakened below its former lower bilateral limit.

Developments in other indicators tend to confirm that the ERM regained substantial stability in the course of 1994. Short-term interest rate differentials vis-à-vis the Deutsche Mark were less volatile and, on average, comparable to levels before the crises. Intervention activity in support of currencies under downward pressure was substantially reduced and closer to the average recorded between 1988 and 1992. Replenishment of reserves was undertaken by some central banks. The volatility of exchange rates, which had increased significantly (except for the Dutch guilder) following the 2nd August 1993 decision, declined noticeably in the course of 1994, although it did not return to pre-crises levels.

Following their withdrawal from the ERM in September 1992, the pound sterling and the Italian lira depreciated sharply. From March 1993 until the end of the year sterling recovered some ground, but depreciated again in 1994. Its movements against ERM currencies were greater than those in its effective rate because the UK currency moved in part with the US dollar. Sterling ended 1994 some 13% below its August 1992 level against the Deutsche Mark, although it depreciated by only 1% between end-1992 and end-1994. The Italian lira, while stabilising or even recovering on several occasions, followed a downward trend during most of 1993 and 1994, depreciating overall by over 27% with respect to the rate prevailing at end-August 1992 against the German currency, leading to a substantial over-correction of the competitive position. Political factors may have played an important role in influencing the exchange rate of the lira.

Chart 4 **Short-term interest rates ***

(Three-month interbank rates; monthly average)



Source: National data.

* For reasons of scaling no rate is shown for Greece; the Greek three-month interest rate stood at 17.8% at end-December 1994. The differential with Germany was 12.6 percentage points at this time.

The Greek drachma experienced two main episodes of market tensions. The first, in August-September 1993, was linked to the widening of the ERM band and followed the removal, in May 1993, of most foreign exchange restrictions on medium and long-term financial transactions. The second, in May 1994, was a result of expectations that the lifting of all remaining restrictions on short-term capital movements, scheduled at the end of June 1994, would be accompanied by a devaluation of the currency. In both cases the Bank of Greece resisted the depreciation of the drachma beyond its target by taking appropriate steps, thereby demonstrating the Greek authorities' continuing commitment to an exchange rate policy aimed at not fully accommodating inflation differentials.

The main underlying factors

The protracted tensions experienced in the EMS during the first half of 1993 resulted from the combined effects of a set of factors, the relevance of which differed among member countries and changed over time as the crisis unfolded. External factors played a lesser role than in 1992, as the US dollar appreciated vis-à-vis European currencies after the weakness recorded in 1992. Likewise, intra-EMS competitive positions represented a less important source of tensions, since the misalignments which had built up prior to the summer of 1992 had been, to a large extent, corrected in the remainder of the year.

The main factor underlying the recurrent episodes of tensions in the first half of 1993 was the markets' perception that the authorities were facing policy dilemmas and that the commitment to defend the prevailing central rates had weakened. The markets saw a potential conflict between, on the one hand, the interest rate level consistent with low inflation and weak economic activity in some countries and, on the other, the level of interest rates needed to maintain exchange rate stability in the ERM, given the domestic monetary policy requirements in Germany arising from an unbalanced policy mix and persisting inflationary pressures after unification. The behaviour of market participants, which followed a pattern of "self-fulfilling attacks", as reflected in the serial nature of some episodes of tensions, with profits from previous realignments leading to further expected profits from new attacks, also contributed to fuel tensions. Finally, the credibility of the ERM itself had deteriorated as a result of the repeated realignments in 1992-93.

The policy responses

The interest rate instrument was resorted to repeatedly in 1993 to counteract market pressure by raising the cost of speculative positions. It was ineffective in some cases, as market participants considered that interest rate increases were creating or exacerbating policy dilemmas and were therefore regarded as unsustainable. This was particularly the case in member countries whose economies are highly sensitive to short-term interest rate increases, owing to a more rapid transmission mechanism from official to market interest rates.

Intervention, both intra-marginal and at the margins, was undertaken before the widening of the ERM bands on an even larger scale than in 1992. However, despite the amounts involved, intervention in several episodes of tensions could not entirely absorb market pressures and may even, on certain occasions, have exacerbated them.

The widening of the ERM fluctuation bands decided on 2nd August 1993 aimed at restoring a two-way risk. This approach was deemed to be more appropriate than a realignment, since a change in ERM central rates was not considered to be warranted by underlying economic developments in the member countries, and would have further undermined the credibility of the system.

The wider fluctuation margins combined with cautious interest rate policies were effective in deterring speculative movements. The satisfactory performance of the new ERM setting was also facilitated by the further gradual easing of monetary policy in all member countries in the autumn of 1993 and by the fact that the three main factors behind the market tensions experienced in 1992-93, namely misaligned real exchange rates, an unbalanced policy mix in Germany and cyclical divergences in a context of decelerating economic activity, had all been eliminated by the end of 1993.

2.2 Developments in bond markets

In 1993 a global decline in long-term bond yields occurred (see Table 3). During the year, the US 10-year bond yield declined by 85 basis points while the equivalent German yield decreased by 140 basis points and the weighted average of EU yields fell by 250 basis points. Within the EU bond yield differentials tended to narrow. However, inflation expectations in the United States turned upwards in late 1993 as commodity prices began to rise while the rate of unemployment fell sharply and expectations regarding future economic growth improved. These patterns contributed to a turning-point in US long-term bond yields in October but left European yields initially unaffected. Despite this change in sentiment in the United States, bond market investors' expectations for 1994 were relatively optimistic since the US economy continued to expand with little evidence of inflation, while continental European interest rates were expected to decline on the basis of a weak recovery accompanied by low inflation and Japanese interest rates were expected to remain low as the economy remained weak.

A number of factors underlay the dramatic revision of global expectations which took place in early 1994. First, the increase in the federal funds rate from 3 to 3.25% on 4th February 1994 was perceived as the turning-point in the interest rate cycle. Second, the breakdown of the US-Japanese trade talks in early February 1994 and the subsequent weakening of the dollar increased the exchange rate risk of holding US bonds. Third, the publication of revised data in March indicating an annualised increase of 7.5% in US GDP at the end of 1993 may have fuelled expectations that the US economy would experience inflationary pressure during 1994. All these factors contributed to a further sharp decline in US bond prices, which had a knock-on effect in other bond markets - particularly in Europe - despite the fact that most European countries were behind the United States in the business cycle. In 1994 10-year US bond yields rose by 201 basis points. The yield curve differential increased by somewhat less, owing to the rise in short-term rates as monetary policy was progressively tightened.

Table 3 **Long-term interest rates**

(ten year bond yields*; end-month; in percentages)

	December 1992	December 1993	June 1994	December 1994	Change [(a)] 1993	Change [(a)] 1994
Belgium	7.71	6.42	7.72	8.31	-1.29	1.89
Denmark	8.91	6.09	8.18	9.14	-2.82	3.05
Germany	7.10	5.70	7.19	7.83	-1.40	2.13
Greece	24.50	22.25	20.00	19.00	-2.25	-3.25
Spain	12.46	8.12	10.40	11.79	-4.34	3.67
France	8.07	5.64	7.50	8.28	-2.43	2.64
Ireland	10.12	6.26	8.64	8.76	-3.86	2.50
Italy	13.54	8.84	10.59	12.34	-4.70	3.50
Luxembourg [(b)]	8.08	6.54	6.35	6.23	-1.54	-0.31
Netherlands	7.22	5.50	7.06	7.76	-1.72	2.26
Portugal	13.13 (e)	8.92	11.02	11.68	-4.21	2.76
United Kingdom	8.17	6.07	8.91	8.85	-2.10	2.78
EU-12 [(c)]	9.41	6.91	8.80	9.58	-2.50	2.67
Austria	7.45	5.99	7.13	7.62	-1.46	1.63
Finland	10.65	6.71	9.67	10.09	-3.94	3.38
Sweden [(d)]	9.91	7.35	9.78	10.68	-2.56	3.33
United States	6.68	5.83	7.34	7.84	-0.85	2.01
Japan	4.52	3.04	4.31	4.59	-1.48	1.55

Source: National data.
* Or closest available bond maturity.
(a) Percentage points, difference end-year on end-year.
(b) Weekly data over the full period.
(c) See footnote to Chart 2.
(d) Average monthly data over the full period.
(e) For Portugal 3 1/2 year bond yield.

Comparable bond yields in the EU rose on average by about 267 basis points - albeit varying from country to country - and the yield curve steepened considerably and became positive in countries where it previously had an inverted slope. Several factors may have contributed to the strong correlation of yields on the US and European bond markets (see Chart 5). Coupling may have partly reflected the general trend towards the growing integration of capital markets, large increases in cross-border capital flows and a greater desire for international diversification. More specifically, some purchases of European bonds in 1993 were leveraged at lower US interest rates, while the exchange rate risk was hedged. When US interest rates rose, running such positions became more costly and they were often unwound. However, although such technical or speculative factors may explain the short-term impact of increases in US bond rates on European ones, they do not explain the persistence of the trend throughout the year.

A number of factors underlay the world-wide rise in long-term bond rates in 1994 which, in most cases, was broadly similar in size to the fall in 1993. There was a general upward movement in real interest rates, which, in an environment of highly integrated financial markets, tended to correlate across the world. This trend was driven by a continuation of both long-term factors and cyclical developments. The late 1980s was a period characterised by low propensities to save internationally, partly reflecting the impact of financial liberalisation and deregulation, which reduced liquidity constraints on borrowing and entailed a movement away from non-price credit rationing to market risk assessment. Furthermore, expected returns on investment increased world-wide, reflecting structural reforms and the relatively lower inflation environment in OECD countries, economic developments in eastern Europe, Latin America and the Far East, and the liberalisation of international trade. Overall, this contributed to an expected imbalance in saving and investment.

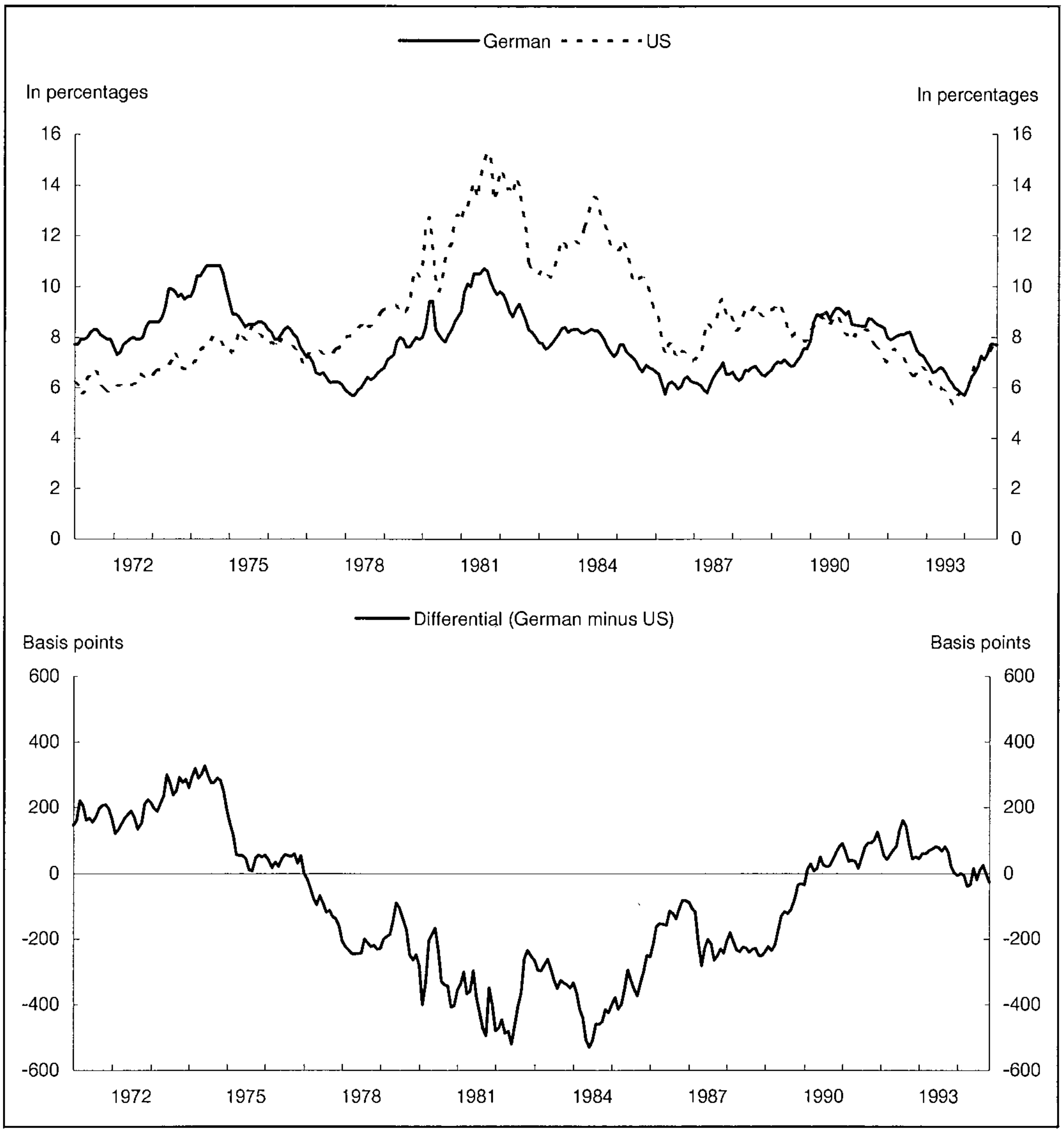
Cyclical factors also played an important role in boosting real interest rates. The unexpected strength of the recovery in Europe, vigorous growth in the United States and a general improvement in the outlook for the industrialised countries may have put upward pressure on real interest rates, reflecting an expected future shortage of capital. At the same time, the high current and relatively high projected government deficits fuelled these expectations. Some evidence of the overall increase in the real rate of interest that took place in 1994 is provided by yields on index-linked UK and Danish bonds, which exclude inflation premia. These show an increase of around 90 basis points.

Apart from an increase in real interest rates, two further factors explain the overall increase in bond yields and the steepening of the yield curve. One was the revision of market expectations about future inflation. This revision might have been partially caused by the strength of the economic recovery and the impact of the projections for government deficits. In addition to their expansionary influence on aggregate demand, large deficits can increase the incentive for governments to allow inflation to rise and/or allow their currencies to weaken. The other factor was uncertainty about both expected future inflation and the expected real rate, which typically generates a risk premium.

The relatively high volatility of European bond markets in 1994, indicated by measures derived from options prices, suggests that uncertainty may have played an important role in the rise in bond yields. A number of influences can be identified. First, when economies enter a turning-point in the business cycle, uncertainty about both future real and inflationary developments tends to increase. Second, if inflation is expected to be higher in the future, then uncertainty about inflation tends also to be higher, reflecting past experience of the coincidence of high and volatile inflation. Third, political uncertainty seems to have been a key factor in some countries. Finally, as seems to have been the case in the United States during the year, uncertainty about the response of the monetary authorities to expectations of future inflation may also have been a causal factor.

However, expectations of an increase in inflation in Europe had not materialised by the end of 1994. Although the economic recovery in 1994 was more robust than had been originally expected, there was no evidence of a general rise in inflation, either from surveys of agents' expectations in the real economy or from economic forecasts.

Chart 5 **US and German 10-year bond yields and yield differentials**



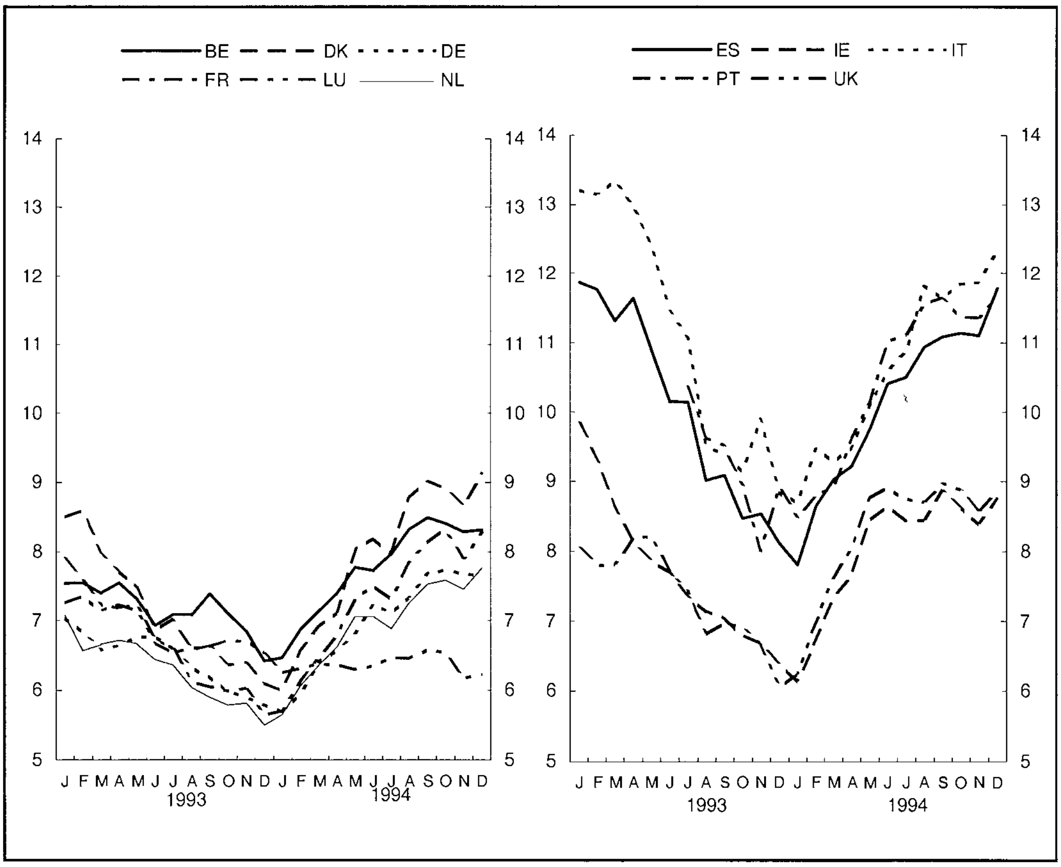
Source: National data.

The explanations provided above relate mainly to fundamental economic factors and rely to a large extent on the assumption that bond markets behave rationally at all times and take into account all information relevant to the valuation of bonds. However, bond prices can become detached from underlying fundamentals for short periods. For example, it seems likely that the sharp reduction in bond yields in 1993 reflected such a partial detachment since extrapolative or "chartist" expectations of future decreases in bond yields became self-fulfilling. As mentioned above, the accumulation of negative information about bond markets in the United States in the early part of 1994 resulted in a correction of bond prices which had a knock-on effect in European bond markets. It may be argued that an aspect of this correction was that a growing number of traders retreated from the markets and that this may in turn have led to a sharp increase in volatility.

Although the pattern of European bond yields over 1993-94 can to some extent be explained by international factors, country-specific factors also played an important role, as indicated by the fact that the changes in bond yields varied among countries. For example, falls in yields in 1993 amounted to around four percentage points in Spain, Ireland and Italy, and over two percentage points in Denmark, Greece, France and the United Kingdom. In other EU countries the declines were less sizable.

In 1994 Belgian, German and Dutch long-term bond yields rose by 189, 213 and 226 basis points respectively, while those in Spain and Italy rose by 367 and 350 basis points respectively. Among the new entrants, similar yields increased in Sweden by 333 basis points and in Finland by 338 basis points. The reasons for such differences may vary between countries. However, in general it appears that the relative increases in most countries' bond yields in 1994 are largely explicable in terms of past inflation performance, previous exchange rate developments and the evolution of fiscal positions, all of which may affect the perceived risk to the value of bonds of individual countries. Hence, countries such as Italy and Spain - as well as Sweden and Finland - which have relatively high historical inflation rates and/or large past devaluations or depreciations, and had relatively high fiscal deficits at the time, experienced larger increases in long-term yields in 1994. Consistent with this, countries such as Belgium, the Netherlands, Germany and France - as well as Austria - with better inflation track records, more stable exchange rates and lower current fiscal deficits, experienced considerably smaller fluctuations in long-term bond yields (see Chart 6).

Chart 6 **Long-term bond yields ***
(monthly averages; in percentages)



Source: National data.
* 10-year bond yields or closest available bond maturity. For reasons of scaling no rate is shown for Greece. Data for 1993 and 1994 as shown in Table 3.

While the general rise in European bond yields in 1994 was closely associated with the assessment of economic fundamentals, underlying real rates and increased uncertainty, expectations of a significant increase in future inflation were not supported in Europe as a whole on the basis of price trends, central bank forecasts of inflation or surveys conducted in the real economy. Allied to this, a dampening influence on inflation expectations across the Union should have been provided by recent structural changes in European labour markets to increase real wage flexibility, institutional changes in some countries towards increased central bank independence, and the increasing attention paid to the maintenance of low inflation. However, the inflation forecasts of financial markets seem to have differed from official forecasts for some countries, reflecting the length of time needed to earn credibility from financial markets and related concerns about fiscal deficits. Finally, non-fundamental factors may have played a role, and the increased integration of capital markets together with leveraged trading strategies appear to have led to a strong coupling of US and European bond markets.

2.3 Developments in other asset markets

In 1993 the general trend in European equity market prices was upward. By the beginning of 1994, national stock market indices were either at or near their previously recorded highs. This upward trend, which was fairly well synchronised across the major European stock markets, marked the continuation of a pattern which was established towards the end of 1992, as troughs in economic activity and subsequent recoveries were foreseen. Strengthening indications of economic recovery and an upturn in corporate profits were the major factors behind the rise, supported by declines in both long and short-term interest rates. In some countries the increase in equity prices was also given further impetus in 1993 by the depreciation in exchange rates which had occurred during the previous year. However, in the course of 1994 the upward trend came to an end across Europe and prices even declined in a number of markets. To some extent, the falls may have reflected portfolio balance considerations, as higher bond yields require a higher return on equity to encourage investors to hold them. That said, the scale of the decline in equity prices was fairly limited relative to bond prices, and in most cases only offset rises in 1994 prior to the downturn. Overall, European stock markets ended the year close to the levels reached at the end of 1993.

Developments in residential and commercial real estate markets have played a major role in the recent economic cycle both in a number of European countries and elsewhere. In particular, the scale of the declines recorded in nominal property prices often had serious implications for the financial positions of households, property companies and banks. In most Member States for which data are available residential property prices were stable in 1993-94. However, some increases occurred in Denmark and the Netherlands, reflecting country-specific factors. In the United Kingdom residential property prices stabilised in 1993-94 after a large and protracted decline. Stability also gradually returned to prices in commercial real estate markets in most countries after the falls of recent years (as measured by property price indices based on sales in prime city locations). Prices in Spain and the United Kingdom, for example, showed some growth after several years of decline.

3. Policy developments in the EU

As has been seen in Sections 1 and 2 above, monetary policy-makers in EU countries have experienced increasingly favourable economic conditions in 1993-94, while at the same time facing difficult challenges posed by developments in foreign exchange and bond markets. Moreover, the development of fiscal balances remained a matter of serious policy concern. Section 3.1 presents the background on fiscal policy, and is followed by assessments of monetary policy (Section 3.2) and the macroeconomic policy mix (Section 3.3). The data used for fiscal indicators are those provided by the Commission in its autumn 1994 forecast; data for 1994 are estimates.

3.1 Fiscal policy

The early 1990s marked a sharp reversal of trends in general government deficits in the Union. Following a prolonged period of decreasing deficits, fiscal balances deteriorated significantly from 1989 onwards. After standing at 5% of GDP in 1992, deficits in the Union reached 6% of GDP in 1993, the highest level on record since the foundation of the European Community. In 1994 the aggregate public deficit came down, albeit marginally, to 5.6% of GDP (see Table 4).

Developments in individual countries were broadly in line with these overall patterns. While in 1993 the public deficit rose in nearly all Member States, deficits tended to fall in 1994, although not by enough to offset the sizable increases seen in 1993. Hence developments over the two-year period entailed for most countries a deterioration relative to the reference value of 3% of GDP laid down by the Maastricht Treaty. At the same time, substantial cross-country differences in deficit/GDP ratios prevailed in 1994. At the upper end of the range, Greece and Italy continued to record the largest deficits, while the majority of Member States had imbalances of around 4 to 6%. Only Germany and Ireland had deficits of below 3%, while Luxembourg recorded a surplus.

In assessing recent trends in public deficits in greater detail, various estimates by international organisations of cyclical and structural components of the actual budget deficits can be used. While serious methodological caveats argue for a cautious application of such estimates, they can provide useful information, in particular with regard to assessing changes in the structural balance (as opposed to levels).

On the basis of recent estimates by the Commission of structural deficits in the EU, it appears that fiscal developments in the Union as a whole in 1993-94 were predominantly, if not entirely, a reflection of cyclical factors. In 1994 the structural deficit at the aggregate level was virtually unchanged, suggesting that the improvement which had taken place in the aggregate deficit was due to the resumption of growth. The deterioration of the deficit positions in 1993, too, seems to have been strongly affected by the recession, while structural deficits declined slightly on average.

Consideration of the structural and cyclical components of fiscal deficits raises the issue of the extent to which future improvements in the fiscal deficits of EU countries will be related to the expected continuation of economic growth. As observed in 1993-94, the economic response of the government's budget to the cycle is rather straightforward, functioning through automatic stabilisers. In an upturn, these include higher direct tax receipts resulting from stronger activity as well as the reduced need to disburse unemployment benefits, and vice versa in a recession. However, these effects can only

Table 4 **Fiscal indicators for EU Member States**

(as a percentage of GDP)

	General government lending (+)/borrowing (-)				
	1990	1991	1992	1993	1994 [a]
Belgium	-5.4	-6.5	-6.7	-6.6	-5.5
Denmark	-1.5	-2.1	-2.5	-4.4	-4.3
Germany [b]	-2.1	-3.2	-2.6	-3.3	-2.9
Greece	-14.0	-13.0	-11.7	-13.3	-14.1
Spain	-3.9	-4.9	-4.2	-7.5	-7.0
France	-1.6	-2.2	-3.9	-5.8	-5.6
Ireland	-2.2	-2.1	-2.2	-2.5	-2.4
Italy	-10.9	-10.2	-9.5	-9.5	-9.6
Luxembourg	5.9	2.3	0.3	1.1	1.3
Netherlands	-5.1	-2.9	-3.9	-3.3	-3.8
Portugal	-5.5	-6.6	-3.3	-7.2	-6.2
United Kingdom	-1.5	-2.6	-6.2	-7.8	-6.3
EU-12 [c]	-4.0	-4.6	-5.0	-6.0	-5.6
Memo item: EU Cyclically-adjusted deficit	-5.5	-5.6	-5.3	-5.0	-4.9
	General government gross debt				
	1990	1991	1992	1993	1994 [a]
Belgium	130.8	132.9	133.8	138.9	140.1
Denmark [d]	59.6	64.6	68.8	79.5	78.0
Germany [b]	43.8	42.1	44.8	48.1	51.0
Greece	82.6	86.1	92.3	115.2	121.3
Spain	45.1	45.9	48.2	59.8	63.5
France	35.4	35.8	39.6	45.8	50.4
Ireland	96.8	96.2	93.4	96.1	89.0
Italy	97.9	101.3	108.4	118.6	123.7
Luxembourg	5.4	4.9	6.0	7.8	9.2
Netherlands	78.8	78.9	79.9	81.4	78.8
Portugal	67.7	69.3	61.7	66.9	70.4
United Kingdom	...	35.8	42.0	48.3	50.4
EU-12 [c]	...	57.0	60.8	66.1	68.9

Source: European Commission services, based on figures presented by Member States, European Commission forecasts (Autumn 1994).

(a) Provisional.

(b) Western Germany in 1990, whole of Germany thereafter.

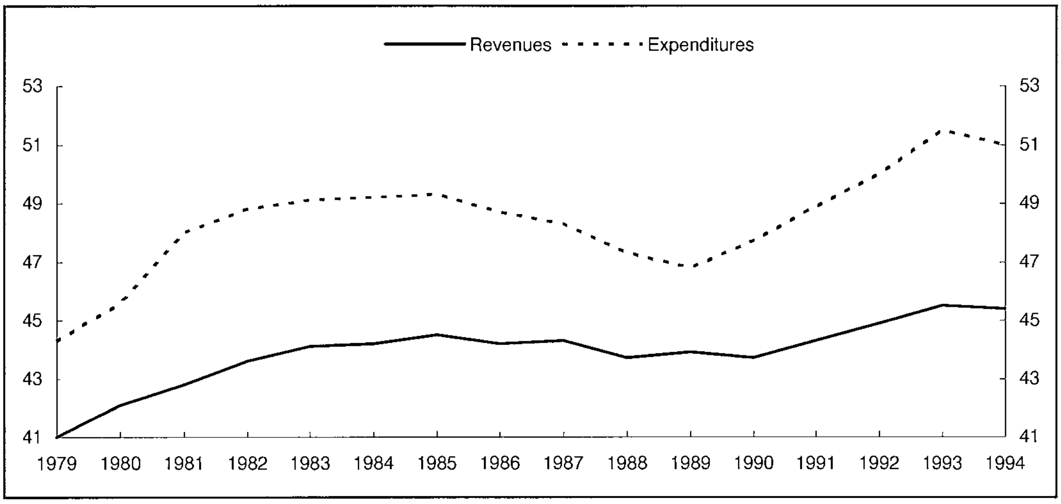
(c) See footnote to Chart 2.

(d) See footnote (e) to Table 9.

temporarily offset a deterioration in structural balances. Improvements in structural balances are needed not only to render the fiscal position sustainable, but also to help to address long-term problems faced by the Member States. In particular, the problem of an ageing society puts upward pressure on expenditure on, for example, pension payments and health care, which tends to be funded out of current revenue. Given the fact that the recession has come to an end and economic activity has picked up considerably, it appears that overall economic conditions are now favourable to fiscal consolidation.

Continuous efforts towards reducing the size of the public sector are also desirable. The overall rise in deficits since the beginning of the decade has been accompanied by a significant expansion in both public spending and public revenue, which will need to be restrained (see Chart 7). In 1993 total expenditure and receipts reached new record levels in the Union as a whole, at around 51.5% and 45.5% of GDP respectively. In 1994 the expenditure ratio fell slightly to 51%, while the level of public revenues was maintained. The rise in expenditures in 1993 was to a large extent attributable to a rise in public consumption and transfer payments. As a consequence, the general government primary balance (public deficits before interest payments on public debt) deteriorated into a deficit equivalent to 0.6% of GDP in 1993 and recovered only slightly in 1994.

Chart 7 **Public revenues and expenditures in the EU**
(as a percentage of Union GDP)



Source: European Commission.

It is important to add that the figures for expenditures and revenues mentioned above mask, once again, some rather marked divergences between countries. For example, in 1993 increases in expenditure ratios were above average in Denmark, Greece, Spain, France and Italy, whereas in 1994 preliminary estimates suggest that there was a decline on average, with the exception of Denmark, Greece, France and Portugal. Over the medium term however, most EU countries have increased their expenditure and revenue ratios substantially, and in only a few cases have corrections taken place more recently. A long-run tendency towards increasing expenditure/GDP ratios will generally be difficult to offset by rising revenue ratios, particularly in those countries where actual revenue ratios are comparatively high. In particular, as tax pressures increase there is often increased evasion as well as adverse affects on incentives and economic efficiency.

Overall, it is of concern that the rise in deficits was accompanied by a significant expansion in public expenditure. This is the cause of a number of structural rigidities in EU economies, which in turn contribute to reducing competitiveness vis-à-vis the rest of the world. Against this background, fiscal consolidation in most Member States should focus primarily on cutting current public expenditure rather than on further increasing the tax burden of the private sector.

As a result of the developments highlighted above, the gross public debt ratio of the Union climbed by more than five percentage points to 66% in 1993, and by almost three percentage points to 69% in 1994 (see Table 4). The rapid rise in the debt ratios in both years reflected the large new net borrowing requirements of the governments of Member States, and in 1993 it was also boosted by the slow growth of nominal GDP during the recession. However, in some countries special factors such as government deposits with central banks and valuation effects related to exchange rate depreciation (for debt denominated in foreign currency) should be taken into consideration, since they accounted for some significant variations in the debt ratio. This was particularly the case in Denmark, Greece, Spain, Italy and Portugal. Between 1992 and 1994 debt ratios increased in all EU countries except Ireland and the Netherlands. In Greece the ratio rose from 92 to 121%, in Italy from 108 to 124%, in Spain from 48 to 64%, in Denmark from 69 to 78%, in France from 40 to 50%, in the United Kingdom from 42 to 50%, and in Germany from 45 to 51%. Overall, there was a tendency for those countries (with the exception of Luxembourg) with debt ratios below the 60% threshold of the Maastricht Treaty to approach this value rapidly while other countries (with the exception of Ireland) with debt ratios well above 60% diverged even further.

From an analytical point of view, the evolution of debt ratios depends on the differential between nominal GDP growth and the interest rate applying to the stock of debt, and on the development of the primary balance. While stronger nominal GDP growth and lower interest rates may help to improve the debt ratio, the need for greater efforts to redress the primary balance will be unavoidable.

A sustained imbalance in the fiscal policy stance of the order of magnitude currently observed implies serious risks for price stability, as well as for potential growth in the longer run. A large share of the public sector in the economy also creates a less favourable environment for the pursuit of stability-oriented monetary policies. The issue of the mix between monetary and fiscal policy is discussed in Section 3.3.

3.2 Monetary policy

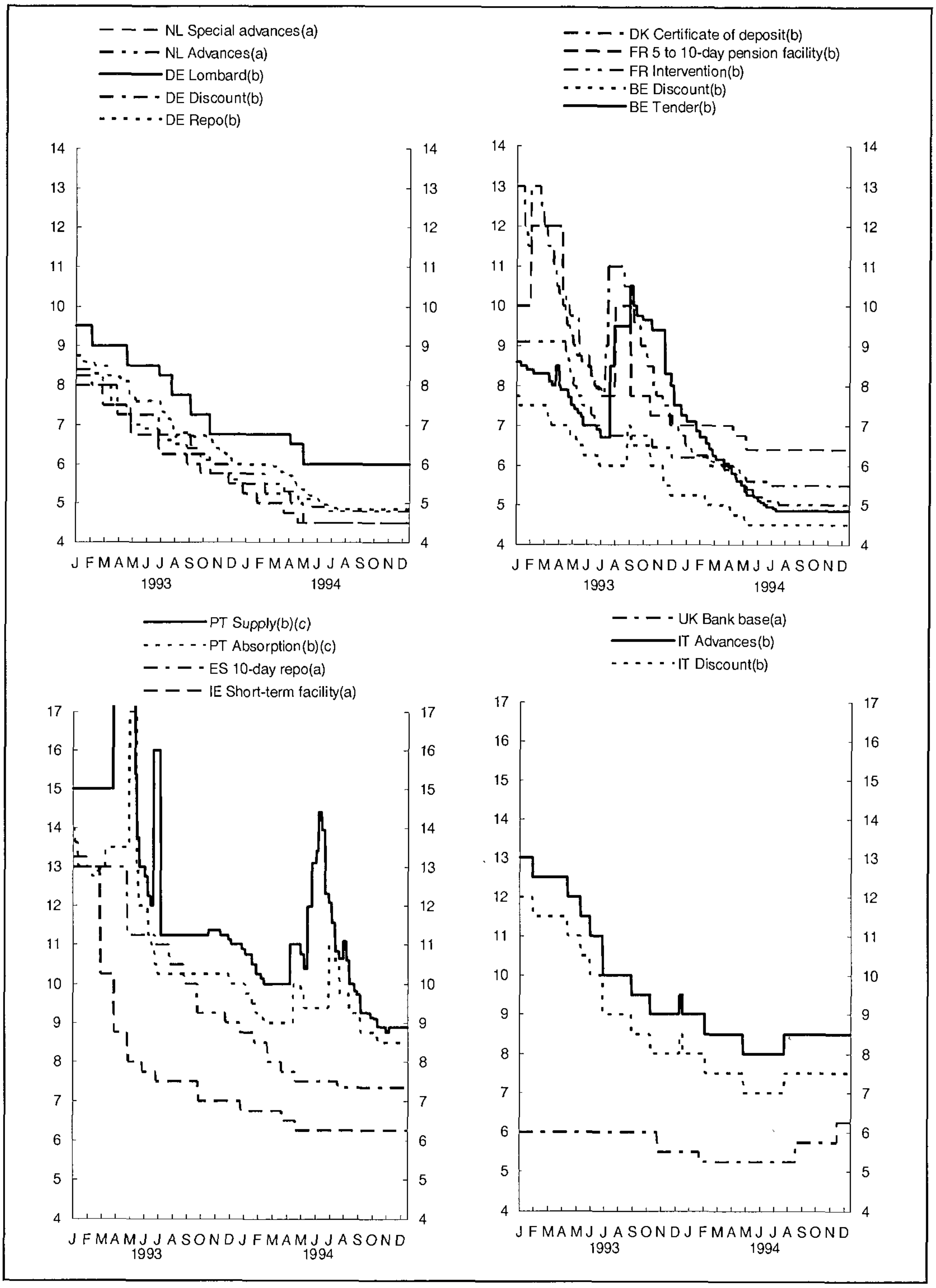
This section reviews monetary developments in the EU Member States, focusing on short-term interest rates, monetary aggregates and other monetary indicators. Furthermore, account is taken of the changes and continuity in monetary policy strategies after the widening of the ERM fluctuation bands.

Short-term interest rates

For most of 1993-94, central banks in the Union continued their policy of gradually lowering official or key interest rates, thus allowing short-term market interest rates to decline further (see Chart 8). However, in some member countries short-term interest rates rose sharply for short periods, reflecting the exchange rate tensions discussed in Section 2.1. Overall, the process of lowering official or key interest rates continued until the summer of 1994. Only Greece and Portugal reduced their official rates later in the year from the high levels they had maintained in late spring 1994 when defending their respective currencies against speculative pressures.

Chart 8 **Official or key policy interest rates in EU Member States** *

(in percentages)



Source: National data.

*For reasons of scaling no rate is shown for Greece; the Greek lombard rate stood at 30% at end-December 1994. Also, the Portuguese supply rate was in excess of 17% between March and May 1993. The series has been left blank between these dates.

(a) End-of-month.

(b) End-of-week.

(c) Rates on occasional operations (up to one week).

Although official or key interest rates were only reduced in small successive steps, a substantial overall reduction has been achieved. The German discount rate, for example, was lowered by 4.25 percentage points from its peak in July 1992 to stabilise at a level of 4.5% since May 1994. Over the two years up to July 1994, the German repo rate fell by 4.85 percentage points, after which it was maintained at a level of 4.85% for the rest of 1994.

In general, and partly as a result of the cautious manner in which ERM participants relaxed their monetary policies, the exchange rate tensions of July 1993 that had led to the widening of the fluctuation bands in August abated. Participating currencies moved back within their former intervention limits or fluctuated close to their former lower bilateral limits against the Deutsche Mark. For many countries, the restoration of stability within the ERM was accompanied by a return to pre-crises short-term interest rate differentials vis-à-vis Germany (see also Chart 4), as well as by a reduction in volatility. Belgian three-month interbank rates increased substantially in the summer of 1993, but fell sharply afterwards and were again equal to German rates towards the end of 1994. Dutch short-term rates fluctuated slightly below their German equivalents, but moved up to that level in mid-1994. French money market rates maintained a relatively stable differential against their German counterparts for most of 1994. At the year-end there was some slippage of the French franc and an increase in the short-term interest rate differential caused by political developments. Similar but more pronounced factors were responsible for triggering some instability in exchange rates and short-term interest rates elsewhere, particularly in Spain.

Outside the ERM, following indications of a deterioration in the outlook for inflation, the central banks of Italy and the United Kingdom decided on pre-emptive moves to raise their official interest rates in the second half of 1994, underlining their commitment to achieving and maintaining price stability.

Monetary aggregates

During the course of 1993-94 there were significant divergences in the pace of monetary expansion in individual countries. To a substantial degree, however, these divergences can be accounted for by exceptional or temporary factors, most notably in Germany and France, where monetary aggregates were distorted in opposite directions. This situation complicated the conduct of monetary policy for those central banks setting monetary targets or monitoring ranges and led some countries to focus on a wider variety of indicators.

Monetary growth in Germany continued to be fuelled by rapid credit expansion and exceeded the target range for most of 1993. After a considerable overshoot in early 1994, which to a large extent was caused by changes in tax legislation and rising uncertainty in global bond markets, the growth rate of M3 decelerated appreciably in the following months and entered the target range towards year-end (see Table 5). The slowdown of German M3 was mainly accounted for by the restructuring of the portfolios of non-banks towards long-term bank liabilities not included in the target aggregate following the normalisation of the yield curve and higher long-term interest rates. The fading influence of tax-related special factors and outflows of capital further contributed to this development. Investment by the public in Deutsche Mark-denominated money market funds (authorised in 1994 and not included in M3) also played a role.

Table 5 **Monetary aggregates - targets and monitoring ranges**

(annual percentage changes*)

	Target variable	1993		1994		1995
		Target	Outturn	Target	Outturn	Target
Germany	M3	4.5-6.5	7.5	4-6	5.7	4-6
Greece	M3	9-12	15.0	8-11	8.1	7-9
Spain	ALP	4.5-7.5	8.6	-	-	-
France	M3 [(a)]	4-6.5	-2.1	5	1.2	5
Italy	M2	5-7	7.9	5-7	2.9	5
	Monitoring variable	Range	Outturn	Range	Outturn	Range
Spain	ALP [(b)]	-	-	3-7	8.2	<8
United	M0	0-4	4.5	0-4	5.6	0-4
Kingdom	M4	3-9	3.3	3-9	5.6	3-9

Source: National central banks.
* Fourth quarter-fourth quarter or December-December (UK: March-March).
(a) Medium-term objective from 1994.
(b) Medium-term reference from 1995.

Other countries which had set monetary targets or monitoring ranges also experienced some difficulties in keeping money growth on the right track in 1993 and 1994. In France the rate of monetary expansion turned negative in the summer of 1993 as private households, stimulated by fiscal changes, made substantial transfers from short-term financial instruments (in particular investments in money market funds which are included in French M3) into a special government bond and into shares of privatised companies. One of the factors underlying the decline in M3 was the stagnation of private credit growth. In the course of 1994, growth of M3 accelerated but remained well below its medium-term target. Gross total domestic debt was used as a supplementary monetary indicator after the beginning of 1994. Its growth also decelerated substantially in 1994, but due to the strength of credit demand from the government it remained positive.

Money demand in Spain was fairly volatile in 1993 and 1994 as a result of portfolio shifts against the background of ongoing financial innovation and increasing uncertainty in bond markets. The monetary aggregate ALP (liquid assets held by the public) exceeded the reference range in both 1993 and 1994. This was also the case in Italy in 1993, partly in connection with balance-of-payments surpluses. In the course of 1994, broad money M2 growth in Italy exceeded the target range in the first half of the year, but showed a sharp deceleration in the second half, resulting in a fourth-quarter increase distinctly below the lower limit of the target range for the year. In the United Kingdom the growth rate of narrow money (M0) rose well above its monitoring range in 1994. This can be related to past interest rate reductions which brought down the opportunity costs of holding money and to relatively strong growth in retail sales. M4 growth in the United Kingdom stayed close to the middle of its monitoring range. After an earlier upward trend, monetary growth in Greece started to decelerate, moving within the target range towards the end of the year.

When aggregated, the growth of broad money (harmonised M3) at the Union level gradually decelerated in 1993 and stabilised at an annual average growth rate of just over 5.0% in 1994. This slowdown in the rate of monetary expansion was accompanied by a fall in short-term interest rates and the recovery of nominal income growth in the Union. These developments, however, have to be seen against the background of diverging trends at the individual country level.

Other monetary indicators

Short-term real interest rates in the Union, measured as the difference between the short-term nominal market interest rate and the past twelve-month rise in consumer prices, were higher than usual in 1993 considering the stage reached in the business cycle. For the EU as a whole they nevertheless came down appreciably from their peak of 8% in the autumn of 1992 to a low of 3.5% in August 1994. A slight increase in short-term real interest rates was however recorded following the strong pick-up in economic activity.

The yield curve showed a significant turnaround during 1993-94, moving from a downward to a more normal upward slope in all Member States (with the earliest shifts being seen in Italy and the United Kingdom) although, contrary to historical experience, the economic recovery in continental Europe set in even before the yield curve had turned positive. The turnaround initially reflected the gradual easing of monetary conditions highlighted above before the sudden surge in long-term interest rates took over as the dominant factor.

Although in a few countries real estate markets were buoyant, asset prices in general were subdued in 1994 and therefore offered few grounds for concern about inflation (see Section 2.3). The prices of short-term interest rate futures, however, indicated more concern about the outlook for inflation. In the first quarter of 1994, three-month Euro-Deutsche Mark interest rate futures showed a turnaround - reflecting a change in expectations from a prospective further relaxation to a tightening of German monetary policy. Three-month sterling futures indicated a yet more substantial turnaround in expected short-term interest rates. Such implicit expectations should be considered with caution, however, as these futures contracts seem to overreact to new information and may also reflect higher risk premia in view of increased uncertainty in financial markets in general.

Change and continuity in monetary policy strategies

After the widening of the fluctuation bands in the ERM on 2nd August 1993 (see Section 2.1), the central banks of the participating countries had in principle the opportunity to use the increased room for manoeuvre to set monetary policies with less emphasis on the exchange rate. This was seen by many commentators at the time as a solution to the perceived policy dilemma in several countries - namely that of having to maintain short-term interest rates at a level which was thought to be at variance with weak economic growth and low or decelerating inflation, as well as being inappropriate in the context of the differences in monetary transmission processes (see Box 2). The solution of downgrading the exchange rate as a nominal anchor was, however, not generally pursued, thereby confirming that the ERM continued to function as a co-ordinating framework for national monetary policies. Nevertheless, some changes in monetary policy strategies occurred in several EU countries in 1993-94.

What has not changed is the final objective of monetary policy, namely price stability, which is a precondition for sustainable economic growth and employment. This primary objective may be defined as the achievement of an inflation rate that no longer distorts the saving and investment decisions of private agents.

Within the ERM, the Bundesbank continued in 1993-94 to be guided by an intermediate money supply target for M3. Central banks of most participating countries adhered to the exchange rate as their key intermediate target for achieving the primary objective or, in the case of the Banque de France, maintained an intermediate objective both for the external value of the currency and the growth rate of M3. Some other ERM countries had found it useful in the past to publish an intermediate monetary target with the aim of providing additional support for the exchange rate objective. More recently, however, they were confronted with the question of whether and how to adapt their monetary policy strategies to the deregulation of financial markets, the liberalisation of international capital flows, increasingly strong economic and financial integration, the distortions resulting from financial innovations and the new ERM setting.

Central banks of a few larger and less open ERM economies have tended to adjust their monetary targeting practices, or have opted for an alternative. From 1994 the Banque de France placed its M3 target in a medium-term context of 5% growth and supplemented it with total domestic debt as an important indicator of financial conditions. In addition, developments in long-term interest rates and the balance of payments were taken into account. After the liberalisation of cross-border capital flows in February 1992 the Banco de España experienced increasing difficulties in controlling its central monetary aggregate ALP. The emergence of new financial instruments (primarily mutual funds) and frequent portfolio switching by the public further added to recent stability problems. Under these circumstances it was recognised as of 1994 that ALP could only provide a quantitative reference framework for assessing whether monetary conditions

Box 2 Differences in monetary transmission processes

A central bank, as monopoly supplier of base money, is in a position to influence strongly, if not control, money market interest rates by determining the conditions at which it provides or absorbs liquidity. The various channels through which such changes in official or key interest rates are transmitted to output and inflation together make up the monetary transmission process. Whereas there is broad similarity between these channels in EU countries, transnational differences in transmission processes imply that a given change in the interest rate will affect prices and output across Member States differently over time. In Stage Two, differences in transmission processes might become a source of policy conflicts in individual Member States if the interest rate policy needed to preserve exchange rate stability were to differ from that deemed consistent with domestic policy objectives. They will also have important implications for a future Monetary Union, as discussed in Chapter II.

Some important areas of divergence between Member States concern:

- the relative importance of financing at long-term fixed rates versus variable or short-term rates;
- the size and composition of balance-sheet positions of the non-financial sectors;
- the degree of openness of the economy and the importance of the exchange rate channel;
- the speed with which money market rates and changes in official interest rates feed through to lending and borrowing rates;
- differences in the wage-price mechanism.

Various problems may arise for monetary policy when there are divergences in these areas. When private sector financing at short-term or variable rates is predominant, monetary policy will have a greater impact on an economy for a given composition of private sector balance sheets. In the EU, lending at short-term rates is of relatively minor importance for both households and enterprises in Denmark, Germany, the Netherlands and Sweden, and to a lesser extent Belgium, France and Austria.

The size and composition of private sector balance-sheet positions will affect the degree to which these potential effects actually impinge on behaviour. A high proportion of lending linked to short-term or variable rates (as in the United Kingdom and Ireland) contributes to a relatively rapid and pronounced pass-through of changes in official rates to aggregate spending. Even if debt is largely long-term and fixed rate, high indebtedness (as in Sweden) may have an effect on transmission.

If a large proportion of public sector debt is at variable rate or is short-term, as in Portugal, Italy and Greece, this implies that monetary contraction may relatively rapidly be offset by fiscal expansion, as long as increased interest payments on existing debt accrue to domestic residents. This effect will vary with public sector indebtedness (see Table 4). But in the medium term there may be a contractionary effect, as rising interest payments and the threat of a spiral in interest obligations forces the public sector to tighten fiscal policy. In this context there is a strong correlation between governments' ability to issue long-term fixed rate debt and past inflation. Moreover, a high proportion of debt in foreign currency introduces a relation from monetary policy to fiscal policy via the exchange rate.

The degree of openness of Member States determines, inter alia, the speed and magnitude of the pass-through of exchange rate changes provoked by monetary policy actions to output and inflation. Total openness, and hence sensitivity to external developments, is tending to increase in some EU countries in line with the process of integration. However, to the extent that Member States succeed in maintaining stable intra-EU exchange rates, differences in extra-EU trade flows are the best measure of the scope of difference in transmission via the exchange rate. Extra-EU openness is particularly high - exports plus imports are over 25% of GDP - in the BLEU and Ireland, and is significantly more important in Germany and the United Kingdom than in France and Italy.

Box 2 (Cont'd)

Transmission may also differ between EU countries since the speed with which money market rates feed through into bank lending and deposit rates varies, and because differences in wage-price behaviour affect the degree to which changes in excess demand arising from monetary policy have an impact on output and inflation.

While it is relatively easy to detect individual differences in structure, it is less straightforward to assess the extent to which these differences, when they are aggregated to a macroeconomic level, have a significant impact on the overall transmission process. The most significant result which emerges from a comparison of simulations using macroeconomic models is that, among the four largest Member States, the pass-through of changes in official interest rates to nominal GDP is faster and stronger in the United Kingdom than in Germany, France or Italy. But structural breaks in empirical relationships, which might change or undermine the applicability of these results to the current situation, cannot be ruled out.

Some of these differences in transmission processes are likely to diminish in the coming years as a consequence of the increasing convergence of inflation rates across Member States (which may, for example, encourage long-term fixed rate financing), as well as effects of growing international competition and financial integration (which may make the pass-through from money market rates to bank lending rates more uniform). In addition, there have been various institutional changes affecting financial markets and labour markets recently which may also increase convergence (on labour markets, see Box 1). But some differences in openness and in net asset positions, most notably those arising from differences in agents' preferences, are likely to persist.

were compatible with progress towards price stability. As of 1995 the Banco de España replaced its monetary target by a direct inflation objective for the medium term (see Table 6), while reaffirming its exchange rate commitment and continuing to examine various complementary indicators, among which ALP has a prominent position. Finally, with effect from the beginning of 1993 some smaller open economies such as Denmark, the Netherlands and Portugal chose to abandon their respective intermediate targets for (the domestic counterpart of) monetary expansion.

Table 6 **Published inflation targets**

(annual percentage changes)

	Inflation variable [a]	1993		1994		1995	Medium term target
		Target	Outturn	Target	Outturn	Target	
Spain	CPI	-	4.6	-	4.7	-	<3 [b]
France	CPI	-	2.1	≤2	1.6	≤2	≤2
Italy	CPI	4-5	4.3	3.5	3.9	2.5	-
Finland	CPIX	-	2.6	-	1.3	2	2
Sweden	CPI	- [c]	4.7	- [c]	2.4	1-3	1-3
United Kingdom	RPIX	1-4	3.0	1-4	2.4	1-4	1-2.5 [d]

Source: National data.

(a) CPI = Consumer price index. CPIX = CPI excluding the effect of indirect taxes, subsidies and capital expenditure on housing. RPIX = Retail price index excluding mortgage interest payments.

(b) Objective for 1997.

(c) The inflation target for 1993 and 1994 was to prevent the underlying inflation rate from increasing.

(d) By the end of the current Parliament (April 1997 at the latest).

Countries that suspended ERM membership in 1992 had to redefine their monetary policy strategies in a more fundamental way, trying to find new ways to convey their commitment to price stability to the public. To this end, the UK monetary authorities developed a monetary policy framework centred around a direct inflation objective (see Table 6). Interest rate decisions are based on a careful assessment of the medium-term outlook for inflation, taking account of the information contained in all available indicators, including narrow and broad monetary aggregates (for which monitoring ranges are set), the effective exchange rate and asset prices. In Italy, a quantitative monetary target gained importance after the floating of the lira, although it was monitored in combination with other indicators, notably a credit aggregate and the exchange rate. However, against the background of recent turbulence in credit and financial markets affecting M2 growth and making its interpretation more tenuous, the Banca d'Italia decided to announce for 1995 a central reference target for M2, of 5%, and to use a variety of indicators of future inflationary pressures, with the exchange rate continuing to play an important role.

The Bank of Greece set an intermediate target for the expansion of M3, consistent with a declining rate of inflation. In addition, it followed a non-accommodating exchange rate policy, allowing effective depreciations only partially to compensate for higher inflation against foreign competitors. Following the gradual liberalisation of capital movements, which was completed in May 1994, the exchange rate target was given more weight, while less emphasis was placed on the monetary target.

Of the new entrant countries, Austria has traditionally maintained a close link with the Deutsche Mark as its nominal anchor, whereas Sweden and Finland announced explicit inflation targets after the decision to float their currencies.

Appropriateness of monetary policies in the EU

The appropriateness of the monetary policy stance cannot be assessed adequately on a Union-wide basis alone, but requires individual country analyses. The reasons for this are straightforward. First, national central banks remain responsible for their own monetary policy stance in Stage Two. Second, besides cyclical differences, structural differences between EU countries - which, for example, affect monetary transmission mechanisms (see Box 2) - continue to exist and are likely to be reduced only very gradually. For the time being, central banks will thus be confronted with different operating environments.

In Germany, economic conditions in 1993-94 were such that the Bundesbank could carry forward its policy of carefully reducing official and key interest rates, which it had initiated in September 1992. The improving outlook for inflation - to which a strong Deutsche Mark, the prospect of fiscal consolidation and the conclusion of moderate wage agreements contributed to a considerable extent - provided the major justification for this. Furthermore, the steady decline in German long-term interest rates in 1993 and early 1994 seemed to confirm that financial markets were confident that, over the longer term, inflation would come down. Although the growth rate of M3 exceeded the target range for a long period of time, a substantial part of this overshooting was considered to be a temporary phenomenon related to various exceptional factors, and not to indicate higher future inflation. Nevertheless, given the difficulty of assessing underlying monetary conditions, a cautious approach to interest rate policy was warranted so as not to endanger credibility and not to add to uncertainty in financial markets. In retrospect, the

Bundesbank succeeded both in reducing monetary expansion to target levels and in bringing inflation down to a lower level, while maintaining the credibility of its monetary targeting strategy and not endangering the economic recovery.

There is some evidence that other EU central banks have gained credibility in financial markets during the past two years in terms of their determination to maintain an anti-inflationary policy stance. In the latter part of 1993 and early 1994 central banks of ERM countries carefully reduced official and key interest rates and managed to bring down short-term interest rate differentials relative to Germany while avoiding major exchange rate tensions for much of the period. Besides the progress made in the convergence of inflation rates, the synchronised nature of the economic upswing also seems to have played a favourable role in this regard. On the other hand, a few brief periods of exchange rate instability have occurred, typically related to domestic political uncertainties, which temporarily pushed up short-term interest rate differentials. Furthermore, long-term interest rate differentials vis-à-vis Germany tended to rise in the course of 1994, indicating among other factors the persistence of underlying economic problems (see Section 2.2).

Outside the ERM, the monetary authorities of the United Kingdom have increased their credibility, following the resolution with which they raised interest rates twice in 1994 to avert inflationary dangers. As already noted, in weighing the risks for inflation, the UK monetary authorities make use of a wide range of indicators, combining them into an inflation projection for the following two years based on an assumption of unchanged policies. When this projection revealed an increasing likelihood of an overshooting of the target range set for the end of the current Parliament (1-2.5%), early steps in raising official short-term interest rates were judged to be warranted - even though the prevailing rate of inflation was at its lowest level for 27 years. In Italy monetary policy was also tightened following indications of a pick-up in inflation. Just as in Greece, the monetary authorities also had to carry the burden of fiscal imbalances that seriously disturbed the appropriate policy mix.

To summarise, the uncertainty created by the ERM turmoil of 1992-93 had made it essential that monetary policy should continue to provide a credible anchor for nominal stability. Interest rate policy thus had to be carried out in a cautious manner, without taking undue risks, especially because it remained unclear in many countries whether fiscal policy and wages would follow the same stability-oriented course. The restoration of stability within the ERM, in combination with the substantial slowdown in the rate of inflation across the Union, may be seen as prima facie evidence that the course of monetary policies in individual countries and in the Union as a whole was broadly appropriate. Section 4.1 of this chapter reconsiders the concept of appropriateness in a forward-looking sense.

3.3 The macroeconomic policy mix

The maintenance of price stability requires the co-operation and support of fiscal policy so as to create a balanced policy mix. In this context, the task of the monetary authorities in recent years has not been an easy one, and has been complicated by increasing public deficits and high public debt in many Member States.

First, persistently high public borrowing requirements could generate doubts about the sustainability of a non-accommodative monetary policy stance, leading to expectations of increased inflation and exchange rate depreciation. It is possible that such expectations induce economic agents to incorporate these into prices and wage negotiations. Second, rising public debt as a result of such deficits puts a strain on capital markets and makes fiscal positions increasingly sensitive to interest rate fluctuations, rendering the task of central banks more difficult.

Fiscal policy in the Union created an environment in the early 1990s which was not conducive to price stability. Given the lack of progress in fiscal consolidation monetary policy was overburdened. Central banks had no option but to maintain a non-accommodative stance, setting higher levels of short-term interest rates for much longer than would have been the case had fiscal policy been more supportive. In retrospect, the unbalanced policy mix kept inflation too high for too long and has certainly not been optimal for economic growth. If confidence in the monetary policy framework had been combined with a more supportive fiscal policy, the results for inflation and activity might have been better.

Box 3 The economic situation of the new EU Member States

Austria, Finland and Sweden joined the European Union on 1st January 1995, following the positive outcomes of referenda held on 12th June, 16th October and 13th November 1994 respectively.

Main economic indicators for the new EU Member States

		Real GDP (a)	Inflation (b)	Nominal effective exchange rate (1991=100)	Long-term interest rate (c)	General government lending(+) or borrowing(-) (d)	General government gross debt (d)(e)
Austria	1993	-0.3	3.6	103.2	6.8	-4.1	63.5
	1994	2.8	3.0	103.8	7.0	-4.4	65.0
	1995	3.1	2.5	105.0	...	-4.9	...
Finland	1993	-2.6	2.2	75.0	8.8	-7.2	61.8
	1994	3.7	1.1	81.2	9.1	-4.7	70.0
	1995	5.0	2.0	85.8	...	-5.0	76.0
Sweden	1993	-2.1	4.7	81.1	8.6	-13.3	74.4
	1994	2.2	2.4	80.2	9.5	-11.7	81.0
	1995	2.7	2.9	80.5	...	-9.6	...

Sources: European Commission (real GDP, general government lending or borrowing, general government gross debt), national data (inflation (CPI), long-term interest rates), OECD (effective exchange rates). Figures for 1995 are drawn from the European Commission - Autumn forecasts 1994. The data may be subject to revision.

(a) Annual percentage changes. (b) Annual rates. (c) In percentages, annual average. (d) As a percentage of GDP. (e) Data not completely in line with the Maastricht definition.

Box 3 (Cont'd)

As in most EU countries, growth in the Austrian economy picked up in 1994 after stagnation in 1993, while consumer price inflation decreased. Compared with those in the other new entrant countries, public finances in Austria seem less unbalanced, though further improvement is necessary in order to meet the reference values of the Maastricht Treaty criteria on public finances.

The Finnish and Swedish economies are recovering from severe recessions and experienced positive growth rates in 1994 after declines in output in the preceding years. The severity of the Finnish recession was largely due to the loss of export markets stemming from the collapse of the Soviet Union. In both countries export growth has helped the economy out of recession after substantial depreciations of the exchange rate. Substantial public deficits emerged in both countries as a consequence of unemployment benefits acting as automatic stabilisers. In Sweden, the tax reform plan passed by Parliament in 1989/90, which came into full effect from 1991, contributed to the increase in deficits. Fiscal deficits have, during recent years, led to marked rises in public debt in Finland and Sweden. At the beginning of the 1990s a banking crisis and financial support by the governments also contributed to the increase in public debt. Furthermore, long-term interest rates in Finland and Sweden were above the EU average in 1994 despite the low inflation rates. Inflation in Sweden reached a trough in spring 1994. To counteract rising inflationary pressures, Sveriges Riksbank raised official interest rates in the autumn of 1994. In Finland, Suomen Pankki raised its tender rate in December 1994 by 50 basis points.

All the new EU countries have become members of the European Monetary System, but only Austria has decided to enter the Exchange Rate Mechanism with effect from January 1995. The Austrian schilling has demonstrated a high degree of exchange rate stability sustained for a long period vis-à-vis the Deutsche Mark. Finland and Sweden abandoned the policy of pegging their currencies to the ECU in the autumn of 1992 after a period of severe pressure on the Finnish markka and the Swedish krona. Following the decision to float their currencies, the authorities in both countries adopted a new monetary policy framework based on inflation targets, without the exchange rate as an intermediate target. Owing to the present macroeconomic imbalances in the Finnish and the Swedish economies, the authorities in the respective countries have decided to postpone their participation in the ERM. The enlargement of the EMS and ERM membership did not lead to any change in the existing parity grid or in the composition of the ECU basket (the latter being fixed under the Treaty).

4. Prospects and challenges

In making an assessment of the factors likely to influence monetary policies in 1995 it is important to consider the broad macroeconomic prospects for 1995, and the appropriate monetary policy for the EU as a whole in the light of these, before going on to assess the main challenges - namely the risks to the central forecasts, the maintenance of exchange rate stability, bond market developments and fiscal policy issues. It should be noted that this part, too, mainly refers to the Community of twelve when reference is made to the Union or EU. Background information regarding the new entrants is provided in Box 3.

4.1 Prospects

Short-term economic prospects

According to the latest economic forecasts from the European Commission, the OECD and the IMF, real economic developments outside the Union are likely to continue to provide a favourable stimulus to the economic recovery in Europe. Output in the United

States is expected to grow by around 3% in 1995, while at the same time the Japanese economy is gradually entering a period of recovery, with growth forecast to pick up to 2.5% in 1995. It is not yet clear whether or to what extent the economic damage caused by the Kobe earthquake will retard the recovery. In other regions, notably South-East Asia, a continuation of growth is also anticipated. World trade is expected to grow by 6%. As regards external influences on inflation, continued price increases in all categories of traded goods are foreseen. The impact of these developments on prices in the Union will also depend on the pattern of exchange rates in 1995.

Table 7 **Forecasts of main EU economic developments**

(annual percentage changes)

	1995			1996	
	EC	OECD	IMF	EC	OECD
Real GDP	2.9	3.0	2.9	3.2	3.2
Investment [a]	5.7	5.3	4.9	6.3	5.9
Employment	0.8	0.9	0.7	1.1	1.1
GDP deflator	2.8	2.5	2.7	3.0	2.6
General government deficit [b]	-4.7	-5.1	-5.1	-3.9	-4.2
Current account [b]	0.5	0.5	...	0.6	0.6

Sources: European Commission, OECD, IMF.
(a) Real growth in gross fixed capital formation.
(b) As a percentage of GDP, European Commission National Accounts figures.

Economic prospects for EU countries in 1995 must also be viewed against the increasingly favourable background of trends in 1994, with economic activity accelerating and the rise in rates of unemployment coming to an end.

According to forecasts by the European Commission, the IMF and the OECD (see Table 7), activity in 1995 is expected to pick up throughout the EU-12, with real GDP growth averaging nearly 3%. A marked synchronisation of growth is forecast; only in Ireland and Denmark (as well as in Finland) is activity expected to grow somewhat faster than on average, while in Greece a continuation of relatively slow growth is anticipated. As regards the composition of growth, net trade - largely growth in exports - is expected to continue to provide a major impetus. With business sentiment improving steadily, investment activity is expected to expand strongly in 1995. Private consumption, which was subdued in 1994, is likely to be more buoyant given that consumer confidence has improved in recent months and the increase in unemployment rates has come to a halt. On the other hand, consumption may be adversely affected by tax increases already announced or due to come into force in many countries.

Reflecting the dominance of external demand, both trade and current account balances of the Union as a whole are expected to improve further in 1995. Among the individual countries, the most notable improvement in the current account balance in 1995 is anticipated in Italy; some deterioration is, however, forecast in Denmark, reflecting particularly strong growth in domestic demand.

In the Union as a whole, a slight deceleration in inflation to just below 3% is anticipated from 1994 to 1995. As for real growth, a further convergence of inflation rates is expected: forecasts suggest that inflation will be in a range of around 2-3% in most

Member States; Greece, and to a lesser extent Spain, Italy and Portugal, will be the main exceptions.

A key factor contributing to the central projection for inflation is expected to be wage behaviour. Although some pick-up in wage inflation and unit labour costs is expected in 1995, increases in most countries are likely to remain significantly below those recorded in previous recoveries. In most countries, reductions in unemployment rates and positive employment growth are anticipated in 1995. However, levels of unemployment are expected to remain well above those seen at this stage in former recoveries, which is an indication of the rise in the level of structural unemployment in the interim. Moreover, there are significant risks for inflation, as discussed below.

The following sections assess monetary policy in the context of the above-mentioned projections.

Monetary objectives in individual countries

A number of announcements have been made regarding the intermediate targets and final objectives of monetary authorities in 1995. In the context of the respective national monetary policy frameworks, all of the announcements aim to underpin the objective of price stability, both in the presence of the resumption of economic growth and in the medium term.

Among the ERM countries, the Bundesbank announced a target for German M3 of 4-6%, identical to that adopted for 1994, which is considered to be compatible with potential growth and price stability. The target assumes a normative inflation rate of 2%, together with 2.75% growth in productive potential and a 1% fall in trend velocity. The target also seeks to offset most of the excessive monetary growth that occurred over 1994 on average. In addition to its ERM commitments, the Banque de France set a medium-term objective of 5% growth for French M3 and a ceiling of 2% inflation both for 1995 and in the medium term. The Banco de España, while reaffirming its commitment to exchange rate stability, has set an inflation objective of below 3% to be achieved by 1997. Other ERM countries intend to rely exclusively on the exchange rate to ensure price stability.

Of the non-ERM countries, the authorities in the United Kingdom have reaffirmed their inflation objective of 1-4%, with the intention of it being in the lower half of this range by April 1997 at the latest, and the Banca d'Italia will set monetary policy to seek to attain the Government's inflation target for 1995, which was set at 2.5% at the end of September 1994.

If there are signs of inflationary pressures emerging in Member States as growth rates pick up, and given the lags in the response of the economy to monetary policy, it is important that monetary policy be tightened at an early stage. This applies to all Member States; particular vigilance is required in those where inflation is relatively high and hence convergence is incomplete.

The mutual compatibility of national monetary policies and conditions in the Union

For countries which attach priority to stable exchange rates, national monetary policies may be seen as compatible if they contribute to convergence towards price stability without major exchange rate pressures arising. For other countries, it appears more relevant to define national monetary policies as compatible if they promote convergence towards price stability.

According to these criteria, monetary policy objectives may be considered to be broadly compatible in 1995. Nevertheless, at the time of writing, some cyclical differences continue to exist. Some countries are more advanced in the cycle than others. Over and above that, some economies started the recovery with a narrower output gap than others and with higher market interest rates.

At the present juncture, structural differences probably pose a greater threat to mutual compatibility than cyclical ones. Indeed, structural differences across Member States (in public and private debt levels and debt structures, unemployment rates, inflation rates, etc.) imply different environments for national central banks to operate in (see Box 2). In this context, adverse developments such as a lack of fiscal consolidation in countries in a critical fiscal situation could affect exchange rate stability for those countries. In the longer term, mutual compatibility may be more readily attainable as structural convergence proceeds.

As regards the implications of the rise in long-term yields during 1994 for mutual compatibility, the impact of a given change in long-term rates differs across countries, again depending on the financial structure of the economies. Some countries where the rise in bond yields has been particularly strong have private sectors whose long-term fixed rate borrowing is relatively limited, thus the importance of higher yields is limited. This is the case in Spain and Italy. Nevertheless, a more pronounced differentiation of long-term interest rates across countries might become a source of compatibility problems, since it could adversely affect investment and potential output in the medium term, as well as complicate fiscal consolidation, particularly in countries with high stocks of public debt.

4.2 Challenges for the future

Inflationary risks in the economic outlook

The central forecast for inflation appears favourable given the strength of the upturn. This is to some extent related to the previous recession, which had caused significant output gaps to emerge in several countries. In some countries, actual GDP growth is expected to be below or only slightly above potential growth in 1995, which would imply that the output gap is closing only slowly. In other countries, the output gap seems to be rather small already. However, an exact assessment of the amount of slack is difficult. Potential output may have been adversely affected by the rise in structural unemployment and low investment; furthermore, price increases might also result from bottlenecks in individual sectors of the economy. Countervailing factors arguing against concern over output gaps may be that flexibility in the use of capital is greater than in the past.

The behaviour of wages is an important element of uncertainty in the inflation outlook. After two years of modest wage rises there is a risk of stronger wage pressure in the wake of the economic upturn. On the other hand, unemployment is high and in some countries wage flexibility may have increased as a consequence of recent agreements between the social partners and/or labour market reforms.

The successful pursuit of stability-oriented policies may also be jeopardised in other respects by the functioning of the labour market. There is widespread evidence that the level of structural unemployment has continued to rise in recent years, implying that the cyclical upswing will only be able to resolve a part of the unemployment problem. Consequently, although unemployment rates are high, a continuation of moderate wage increases cannot be taken for granted as economies could rapidly hit bottlenecks or meet skills shortages. Moreover, if a large proportion of unemployment were to persist in a boom this could also risk losing public support for policies which aim at achieving and maintaining price stability. The solution to the structural unemployment problem calls for supply-side measures which mainly address labour market rigidities. Progress in this area is vital in order to ensure price stability.

There are further risks for inflation prospects in countries whose currencies have depreciated in recent years. So far, the effect of recent changes in exchange rates on domestic consumer prices has been smaller than could have been expected on the basis of past experience. However, as the depreciation of exchange rates has led to a reduction in real incomes, there is a risk that those who have lost out will attempt to use the more favourable economic climate to restore their income positions.

Upward inflationary pressure may also come from developments outside the Union. For example, the rise in commodity prices could become a serious source of concern.

Maintenance of exchange rate stability in the ERM

The widening of the exchange rate bands in August 1993 has served the desired objective of reducing the incidence of "one-way bets" on exchange rates, inducing instead a two-way risk for speculators. As the convergence of inflation towards low levels makes further progress, ensuring that competitive positions do not get sharply out of line, this will be the best guarantee of limiting exchange rate tensions in the future. Moreover, the expected close convergence in growth rates in 1995 will reduce tensions between economies growing more slowly and those undergoing rapid growth - tensions which in 1992 caused a conflict of internal and external objectives for some countries in the former group. More generally, the progress of sustained convergence and optimism regarding the economic outlook increases the perceived consistency of economic policy.

Nonetheless, it should be borne in mind that there have been periods of exchange rate tension, in particular during late 1994. These have illustrated the fact that markets are alert to any perceptions of policy conflict, notably in countries with high public debt and/or political uncertainties.

Monetary policy implications of bond market developments

Following the discussion in Section 2.2, the policy implications to be drawn for 1995 from recent bond market developments depend on the extent to which rises in long-term nominal yields were caused by increasing inflation expectations, higher real interest rates or rising uncertainty.

In most EU countries, it appears that the general rise in bond yields does not signal an immediate upturn in inflation, and hence a monetary policy response would be inappropriate. However, in countries where the risks of inflation are more immediate, a tighter monetary stance is required.

The rise in long-term interest rates is probably partly a reflection of the increase in world real interest rates due to more favourable growth prospects at a global level and hence does not seem to require policy action. However, to the extent that the rise in real interest rates at a national level also reflects a crowding-out effect arising from current and planned government deficits, there is a clear risk of burdening the economic recovery currently under way and stifling future prospects for growth.

Cross-country differences in changes in bond yields are considered to indicate important concerns in the markets, particularly about fiscal positions, as well as an increased focus on relative long-term records of exchange rate and price stability. Besides the crowding-out effect noted above, the principal concern in terms of fiscal policy appears to have been heightened uncertainty over the sustainability of fiscal positions and related fears of an easing of the counter-inflationary stance. The implication of these patterns is that the appropriate response to higher yields is fiscal tightening. To reduce uncertainty, monetary policy must be geared to ensuring the long-term credibility of the counter-inflationary framework.

Fiscal policy perspectives

According to Commission estimates, the average fiscal deficit in the Union fell by 0.4 percentage points in 1994 to 5.6%. In 1995 reductions in actual deficits are expected in virtually all Union countries, bringing the EU average to 4.7%, although only a few countries will meet the 3% reference value (see Table 8). The improvement in 1995 will stem largely from cyclical factors, but some structural improvements are also anticipated. Despite this, structural deficits will probably remain high in many countries, and longer-term projections suggest that actual public deficits in several countries will remain at very high levels despite the maturing of the recovery. On average, debt ratios are likely to worsen, to 73% of GDP in 1995, compared with 69% in 1994. Meanwhile, if the current pattern of real interest rates and growth rates is maintained, the objective of stabilising or reducing debt ratios might be harder to achieve, particularly in countries with exceptionally high levels of outstanding debt.

Fiscal policy will play a crucial role in ensuring the durability of a non-inflationary recovery. There is a clear need for governments in the EU to take determined structural budget adjustment measures, but there is a risk that consolidation efforts may not materialise in a period in which the cyclical upswing tends to reduce actual deficits. The experience of the late 1980s, when many governments effectively loosened fiscal policy in the face of strong economic growth, must be seen as a lesson in this respect. Progress towards fiscal consolidation is not only needed to bring budgets back onto a sustainable path and help to restore acceptable levels of public debt but also to help reduce bond yields. Such progress is also essential towards checking inflationary pressures in a cyclical phase in which activity approaches potential. Without continued efforts to reduce the structural part of the fiscal balance, no lasting progress can be made towards a viable fiscal position and a more balanced policy mix in the Union as a whole. Fiscal consolidation is all the more important in those countries where monetary policy is already overburdened. In this respect, it is of major importance that the commitments included in convergence programmes be respected and that more attention be paid to the

Table 8 **Public finances in EU Member States**

(forecasts for 1995-96; as a percentage of GDP)

	General government lending (+) or borrowing (-)		General government gross debt	
	1995	1996	1995	1996
Belgium	-4.7	-4.0	138.7	136.0
Denmark	-3.0	-2.2	78.0 [a]	78.2 [a]
Germany	-2.4	-2.0	59.4	58.9
Greece	-13.3	-12.9	125.4	128.1
Spain	-6.0	-4.7	65.8	66.1
France	-4.9	-3.9	53.4	55.6
Ireland	-2.0	-1.5	83.7	79.1
Italy	-8.6	-7.9	126.8	128.6
Luxembourg	1.6	2.0	9.8	9.9
Netherlands	-3.5	-2.7	78.8	78.0
Portugal	-5.8	-4.8	71.7	72.3
United Kingdom	-4.6	-3.4	52.4	53.1
EU-12 [b]	-4.7	-3.9	72.9	73.4

Source: European Commission services, based on figures presented by Member States, European Commission forecasts (Autumn 1994).

(a) See footnote (e) to Table 9. After adjustment, the debt level at end-year is forecast to be 54.6% of GDP in 1995 and 55.2% of GDP in 1996.

(b) See footnote to Chart 2.

distortionary effects of current tax and social security regulations. Structural reforms in the public sector and patterns of consolidation should be strongly weighted towards expenditure restraint rather than tax increases; this would have a positive effect on the efficiency of the economy, thus contributing to the reduction of potential inflationary pressures and helping to guarantee sustainable growth for European economies.

B. PROGRESS TOWARDS CONVERGENCE

1. The role of the EMI in assessing convergence

The Treaty establishing the European Community requires the countries entering Economic and Monetary Union to have fulfilled in advance the necessary conditions for the adoption of a single currency. Under the Treaty, the EMI is assigned an important role in the assessment of convergence. Article 109j (1) provides that the EMI and the Commission shall each prepare a report to the EU Council, focusing particularly on the achievement of a high degree of sustainable convergence by reference to the following criteria:

- "the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best-performing Member States in terms of price stability;
- the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive, as determined in accordance with the Treaty;
- the observance of the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State;
- the durability of convergence achieved by the Member State and of its participation in the Exchange Rate Mechanism of the European Monetary System being reflected in long-term interest rate levels".

The reports of the Commission and the EMI shall also take account of the development of the ECU, the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices.

The report of the EMI will assess the convergence of individual countries and will be submitted in the course of 1996.

In addition, under Article 7 of its Statute, once a year the EMI shall address a report to the EU Council which shall, inter alia, include an assessment of the progress towards convergence in the Community. This Annual Report of the EMI, in addition to the requirements of Article 11 of the Statute, also fulfils the obligations of Article 7 and thus addresses issues of convergence. It is seen as a first step by the EMI towards the preparation of a fully-fledged Article 7 report, forthcoming later this year.

The main text of this section draws on the analyses of prices, fiscal developments, exchange rates and long-term interest rates provided in previous sections, and puts them into perspective in terms of the issue of convergence. Data are summarised in Table 9. Other factors to be taken into account in the assessment of the degree of sustainable convergence will be considered in future Article 7 reports. As the new Member States joined the Union on 1st January 1995, this section on convergence in 1993-94 focuses exclusively on the then twelve EU countries. While the statistical data for a final assessment of convergence in the report required under Article 109j (1) will be provided by the Commission, this Report uses data from several sources, which are of a non-definitive nature, but are considered to approximate to the function required. In addition, in order to clarify these and other issues in more detail, boxes are used to highlight the legal background, statistical questions and issues for further consideration in the light of the provisions of the Treaty on convergence.

Table 9 Economic indicators and the Maastricht Treaty convergence criteria

		Inflation [a]	Long-term interest rate [b]	General government lending (+) or borrowing (-) [c][d]	General government gross debt [c][d]
Belgium	1993	2.8	7.2	-6.6	138.9
	1994	2.4	7.7	-5.5	140.1
Denmark	1993	* 1.3	* 7.3	-4.4	79.5 [e]
	1994	** 2.0	** 7.8	-4.3	78.0 [e]
Germany	1993	4.1 [f]	6.5	-3.3	# 48.1
	1994	3.0 [f]	7.0	# -2.9	# 51.0
Greece	1993	14.5	23.4	-13.3	115.2
	1994	10.8	20.8	-14.1	121.3
Spain	1993	4.6	10.2	-7.5	# 59.8
	1994	4.7	10.0	-7.0	63.5
France	1993	2.1	6.8	-5.8	# 45.8
	1994	* 1.6	* 7.2	-5.6	# 50.4
Ireland	1993	** 1.5	** 7.7	# -2.5	96.1
	1994	2.4	7.9	# -2.4	89.0
Italy	1993	4.3	11.3	-9.5	118.6
	1994	3.9	10.6	-9.6	123.7
Luxembourg	1993	3.6	6.9	# 1.1	# 7.8
	1994	*** 2.1	*** 6.4	# 1.3	# 9.2
Netherlands	1993	2.6	6.4	-3.3	81.4
	1994	2.7	6.9	-3.8	78.8
Portugal	1993	6.5	10.0	-7.2	66.9
	1994	5.2	10.4	-6.2	70.4
United Kingdom	1993	*** 1.6 [g]	*** 7.5	-7.8	# 48.3
	1994	2.4 [g]	8.1	-6.3	# 50.4

Sources: National data (inflation (CPI), long-term interest rates), European Commission (general government lending or borrowing, general government gross debt; see also footnote (e) below). The statistical data to be used in assessing whether the Member States meet the convergence criteria shall be provided by the European Commission.

*,**,*** = first, second and third best performer in terms of price stability.

= public deficit not exceeding 3% of GDP; public debt not exceeding 60% of GDP.

(a) Annual rates.

(b) In percentages, annual average.

(c) As a percentage of GDP.

(d) Provisional for 1994.

(e) General government gross debt figures not adjusted for the assets held by the Danish Social Pension Fund against sectors outside general government, government deposits at the Central Bank for the management of foreign exchange reserves, and government debt from the financing of public undertakings. In accordance with the Council's and Commission's statements concerning Article 1(4) of Council Regulation 3605/93 of 22nd November 1993, for Denmark these items shall be stated separately. After this adjustment the debt level at end-year is 52.1% of GDP in 1993, and 53.5% of GDP in 1994.

(f) Western German consumer price inflation.

(g) The UK's inflation objective is set in terms of the CPI excluding interest payments (RPIX). This measure, which is closer to the harmonised definition of consumer prices currently under consideration, rose at an annual rate of 3.0% in 1993 and 2.4% in 1994.

Although the convergence criteria contained in the Treaty and the Protocol are discussed separately in this Report, it should be stressed that they constitute a coherent and integrated package. By the time of their formal application, they must be satisfied in their totality, without trade-offs among individual provisions. The individual criteria should be interpreted and applied in a strict manner. Thus, they will help to strengthen overall monetary and economic policy co-operation in Stage Two, and prepare for a stability-oriented single monetary policy in Stage Three.

2. Price stability

2.1 Inflation rates in 1993-94

As shown in Table 9, the annual average inflation rates of each of the three best-performing countries in the Union, in both 1993 and 1994, were maintained at levels close to those generally regarded as price stability, viz. inflation rates of 2% or less. In 1993, these countries were Denmark, Ireland and the United Kingdom,[1] which had inflation rates ranging between 1.3 and 1.6%. In 1994, France, Denmark and Luxembourg recorded the lowest rates, within a range of 1.6 to 2.1%.

Several Member States came close to the inflation rates of these best-performing countries. In 1993 they were France, the Netherlands and Belgium, with inflation rates of between 2.1 and 2.8%. In 1994 they were Belgium, Ireland, the Netherlands and the United Kingdom, which had inflation rates of around 2.5%, followed by Germany with an inflation rate of 3%.

In the four countries which evidently still have most to catch up in terms of price stability, inflation rates have come down considerably in the past few years. In Italy, the rate of inflation has decreased continuously since 1990, reaching 4.3% in 1993 and 3.9% in 1994, while in Spain the average inflation rate remained somewhat above 4.5% in both years under consideration. Portugal has reduced its inflation rate by more than half over the past four years to reach 6.5% in 1993 and 5.2% in 1994. Greece has also made progress, but still recorded double-digit inflation (14.5% in 1993 and 10.8% in 1994).

2.2. Assessment of price stability

Overall, the process of convergence towards price stability has made marked headway over the past two years. As discussed in Part A, one important factor in explaining this favourable performance is certainly the recession. Demand pressure was weak and wage growth was moderate, and particularly in the course of 1994 substantial productivity gains could be achieved. These developments were sufficiently strong to counteract inflationary impulses stemming from substantial depreciations of currencies in several countries. A further, perhaps even more important factor, however, is the significant change in economic policy thinking. Price stability is now considered to be one of the major objectives of economic policy in general, and the primary objective of monetary policy in particular. It should be noted, however, that the average inflation rate

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1 Based on the Retail Price Index (RPI). The measure excluding mortgage interest payments (RPIX), which is closer to the harmonised definition of consumer prices currently under consideration, rose by 3.0% in 1993 and 2.4% in 1994.

Box 4 **Price stability**

1. Legal basis

The Treaty establishing the European Community, Article 109j (1) requires:

the price criterion to be judged on the basis of the relative inflation performance, which is "close to that of, at most, the three best-performing Member States in terms of price stability";

The Protocol (No. 6) on the convergence criteria referred to in Article 109j (1) of the Treaty establishing the European Community, Article 1, stipulates:

"The criterion on price stability referred to in the first indent of Article 109j (1) of this Treaty shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1½ percentage points that of, at most, the three best-performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index (CPI) on a comparable basis, taking into account differences in national definitions".

2. Statistical questions

Even though methodologies for calculating consumer price indices in the EU countries share a number of common features, there are also important differences. Before formally assessing which countries fulfil this criterion it is necessary to make significant progress with the work undertaken by the European Commission (EUROSTAT) in order to develop harmonised consumer price indices which are comparable at a Union level, with the assistance of its Working Party on the harmonisation of consumer prices. This work is carried out in close liaison with the EMI. To this effect the Commission has submitted to the EU Council a proposal for a Regulation. Depending on further progress, Member States would, in principle, be able to compile the first harmonised twelve-month CPI data for January 1997. For the reports by the Commission and the EMI in the course of 1996 an interim solution is envisaged, which will allow the reports to draw on figures which are harmonised to the largest extent possible using available data. For the time being, comparisons made in this section are based on national CPIs.

3. Issues for further consideration

The wording in Protocol (No.6) Article 1, does not unambiguously define to which reference value the inflation criterion should apply, as it mentions the notion of "at most, the three best-performing countries". In addition, the wording raises the issue as to how the "sustainability" of price performance is to be assessed.

in the European Union of around 3% was still above that regarded as being consistent with price stability.

In order to strengthen the credibility of policies geared towards attaining this objective, the achievements of the past must be maintained and enhanced in the future. As the economies of the EU countries are recovering, the risks of inflationary pressures could increase and progress towards lower inflation rates may be considerably more difficult to achieve than in the recent past. Therefore, it is important for the social partners to agree on wage settlements which do not jeopardise price stability, for companies to continue adjustment efforts to improve productivity growth, and for fiscal policies to exploit fully the opportunity of the economic upswing to take structural measures to reduce the deficit, rather than to rely on cyclical improvements in fiscal balances or on increasing the burden of indirect taxation, thereby affecting inflation expectations.

The period ahead, therefore, will be a test of the ability of Member States to maintain and deepen their commitment to price stability. For monetary policies a high degree of vigilance is required. It is the task of all the EU central banks to ensure that slippage elsewhere in their economies will not be accommodated, and that timely action is taken if inflationary pressures arise or inflation expectations deteriorate. This will help to ensure sustained growth without inflation. Monetary policy alone, however, will be overburdened if it is not supported by consistent behaviour in other areas.

3. Sustainability of fiscal positions

3.1 Fiscal positions in 1993-94

The fiscal data which are shown in Table 9 were presented by the European Commission in autumn 1994 and may be subject to revision. These data show that deficit to GDP ratios in 1994 improved slightly in many EU countries but continued to remain at worrying levels. Debt ratios soared in most countries between 1993 and 1994.

Measured against the reference value of a deficit to GDP ratio of 3%, two countries remained below this level in 1993 (Ireland and Luxembourg), whilst in 1994 the number of countries increased to three (Germany, Ireland and Luxembourg). Among the remaining countries substantial differences persisted. In 1994, the Netherlands and Denmark recorded ratios of 3.8 and 4.3%, while several other Member States still ran deficits in the range of 5.5 to 7% of GDP (Belgium, Spain, France, Portugal and the United Kingdom). Finally, there were sizable deficit ratios in Italy and Greece (9.6 and 14.1% respectively).

In terms of debt/GDP ratios, only Germany, France, Luxembourg and the United Kingdom maintained ratios of below 60% in 1993 and 1994. Spain exceeded the 60% ratio in 1994. A number of other countries (Ireland, the Netherlands and Portugal) fell in the range of 70 to 90% in 1994, and two of these countries were able to reduce their debt/GDP ratios between 1993 and 1994. Greece and Italy had ratios of between 115 and 124%, which increased further over the reference period, while Belgium's ratio was close to 140% in both years.

3.2 Assessment of the sustainability of fiscal positions

The Maastricht Treaty acknowledges the serious risks associated with an unbalanced fiscal policy stance. It therefore provides for a regular examination of the budgetary situation in individual Member States by the EU Council as from the start of Stage Two of EMU and for sanctions against Member States with excessive deficits as from the start of Stage Three. On the basis of the data available during the first half of 1994 and the opinions of the Commission and the Monetary Committee, the EU Council decided in September 1994 that ten member countries (all but Ireland and Luxembourg) had an excessive deficit. In the case of Ireland, which recorded a deficit ratio of 2.4% and a debt ratio of almost 90% in 1994, compared with 2.5% and 96% in 1993, account was taken of the progress made in the reduction of the debt ratio during the past. Following the requirement under Article 104c (7) of the Treaty, the EU Council adopted recommendations for the Member States which were aimed at bringing the fiscal positions back onto a sustainable path.

Box 5 **Public finances**

1. Legal basis

The Treaty establishing the European Community, Article 109j (1) requires:

"the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive, as determined in accordance with Article 104c (6)". The Protocol (No. 6) on the convergence criteria (Article 2) stipulates that this criterion "shall mean that at the time of the examination the Member State is not the subject of an EU Council decision under Article 104c (6) of this Treaty that an excessive deficit exists".

Article 104(c) sets the excessive deficit procedure. According to Article 104c (2 and 3) the Commission shall prepare a report if in a Member State:

a) "the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value (defined in the Protocol as 3% of GDP), unless

either the ratio has declined substantially and continuously and reached a level that comes close to the reference value;

or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

b) "the ratio of government debt to gross domestic product exceeds a reference value (defined as 60% of GDP in the Protocol) unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace".

In addition, the report prepared by the Commission should take into account "all other relevant factors". The Commission may also prepare a report if, notwithstanding the fulfilment of the requirements under the criterion, it is of the opinion that there is a risk of an excessive deficit in a Member State. The Monetary Committee (respectively the Economic and Financial Committee) shall formulate an opinion on the report of the Commission. Finally, according to Article 104c (6), the EU Council, on the basis of the recommendation of the Commission, shall, acting by qualified majority, decide, after an overall assessment, if an excessive deficit exists in a Member State.

2. Statistical questions

The statistical base for examining fiscal developments is comparable data assembled on a National Accounts basis, in compliance with the European System of Accounts (2nd edition). These data are provided by the Commission, which in turn bases its figures upon data reported by Member States. The figures presented in this Report were published by the Commission in November 1994.

3. Issues for further consideration

Application of the following provisions of the Treaty will require further consideration:

- "the (deficit) ratio has declined substantially and continuously and reached a level that comes close to the reference value, or ..., alternatively, the ... excess ... is only exceptional and temporary and the ratio remains close to the reference value";

- "unless the (debt) ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace";

- "other relevant factors".

The EMI is seriously concerned about fiscal developments in Member States. The deterioration in fiscal balances which started in 1990 continued in 1993 and was only slightly reversed in 1994. In most cases only part of the marked deterioration since 1990 can be attributed to the recession, with a significant proportion being the consequence of a structural deterioration observed over a lengthy period. Moreover, the improvement in deficit ratios in 1994 was largely determined by the cyclical upswing, and, with some exceptions, no significant progress was made in reducing structural deficits. It is also worrisome that the recent rise in deficits was accompanied by a significant expansion in both public spending and public revenue. This has adverse effects on the supply side of the economy and on medium-term growth prospects.

Even a lasting economic recovery will not bring about a radical improvement in fiscal balances if underlying structural imbalances persist. If the economic climate should eventually deteriorate, with fiscal positions again being affected by a cyclical slowdown in revenue growth and an increase in expenditure, existing structural imbalances would quickly reappear in actual deficit figures. But even if continued growth over a longer period of time did contribute to a substantial reduction of actual deficit figures, for example to around 3% of GDP, these could not necessarily be considered as sustainable. A deficit to GDP ratio of this order at a time of buoyant economic activity would rather be considered as insufficient for achieving lasting progress in redressing fiscal balances.

This is why the objective of budgetary policy should be to use the coming upswing to achieve an adequate degree of fiscal consolidation. The recovery under way in all EU Member States provides an opportunity to reverse the fiscal trend of the past years. An environment of sustained growth should be more conducive to bringing expenditure under control and to undertaking sweeping reforms of the functioning and size of the public sector. This would restore flexibility to fiscal policy, allowing automatic stabilisers to operate in future recessions without driving budget deficits above values of 3% of GDP. More fundamentally, a timely reversal of adverse fiscal trends is essential for improving the prospects for sustainable growth and enhancing the effectiveness of monetary policy in achieving price stability.

In assessing fiscal policy convergence important issues are raised, too, when considering the existing stock of debt and its trend over time. In countries with very high debt to GDP ratios clear evidence of a reduction must be shown and policies must be followed that will ensure that the debt ratio referred to in the Treaty is sufficiently diminishing and approaching the reference value at a satisfactory pace. For countries whose debt ratios currently exceed 60% of GDP, the higher the starting debt ratio, the lower the required fiscal deficit ratio. In some cases this implies high primary surpluses, if not a sustained overall surplus position. This implicit relation between trends in deficits and debts underlines the view that the achievement of a deficit of around 3% of GDP cannot be considered as appropriate in all cases.

4. Exchange rate stability

4.1 Exchange rate developments in 1993-94

Exchange rate developments have been presented in more detail in Section A.2. This section gives a very brief summary. The legal background and an opinion of the EMI Council is given in the box.

In 1993, as in the preceding year, exchange rates in the EMS experienced substantial strains. In the first half of 1993 two realignments took place (the Irish pound, the Spanish peseta and the Portuguese escudo were devalued); on 2nd August 1993 unprecedented exchange market pressures led Ministers of Finance and central bank Governors to take the joint decision to widen the ERM fluctuation margins for compulsory intervention to ±15%, while leaving central rates unchanged. As a result of a bilateral agreement, the former fluctuation limits of ±2.25% continue to apply between the Dutch guilder and the Deutsche Mark.

Immediately after the widening of the bands all currencies previously participating in the narrow band, with the exception of the Dutch guilder, traded below their former lower limits against the Deutsche Mark. Between August and mid-October 1993, these deviations ranged between 4 and 8.5% for the Irish pound, the French franc, the Belgian franc and the Danish krone. The Spanish peseta and the Portuguese escudo fluctuated within their former wider limits vis-à-vis the Deutsche Mark.

During most of 1994 the actual use of the wide bands remained close to 6%, except for three short-lived episodes when it reached 8%. In January and December 1994 the peseta weakened, likewise the Portuguese escudo in June. The Belgian franc, the Dutch guilder and, temporarily, the Irish pound were the strongest currencies during these periods.

Three countries remained outside the ERM in 1993-94, namely Greece, Italy and the United Kingdom.

As noted elsewhere, the overall impression of abating exchange rate pressures since the widening of the bands was largely confirmed by declining trends in exchange rate volatility, less volatility in short-term interest rate differentials and substantially reduced intervention activity in support of currencies under downward pressure.

4.2 Assessment of exchange rate stability

Several lessons may be drawn from the experience of the past few years. The economic fundamentals, and particularly all factors determining the development of inflation rates, are important forces in shaping exchange rate behaviour. When reacting to news or revising expectations markets will not only take into account the present state of convergence but will also consider past experience. They need to be convinced that overall macroeconomic policies are effectively geared to price stability. Credibility is strengthened most effectively by a steadfast conduct of policies and an appropriate adaptation of the institutional framework, including the independence of central banks. However, political factors or unexpected events of major importance cannot be ruled out, and hence exchange market reactions may occur to the extent that such phenomena entail uncertainty.

Box 6 **Exchange rate stability**

1. Legal basis

The Treaty establishing the European Community, Article 109j (1), requires:

"the observance of the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State".

The Protocol (No. 6) on the convergence criteria referred to in Article 109j (1) of the Treaty establishing the European Community, Article 3, stipulates:

"The criterion on participation in the Exchange Rate Mechanism of the European Monetary System referred to in the third indent of Article 109j (1) of this Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period".

2. Assessment

On 7th October 1994 the EMI Council gave the following opinion which later was endorsed by the EU Council on the ERM fluctuation bands:

"1. On 2nd August 1993, the Ministers of Finance and central bank Governors jointly took the decision to widen the ERM fluctuation bands for compulsory intervention to 15% while leaving central parities unchanged. Experience since then indicates that the wider band has helped to achieve a sustainable degree of exchange rate stability in the ERM. It has done so by deterring speculative attacks on ERM currencies, thereby preventing large exchange rate depreciation or excessive exchange market intervention and their potentially inflationary consequences. In the light of this experience and in the current circumstances, the EMI Council considers it advisable to maintain the present arrangements.

2. At the same time the EMI Council recommends that member countries should continue to aim at avoiding significant exchange rate fluctuations by gearing their policies to the achievement of price stability and the reduction of fiscal deficits, thereby contributing to the fulfilment of the requirements set out in Article 109j (1) of the Treaty and the relevant Protocol".

It was against this background that the EMI Council gave an opinion to the EU Council on the ERM fluctuation bands (see Box 6). The EMI Council considered it advisable in the prevailing circumstances to maintain the present arrangements and to continue to aim at avoiding significant exchange rate fluctuations by gearing member countries' policies to the achievement of price stability and the reduction of fiscal deficits. This view was endorsed by the EU Council.

5. Convergence in long-term interest rates

5.1 Long-term interest rates in 1993-94

This section refers to data presented in Table 9. While not fully comparable, the long-term interest rates used are deemed to be the most relevant. Efforts to develop the most representative and comparable set of long-term interest rates continue.

The convergence of long-term interest rates displayed a similar pattern in both years under consideration. In 1993 and 1994, a group of eight member countries (all but Greece, Spain, Italy and Portugal) recorded annual average levels within a relatively narrow range of 6.4-7.7% and 6.4-8.1% respectively. Long-term interest rates in Spain, Italy and Portugal were at or somewhat above 10%, while in Greece they were above 20%.

5.2 Assessment of convergence in long-term interest rates

As mentioned in the Treaty, the durability of the convergence achieved by a Member State and of its participation in the ERM should be reflected in the convergence of long-term interest rates. In this respect the Treaty provides for the use of the long-term interest rates of those countries with the lowest inflation rates as reference values. The implication of this provision is that it is not necessarily the lowest long-term interest rate or rates which are used as a yardstick for measuring the durability of convergence. For example, in 1994 the best performer in terms of inflation was France, but its average long-term interest rate of 7.2% exceeded the levels recorded in Luxembourg (6.4%), the Netherlands (6.9%) and Germany (7.0%). Depending on the pattern of inflation and long-term interest rates in individual countries, this may at times lead to different positions of Member States when comparing actual performance in terms of both inflation and long-term interest rates.

Considering the results for 1993-94, overall changes in terms of convergence appear rather small. As most of the countries, on balance, recorded an increase in average long-term interest rates of around 50 basis points in 1994, differentials changed only marginally. Some Member States with comparatively high levels of long-term rates (Greece, Italy, Spain and Portugal) even showed a reduction in differentials vis-à-vis the best performers in 1994. These annual average values, however, mask a considerable widening of interest rate differentials in the course of 1994, in particular between the best-performing countries and Spain, Italy and Portugal. If end-1994 patterns of long-term interest rates persist, they will have a negative impact on the overall picture of convergence. As analysed in detail in Section 2.2, this can be considered to indicate important concerns in the markets, particularly over fiscal positions, as well as an increased focus on countries' long-term records of exchange rate and price stability. Cross-country differences in this respect, leading to a widening of bond yield differentials over the course of 1994, indicate that the progress towards overall convergence still needs to be strengthened by sustained efforts on the part of policy-makers in all quarters.

Box 7 **Long-term interest rates**

1. Legal basis

The Treaty establishing the European Community, Article 109j (1) requires:

"the durability of convergence achieved by the Member State and of its participation in the Exchange Rate Mechanism of the European Monetary System being reflected in the long-term interest rate levels".

The Protocol (No. 6) on the convergence criteria referred to in Article 109j (1) of the Treaty establishing the European Community, Article 4, stipulates:

"The criterion on the convergence of interest rates referred to in the fourth indent of Article 109j (1) of this Treaty shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best-performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions".

2. Statistical issues

The Treaty provisions imply in statistical terms that the representative long-term interest rate statistics should reflect as accurately as possible any changes in market sentiment with respect to the durability of the convergence performance and the participation in the ERM of the Member State concerned. The possible distorting effects of other determinants should be as limited as possible. As for the other statistics to be used for the application of the Protocol or the convergence criteria, the Commission is responsible for supplying the required statistics. Given its expertise in this area, the EMI is currently contributing to a harmonised definition of the interest rate statistics that fulfils the requirements mentioned above. The figures used in Table 9 reflect these ongoing efforts and, for the time being, are deemed to be the most relevant.

3. Issues for further consideration

In the case of this criterion similar issues arise to those involved in assessing the price stability criterion, namely the choice of the country or countries to be used in calculating the reference value for the application of the criterion.

6. Overall convergence and sustainability

Notable progress has been made towards price stability and convergence also increased in some other areas. This is reflected in the return to a higher degree of exchange rate stability in 1994. At the same time, however, deficiencies remain. Several countries still record unsatisfactory levels of inflation rates, and convergence is not established firmly enough to discourage challenges to policy from developments on foreign exchange and bond markets. The largest single problem continued to be the worrisome state of most EU countries' fiscal positions. Although governments are fully aware of the issues at stake and have started to prepare and to take corrective measures, these need to be strengthened and continued on a permanent basis. Visible reductions are required not only in actual but also in underlying structural fiscal deficits. Moreover, convergence is more likely to be sustainable if further progress is made to improve the structural performance of labour and goods markets. On the basis of the developments described above it appears that the overall achievements in convergence are still insufficient.

CHAPTER II

ACTIVITIES OF THE COMMITTEE OF GOVERNORS AND OF THE EMI

INTRODUCTION:
FROM THE COMMITTEE OF GOVERNORS TO THE EMI

With the establishment of the EMI on 1st January 1994, the Committee of Governors of the EEC central banks ceased to exist. The Committee had been established in 1964, in pursuit of the principles underlying the Treaty of Rome, to act as the principal forum for co-operation between the central banks of the member countries. Several developments have taken place since then. In 1971, following the recommendations derived from the Werner Report, the Council adopted a decision on the strengthening of co-operation between central banks. An agreement was signed by the EEC central banks on 10th April 1972 on the narrowing of the margins of exchange rate fluctuations (the "snake" arrangement), and the European Monetary Co-operation Fund (EMCF) was set up in 1973. After the difficulties experienced by the process of European monetary integration in the aftermath of the first oil shock, the Committee of Governors acquired new responsibilities with the establishment of the European Monetary System (EMS) in 1979, in particular in the management of the Exchange Rate Mechanism (ERM) of the EMS. The Committee contributed to the process of monetary unification, which was relaunched in the second half of the 1980s with the Single European Act in 1985, the Delors Report, which provided an outline for the realisation of economic and monetary union in stages, and the Maastricht Treaty, which amended the Treaty of Rome to allow for the realisation of economic and monetary union (EMU).

In the first stage of EMU, which started on 1st July 1990, the tasks of the Committee of Governors were further strengthened, in particular to foster the co-ordination of monetary policies in the Member States with the aim of promoting price stability. The Committee of Governors also started preparatory work in order to enable the EMI to conduct its tasks in Stage Two, which started on 1st January 1994.

In view of the relatively short time available and the complexity of the tasks involved, the preparatory work for Stage Three of EMU was initiated by the Committee of Governors. As indicated in the 1992 Annual Report of the Committee of Governors, the first step was to identify all the issues which should be examined at an early stage, establish a work programme until the end of 1993 and define accordingly the mandates of the three existing sub-committees and the five working groups established for that purpose.

On 29th October 1993, the Governments of the Member States at the level of Heads of State or of Government agreed on the seat of the EMI - Frankfurt - and nominated the President. On 1st November, the Treaty entered into force and hence also the attached Protocol on the Statute of the EMI. On 1st January 1994, the EMI was established and assumed the functions attributed to it in the Treaty. Owing to the delays regarding the ratification of the Treaty and the postponement of the decision on the seat of the EMI and on its President, provisional arrangements had to be made in order to allow the EMI to perform its tasks in the first phase of its existence. Until November 1994 the main functions were performed in Basle, with the co-operation and from the premises of the BIS, which had hosted the Secretariat of the former Committee of Governors. Following the decision of March 1994 on the site of the EMI's premises in the "Eurotower" in Frankfurt, preparations for the move to Frankfurt and the hiring of staff continued in the following months. The EMI Council held its first meeting on its premises in Frankfurt on 15th November 1994.

The following sections summarise the main tasks and functions of the EMI and its organisational structure.

A. THE ROLE AND STRUCTURE OF THE EMI

1. Objectives, tasks and functions of the EMI

The Treaty (Article 109f) and the attached Protocol on the Statute of the EMI set out the objectives, tasks and functions of the EMI.

The overall objective of the EMI is to contribute to the realisation of economic and monetary union, in particular by preparing the conditions necessary for the transition to the third stage. Within this general framework, the EMI shall:

- strengthen central bank co-operation and the co-ordination of national monetary policies with a view to improving convergence and ensuring price stability;
- make the preparations required for the establishment of the European System of Central Banks (ESCB), and for the conduct of a single monetary policy and the creation of a single currency in the third stage.

Several operational and advisory functions derive directly or indirectly from these objectives. In particular, the EMI shall:

- facilitate the use of the ECU and oversee its development, including the smooth functioning of the ECU Clearing and Settlement System;
- monitor the functioning of the EMS and assume the functions previously exercised by the EMCF;
- hold consultations concerning issues falling within the competence of national central banks and affecting the stability of financial institutions and markets;
- be consulted by the Council on any proposed Community legislation, and by national authorities on draft domestic legislation, which falls within its field of competence;
- report annually to the Council on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of EMU;
- have the possibility to hold and manage foreign exchange reserves as an agent for, and at the request of, national central banks.

1.1 Strengthening central bank co-operation and monetary policy co-ordination

In Stage Two, the EMI is expected to strengthen policy co-ordination with the aim of promoting a high degree of macroeconomic convergence. In carrying out this task, the EMI acts in accordance with the same objectives and principles laid down for the ESCB, in particular that the primary objective of monetary policy is to promote price stability.

In fulfilling its duties, the EMI provides a forum for consultations and exchanges of views and information on policy issues, while the conduct of monetary policy remains the ultimate responsibility of the national authorities. The EMI may formulate opinions or recommendations on the overall orientation of monetary policy and exchange rate policy as well as on related measures introduced in each Member State. The EMI may submit opinions or recommendations to governments and to the Council on policies which might affect the internal or external monetary situation in the Community and, in particular, the functioning of the EMS. It holds consultations on issues falling within the competence of national central banks and affecting the stability of financial institutions and markets.

1.2 Preparation for the establishment of the ESCB

Under Article 109f (3) of the Treaty, the EMI has been accorded a distinct responsibility: "At the latest by 31st December 1996, the EMI shall specify the regulatory, organisational and logistical framework necessary for the ESCB to perform its tasks in the third stage".

The regulatory, organisational and logistical framework required for the ESCB to perform its tasks covers, inter alia, the following areas:

- the definition of the concepts and framework for conducting the single monetary policy and the preparation of the ESCB's operational rules and procedures;
- the implementation of a single foreign exchange policy;
- the promotion of efficient cross-border payments;
- the collection and harmonisation, where necessary, of reliable and timely statistics to support the conduct of the single monetary policy;
- the supervision of the technical planning of the printing and issuing of a European banknote;
- the harmonisation of accounting rules and standards of the national central banks and the setting-up of an adequate information systems architecture for the ESCB.

In view of the complexity of the task, the interaction between areas of activity and between the institutions involved, and the short time available for the preparatory work, the EMI Council has organised this work on the basis of a comprehensive plan establishing the main lines of action. This plan, which acts as a guiding instrument for organising, monitoring and assessing the activities conducted by the EMI staff, the Sub-Committees and Working Groups, encompasses the main topics which need to be addressed in the context of preparatory work; it outlines the work schedules involved for the different Sub-Committees and Working Groups, and establishes the chronological order of deliberations on these topics in the EMI Council.

The EMI has to ensure that the preparation for Stage Three undertaken in various areas gives rise to a coherent project which is internally consistent and implemented accordingly. Implementation must be possible, according to the Treaty, by the end of 1996. This calls for devising workable solutions: contingency mechanisms may have to be considered, especially in the light of the sometimes long implementation lags. To ensure that preparatory activities are on schedule, in terms of both content and deadlines, progress will be continuously monitored.

Reports on progress in preparatory work will be communicated to third parties, in particular the European Commission, the Monetary Committee and, annually, to the Council of Ministers in accordance with Article 7.1 of the EMI Statute.

1.3 Oversight of the development of the ECU

In accordance with Article 4.1 of its Statute the EMI "shall facilitate the use of the ECU and oversee its development". This task involves mainly assessing the legal setting in EU countries to examine the regulatory obstacles to the private use of the ECU. In this context the EMI co-operates with the European Commission. Regulatory impediments to the use of the ECU should be removed. However, it is agreed that the ECU should not be endowed with the attributes of a national currency during Stage Two so as not to impinge on the Member States' sovereignty over monetary policy.

The EMI also conducts an annual review of the developments in the financial and non-financial use of the ECU. In addition, the EMI plays a consultative role, on its own initiative or at the request of other Community institutions and the Member States. This includes, in particular, providing clarification on the transition to a single currency in Stage Three and on the continuity of ECU-denominated contracts and instruments.

1.4 Other tasks

The EMI has been entrusted with other operational and advisory tasks which are described in Chapter II, Section B. In accordance with Article 6.4 of its Statute, the EMI is also entitled to hold and manage foreign exchange reserves as an agent for, and at the request of, national central banks. Thus far, however, no such request has been made.

It is also worth noting that, in accordance with Article 109f (7) of the Treaty, the EMI may have additional tasks for the preparation of Stage Three conferred upon it by the Council of Ministers.

2. The organisational structure of the EMI

The European Monetary Institute is an organisation of the European Union, with legal personality and established according to the provisions of the Treaty. The members of the EMI are the central banks of the Member States.

In conducting its tasks the EMI's staff works in close collaboration with three sub-committees and five working groups on specific issues. The structure of the EMI is described below.

2.1 The EMI Council

The EMI's decision-making body is the EMI Council. According to Article 109f (1) of the Treaty and Article 9 of the EMI Statute, the Council directs and manages the EMI. The Council is composed of the President of the EMI and the Governors of the central banks of the Member States. The President of the Council of the European Union and a member of the European Commission may also participate in the EMI Council meetings, without the right to vote. The EMI Council, whose proceedings are confidential, is scheduled to meet at least ten times a year.

In exercising the powers and performing the tasks and duties conferred upon them by the Treaty and the Statute, the members of the EMI Council who are the representatives of their institutions act on their own responsibility. The Council of the EMI may not seek or take any instructions from other Community institutions or bodies or governments of the Member States. The Community institutions and bodies, as well as the governments of the Member States, undertake to respect this principle of independence. Each member of the Council has one vote and the Council normally acts by simple majority of its members. A qualified majority of two-thirds is required, inter alia, in the case of the adoption of opinions and recommendations relating to monetary or foreign exchange policy, for decisions on financial resources or for the adoption of guidelines on the methods for the implementation of conditions necessary for the ESCB to perform its tasks. Unanimity is required in particular for decisions concerning the specification of the ESCB's regulatory, organisational and logistical framework, for publishing opinions and recommendations or for granting third countries' monetary authorities the status of "Other Holder" of official ECUs.

Following a long-standing tradition within the European Community, after the signing of the Act of Accession by the Heads of State or of Government in Corfu in June 1994, the central banks of the applicant countries, Austria, Finland, Norway and Sweden, were invited by the EMI to participate as observers in the meetings of the Council, the Committee of Alternates and the Sub-Committees and Working Groups. Following the outcome of the referendum in Norway in November 1994 on accession to the European Union, with a majority of votes against, the representatives of Norway's central bank abstained from further participation in EMI meetings. When the Act of Accession came into force on 1st January 1995, Austria, Finland and Sweden formally acceded to the European Union and their central bank Governors became members of the EMI Council.

2.2 The President of the EMI

In accordance with the provisions of the Treaty and of the EMI Statute, the President of the EMI is appointed for a three-year term by common accord of the governments of the Member States at the level of Heads of State or of Government, on a recommendation from the Committee of Governors or the EMI Council and after consulting the European Parliament and the EU Council. The President's tasks comprise preparing and chairing the EMI Council meetings, the day-to-day management of the EMI and presenting the views of the EMI. In the absence of the President, his duties are performed by the Vice-President, who is elected from among the Governors who are members of the EMI Council, likewise for a three-year period.

2.3 The internal organisation of the EMI

At its establishment on 1st January 1994, the EMI started with the 28 staff members of the Secretariat of the Committee of Governors. In April, after the decision was made regarding the premises, the Administration Department was established in Frankfurt to set up the infrastructure of the EMI's new offices, to recruit personnel and to prepare the relocation from Basle. As of 31st December 1994 the number of staff was 126. Members of staff have generally been appointed on three-year fixed-term contracts. It is currently planned that staff numbers will reach a level of 199 by end-1995.

The management currently includes the Director General and four Heads of Department. The main responsibilities of the Director General are to assist the President in his tasks, in particular in the day-to-day management of the EMI. The four departments are: the General Secretariat, the Monetary, Economic and Statistics Department, the Administration Department, and the Information and Communications Systems Department.

The General Secretariat consists of two divisions. The Policy Division is responsible for: (a) preparing the Council meetings, maintaining inter-institutional relations, supporting the production and distribution of the EMI's reports and maintaining the EMI's archives; (b) overseeing the ECU Clearing and Settlement System, monitoring Member States' payment systems and preparing for the EU-wide payment systems in Stage Three; (c) supporting the activities of the Monitoring and Concertation Groups, monitoring the functioning of the EMS, facilitating the use of the ECU and overseeing its development, carrying out EMS-related operations and preparing the foreign exchange market operations to be carried out by the ESCB in Stage Three; (d) conducting background analyses for the consultations on issues affecting the stability of financial institutions and markets; and (e) co-ordinating the preparatory work for Stage Three, monitoring, evaluating and reporting on progress made against the timetable of the Treaty. The division works closely with and provides support to the Foreign Exchange Policy and Banking Supervisory Sub-Committees and the Working Groups on EU Payment Systems, Accounting Issues and Printing and Issuing a European Banknote.

The Legal Division is responsible for handling all legal issues within the EMI. These include assisting in the fulfilment of the EMI's mandate, in particular as regards the legal aspects of the preparation of the regulatory and institutional framework of the ESCB and questions related to the interpretation of the Treaty. In addition, the Legal Division assists in the preparation of EMI opinions when consulted by the EU Council or national authorities on draft Community or national legislation falling within its field of competence. The staff of this division provide legal advice to the EMI management on administrative matters. The General Secretariat is also responsible for the EMI's Press and Translation Service.

The Monetary, Economic and Statistics Department consists of three divisions, provides secretarial support to the Monetary Policy Sub-Committee and is responsible for the EMI's library. The Stage Two Division provides economic analyses on issues related to the strengthening of monetary co-operation among central banks and the co-ordination of monetary policies with a view to promoting price stability during Stage Two. It may also assist the Council in formulating opinions and recommendations on macroeconomic policies, including those relating to the convergence criteria, and provide analyses on issues regarding financial markets. In support of these functions, economic research in the division focuses mainly on short and long-term aspects of economic and financial behaviour in EU countries and cross-country comparisons. The Stage Three Division is responsible for providing analyses on the concepts, framework and rules for the single monetary policy in Stage Three of EMU, in particular as regards the definition of the instruments, procedures and intermediate objectives of monetary policy. It contributes to the analysis of the practical implementation of foreign exchange policy in Stage Three. Furthermore, it undertakes economic research with a view to analysing long-term trends and strategies, and advises on operational matters related to the preparation and the start-up of Stage Three at an EU-wide level. Both divisions work closely with the Monetary Policy and Foreign Exchange Policy Sub-Committees.

The Statistics Division has the principal duties of contributing to the improvement of the statistical information which is needed for promoting the co-ordination of monetary policies in Stage Two and preparing the harmonised concepts and approaches and specifying the regulatory, organisational and logistical framework for the statistics which will be needed by the ESCB to perform its tasks. It works closely with the Working Group on Statistics in carrying out these duties. The division also has the task of ensuring the general availability of the statistical data and facilities required throughout the EMI.

The Information and Communications Systems Department currently comprises one division, sub-divided into three functional sections, and is responsible for devising and implementing a technical strategy for the information and communications systems for the EMI and the future ESCB. This work is performed in close co-operation with the Working Group on Information Systems for which the ICS Department provides the secretariat. Furthermore, the ICS Department is responsible for providing technical support for the users of the EMI's information and communications in the EMI itself and, under the oversight of the Working Group on Information Systems, for the monitoring, co-ordination and further development of the communications systems already in place between the EMI and the central banks.

The Administration Department consists of three divisions. The Personnel Division is responsible for: (a) recruitment and personnel policy; (b) salary-related matters and (c) training. The General Services Division is responsible for: (a) premises; (b) procurement and office services; and (c) organisation of conferences, meetings and travel. The Management Services Division deals with: (a) the EMI's internal financial accounts; and (b) management accounting and general organisational issues.

Since Article 6.4 of the Statute entitles the EMI to hold and manage foreign exchange reserves as an agent for, and at the request of, the national central banks, the EMI will establish a Financial Department if needed.

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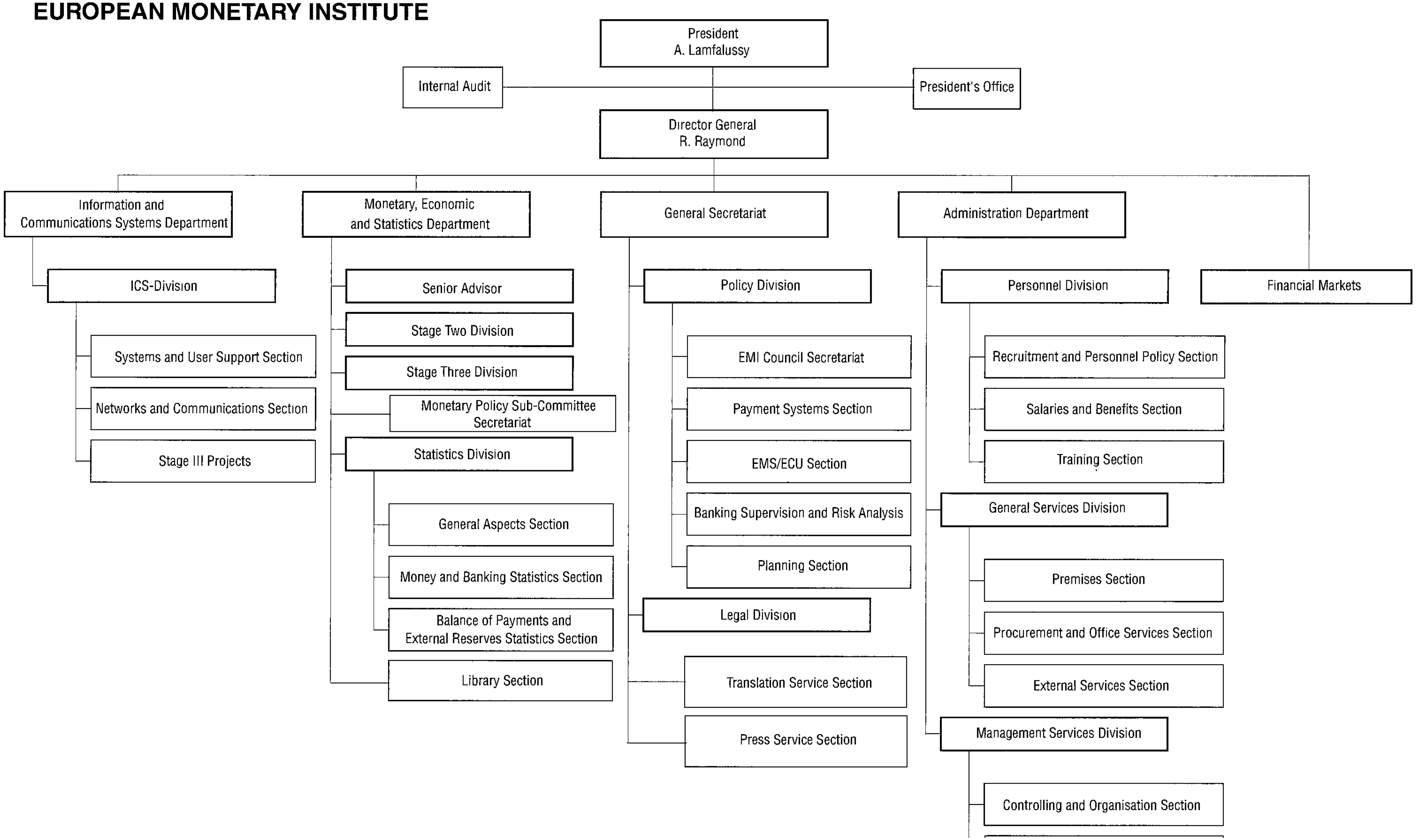
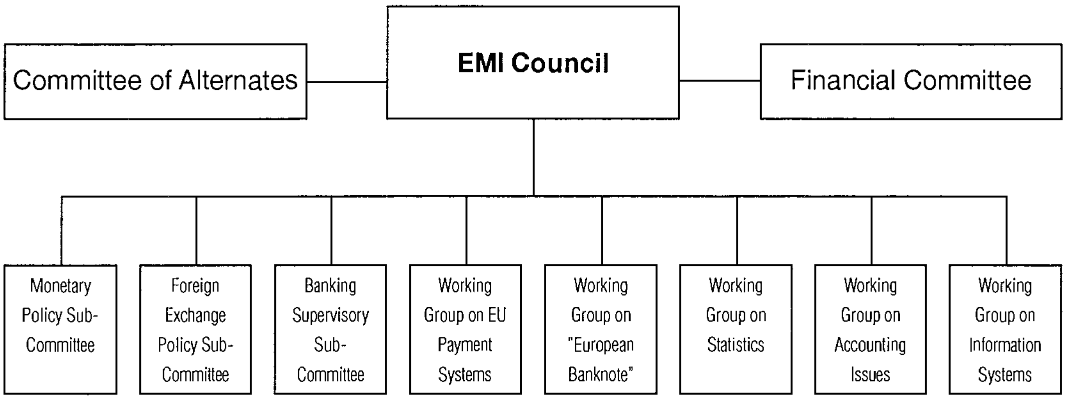


2.4 Committees, sub-committees and working groups

In the performance of its tasks, the EMI Council is assisted by several committees and working groups, according to the following structure:



The Committee of Alternates, chaired by the Director General of the EMI, is composed of senior representatives of EU central banks, appointed by the respective Governors as their Alternates in the EMI Council. The main task of this Committee is to contribute to the preparation of the meetings of the EMI Council.

The Financial Committee is chaired by the Vice-President and also consists of the two most senior members of the EMI Council serving for one year on a rotation basis. The Committee's main responsibility is to examine on the Council's behalf the President's proposals on the annual budget and the annual accounts as well as periodical statements of expenses incurred by the EMI during the financial year and deliver its opinion thereon to the EMI Council.

The sub-committees and working groups, composed of experts from the national central banks, were established under the Committee of Governors, and the EMI Council decided to continue their activities. The chairmen of the sub-committees and working groups have each been appointed for a three-year term commencing on 1st January 1994.

The Monetary Policy Sub-Committee assists the Council in strengthening the co-ordination of national monetary policies in the European Union. To this end, in the framework of the ex ante and ex post exercises, it contributes to the periodic consultations regarding the monitoring of monetary policies, in particular by examining the monetary policy objectives and strategies envisaged by the Member States and their compatibility with the aim of achieving price stability throughout the Union. Furthermore, the Sub-Committee annually reviews developments in the budgetary field. The Sub-Committee also undertakes the necessary studies to facilitate the EMI's task of making the preparations required for the conduct of a single monetary policy. In particular, it studies methods and organisational aspects of the execution of the single monetary policy, with a view to the preparation of the instruments and procedures necessary for fulfilling the ESCB's monetary policy tasks in Stage Three.

The Foreign Exchange Policy Sub-Committee assists the Council in the preparation of discussions on exchange rate developments, the functioning of the EMS and developments in the use of the private ECU. The Sub-Committee also regularly exchanges information with non-EU central banks in the framework of the "concertation procedure" involving representatives of the central banks of nineteen industrialised countries, which provides for sharing data on market developments, intervention and other official foreign exchange transactions. Furthermore, the Sub-Committee is involved in assisting the EMI to prepare the groundwork for the ESCB's foreign exchange-related functions.

The Banking Supervisory Sub-Committee holds regular consultations on issues affecting the stability of financial institutions and markets. In the cases where the national central banks do not have legal responsibility for banking supervision, a representative of the respective national supervisory authority participates in the Sub-Committee.

The Working Group on EU Payment Systems is, under the aegis of the EMI Council, responsible for co-ordinating central banks' activities in the field of payment systems, for analysing ways of facilitating cross-border payments within the context of the Single Market and as a preparation for Stage Three, and for preparing the EMI Council decisions concerning the oversight of the ECU Clearing and Settlement System.

The Working Group on Printing and Issuing a European Banknote assists the EMI in carrying out its task of supervising the technical preparations for the introduction of ECU banknotes. This area of work involves studying the various possible options for the design and production of European banknotes and the issuing, distribution, sorting and handling of the notes once they have been produced.

The Working Group on Statistics contributes to the improvement of the statistical information which is needed for promoting the co-ordination of monetary policies in Stage Two, and also for developing the statistical base necessary for the conduct of the single monetary policy in Stage Three.

The Working Group on Accounting Issues developed the accounting methodology applied by the EMI (see the enclosed Annual Accounts). It is responsible for preparing the ground for recommendations for the harmonisation of accounting rules and standards in the ESCB with particular regard to the statutory provisions on monetary income, the paying-up of capital and the transfer of foreign exchange reserve assets.

The Working Group on Information Systems is responsible for assisting the EMI in devising and implementing a technical strategy for information and communications systems for the EMI and the ESCB.

3. The financial resources of the EMI

Under Article 16 of its Statute, the EMI has been endowed with financial resources amounting to ECU 615.6 million (see the notes to the enclosed Annual Accounts). The level of resources required was determined by the EMI Council on the basis of the annual interest stream that would need to be generated in order to cover the estimated current expenditure in a normal year of operation (some ECU 44 million), together with an allowance for initial investment in equipment for the EMI and working balances of cash. Any surplus arising at year-end will be dealt with in the following manner: firstly, an amount to be determined by the EMI Council will be transferred to a reserve fund, which is repayable together with the initial contributions to the central banks at the liquidation of the EMI; secondly, any remaining surplus not transferred to the EMI's reserves will be repaid to the central banks.

The EMI's financial resources were provided by its member central banks in accordance with a key based on the share of each country's population and GDP, according to the same method to be used in Stage Three for the ECB.

Table 10 **Central banks' share of the EMI's financial resources**

(as a percentage)

	1994	from 1995
Deutsche Bundesbank	24.20	22.55
Banque de France	18.30	17.00
Banca d'Italia	17.05	15.85
Bank of England	16.45	15.35
Banco de España	9.50	8.85
De Nederlandsche Bank	4.55	4.25
National Bank of Belgium	3.00	2.80
Bank of Greece	2.15	2.00
Banco de Portugal	1.95	1.85
Danmarks Nationalbank	1.80	1.70
Central Bank of Ireland	0.90	0.80
Institut Monétaire Luxembourgeois	0.15	0.15
Sveriges Riksbank	-	2.90
Oesterreichische Nationalbank	-	2.30
Suomen Pankki	-	1.65

Source: EMI Council Decisions Nos. 2/94 and 3/95.

Of the estimated annual budget, some 40% is allocated to personnel costs and 25% to rental and maintenance of premises. The remaining 35% covers purchases of goods, services and supplies, one-third of which arise in direct connection with the facilities needed to support the work of the large number of international meetings of the groups described below that take place at the EMI, and from regular liaison with the national and international institutions involved with the EMI's work.

B. THE ACTIVITIES OF THE EMI

1. Co-ordination of monetary and foreign exchange policies

The EMI is entrusted with the task of strengthening the co-ordination of the monetary policies of the Member States with the aim of ensuring price stability. In this context, the EMI should hold regular consultations concerning the course of monetary policies, which in Stage Two are the responsibility of national authorities. It is normally to be consulted by the national monetary authorities before they take decisions on the course of monetary policy in the context of the common framework for ex ante co-ordination. The EMI also monitors the developments of the EMS.

To this end, the EMI has continued and intensified the work which had been initiated and carried out in the first stage of EMU by the Committee of Governors. In this context, economic and monetary developments and policies are monitored regularly with the aim of furthering common assessments of prevailing conditions and appropriate policy responses. The procedure involves reviewing current exchange market and interest rate developments, at the level of experts, on a weekly basis. The main factors with a potential bearing on exchange rate developments, in individual Member States or at the level of the EMS as a whole, are assessed and an examination is made of recent economic developments or prospects, of economic policy decisions taken in the monetary and budgetary fields and of financial market expectations about future exchange rate and interest rate movements. During its regular monthly meetings the EMI Council reviews the economic and financial situation prevailing in individual Member States and current developments in international financial markets.

Furthermore, a forward-looking analysis, the ex ante exercise, is regularly carried out in the autumn before the national authorities take public decisions on the future course of monetary policy. In this framework, the EMI analyses economic, monetary and financial trends and discusses the appropriateness of monetary policy stances in the individual Member States. The overall stance of monetary policy in the Union is examined, as well as the mutual compatibility of national monetary and foreign exchange policies. The ex ante analysis is followed up by an ex post surveillance exercise, which is normally undertaken in the late spring. The ex post analysis reviews monetary policies, comparing recent economic developments with earlier forecasts and examining economic and monetary policy prospects for the remainder of the year.

The analytical foundations of the monitoring framework are continuously reviewed and updated. In 1994, special emphasis was given to the monetary transmission process and the implications of differences in national transmission processes for the co-ordination of monetary policies in the Union.

The EMI also has the right to formulate opinions and recommendations on the overall orientation of monetary policy as well as to make recommendations to the monetary authorities of the Member States concerning the conduct of their monetary and foreign exchange policies. So far, the EMI has seen no need to make use of this provision. In 1994 the EMI also continued the practice of the Committee of Governors of studying in detail, once a year, developments in public finance and their implications for the co-ordination of monetary policies. The EMI recognises the crucial importance of sound fiscal positions for the pursuit of stability-oriented monetary policies. In the spring of 1994 the EMI expressed its concern to the Council on two occasions about the state of public finances in the Union.

2. Preparatory work for Stage Three

One of the main tasks of the EMI is to prepare the ground for the ESCB to be able to perform its tasks from the start of Stage Three. This involves conducting preparatory work in numerous areas of central bank activity, in particular: monetary policy; foreign exchange policy; statistics; payment systems; and issuing banknotes.

2.1 Monetary policy

The Treaty lays down the Statute of the future ESCB and sets the maintenance of price stability as its primary objective. But as regards the modus operandi of the single monetary policy, the Statute states only general principles; for example, the principle of open markets with free competition, the ban on central bank financing of public deficits, and the possible decentralisation of the execution of the ESCB's operations, so that recourse can be made to the national central banks "to the extent deemed possible and appropriate".

The preparatory work involves detailed technical analysis of the various instruments potentially available or already in use in member countries in order to identify institutional differences between countries (a description of the current strategies and instruments of monetary policy in EU Member States is provided in Annex 1). It also entails a general review of the main principles applicable for the elaboration and implementation of monetary policy in the European Union leading to decisions on matters that imply strategic options. The final answers to most of these questions will not be given until a later stage, as they will largely depend on the economic and financial conditions prevailing at the time of entering Stage Three. Nevertheless, the lead time needed to introduce a new operational framework is such that it is necessary to go ahead with preparations. Work in this large area is in progress.

A central issue in the conduct of monetary policy in Stage Three is whether the ESCB should target price stability directly or employ a strategy relying on the adoption of an intermediate target. The effectiveness of both strategies requires a high degree of transparency and credibility and implies the existence of a sufficiently predictable relationship between monetary policy measures and price developments. The choice of strategy requires an empirical assessment which can only be made fully at a later stage, but will nevertheless need to be based to a large extent on past experience and available data. It should be emphasised that, regardless of the choice between the direct and the indirect approach and between various intermediate targets, the ESCB will need to monitor other indicators which could give information on the current and future monetary, economic and financial situation and on the appropriateness of the stance of monetary policy. It is intended to return to these issues in 1996.

In order to assess the impact of the single monetary stance on prices and output it is useful to analyse the differences in the transmission process across countries which might complicate the conduct of the single monetary policy. A preliminary study (see Box 2 in Chapter I) shows that such differences are very closely related to structural and institutional factors. While the growing integration of markets and the move to Stage Three will lead to more convergence in financial areas, it is neither desirable nor possible for all other structural differences across countries to disappear. Such differences also exist within national borders.

In the day-to-day implementation of monetary policy the ESCB will focus on one or several short-term interest rates. In influencing this rate (or these rates) it will convey information to market participants. The ESCB must therefore be able to give clear and unambiguous policy signals, which must not be hampered by differences in local interest rate conditions.

The requirements for a single monetary stance lie both in the field of instruments and procedures and in the integration of interbank markets and payments systems. A high degree of harmonisation of the instruments and procedures is indispensable in order to provide uniform monetary policy signals in every country. Another crucial condition is the presence of sufficient arbitrage possibilities for banks. Only when banks can transfer central bank reserves across national borders freely and within the same day will changes in interest rates be quickly and uniformly transmitted throughout the Union. This has strong implications for the required degree of integration of payment and settlement systems (see Section 2.4 below).

The evaluation of alternative monetary policy instruments and operating procedures must be based on a number of basic principles:

- efficiency: the monetary policy instruments and procedures must enable the ESCB to control its targets efficiently. An important element of an efficient operational framework is that it ensures that the monetary policy signals of the ESCB will be uniform and consistent;
- conformity with market principles: monetary policy implementation should be "in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources" (Maastricht Treaty, Article 105);
- equal treatment: the ESCB should treat all groups of financial institutions that have access to its facilities equally and regardless of their country of origin;
- simplicity and transparency: the monetary policy and procedures should be simple and be employed with clarity, so as to contribute towards meeting the criteria of equal treatment and conformity with market principles in a decentralised central bank system;
- decentralisation: the ESCB shall have recourse to the national central banks to carry out operations "to the extent deemed possible and appropriate" (Article 12 of the ESCB Statute). The fulfilment of this principle may be of practical relevance, in

particular as the ECB can take advantage of national central banks' experience and knowledge of local markets;

- continuity: the transition to the new operational framework at the beginning of Stage Three may be facilitated by relying as much as possible on the initial infrastructure and employing instruments that can be adapted to the changing environment.

Discussions about the operational framework for the implementation of monetary policy by the ESCB (selecting the policy instruments which could be used, defining their desired features and the relevant operational procedures) are currently under way. Based on a careful examination of the individual policy instruments on the basis of national experiences, a comparison will have to be made of the possible alternative options for the overall operational framework in view of the expected characteristics of the economic and financial environment in Stage Three.

The features of a possible system of reserve requirements will have to be prepared at an early stage so that, if necessary, existing systems can be adjusted and new systems can be introduced in time. The same applies to the general features of standing facilities and of open market operations. It will also be necessary to define the types of securities which would be eligible as collateral for standing facilities and as underlying securities for open market operations. Moreover, a technical analysis of the feasibility and features of a decentralised execution of open market operations is needed. Finally, the results of these separate studies will need to be considered together in order to allow discussion of the overall operational framework of the ESCB. These analyses will, however, in no way constrain the freedom of the ESCB in deciding whether and how to use these instruments.

2.2 Foreign exchange policy

From the start of Stage Three of EMU the ESCB has to be ready to conduct a single foreign exchange policy. To enable the ESCB to perform this task, several issues have to be prepared ahead of time. These include, in particular, the transfer of foreign reserve assets from the national central banks to the European Central Bank (ECB), the management of the ECB's and national central banks' reserves, the organisation of foreign exchange intervention and exchange rate relationships with the currencies of Member States not participating in Stage Three.

The EMI has planned to examine these topics in the course of 1995 and 1996. A preliminary analysis started in 1994 on the organisation of foreign exchange intervention. By analogy with the single monetary policy, although the main decisions will be made by the ECB, the organisation of the execution of foreign exchange operations has to be defined and prepared prior to the start of Stage Three. In particular, it will have to be ascertained whether and to what extent foreign exchange operations will have to be centralised or decentralised. The technical feasibility of alternative organisational frameworks as well as their respective efficiency in terms of policy implementation will be assessed before a definite solution is endorsed. Another issue to be examined is the implications for the organisation of foreign exchange policy of the relationships between the new single currency and other currencies, in particular non-EU currencies, on the one hand, and those of the Member States with a derogation, on the other.

2.3 Statistics

The Treaty requires the EMI to "promote the harmonisation, where necessary, of the rules and practices governing the collection, compilation and distribution of statistics in the areas within its field of competence". This involves ensuring the availability of properly articulated Monetary Union statistics in Stage Three and supporting the EMI's efforts towards "strengthening the co-ordination of monetary policies with a view to ensuring price stability".

Given the long lead time involved in the development of statistics, the Committee of Governors started the preparatory work for Stage Three in 1992. A provisional arrangement was subsequently agreed with the Commission that the Committee and its successor, the EMI, should be primarily responsible at the European Union level for the conceptual development of money and banking statistics generally, and for statistics relating to financial flows in the balance of payments and related stocks. The current arrangement is under review, together with the arrangements for co-operation in statistical matters at the EU level. It is intended to define in 1995 the fields of competence and responsibility in the different areas of statistics between the future ESCB and the European Commission (EUROSTAT).

The first task was to establish likely needs for statistics in Stage Three. The results indicated a need for a wide range of monetary, financial and balance-of-payments statistics for the conduct of a single monetary policy. They included properly articulated monetary statistics covering the Monetary Union, available monthly and to a prompt timetable, and timely monthly balance-of-payments data for the Monetary Union, covering at least the key items in transactions with third countries.

As a first follow-up, the Committee of Governors agreed in September 1993 that all central banks would exploit the existing scope for improving the timeliness of the "essential" money and banking statistics and balance-of-payments statistics. It agreed also that, in order to ensure that properly articulated monthly monetary statistics covering the Monetary Union could be compiled from the start of Stage Three, provision should be made in every Member State to allow a breakdown of banks' external positions into those vis-à-vis Monetary Union Member States and those vis-à-vis other countries.

Inventories of statistics already available in member countries and statistics which, if not available, were already planned or could be made available with relative ease, were compiled. Comparing the results of these exercises helped to identify gaps, and indicated where harmonisation was necessary. There proved to be a large common element in the statistics of member countries, with a good correspondence to the stated requirements for Monetary Union. But there are numerous differences of detail, and some more substantial differences, reflecting different emphases in policy and varying financial structures and practices.

By the end of 1994 the Council of the EMI had agreed on the concept of "Monetary Financial Institution" whose balance sheet should be incorporated in the consolidated balance sheet of the banking system of the Monetary Union and on the format for this consolidated balance sheet. The Council had also agreed on the need for monthly balance-of-payments statistics covering the Monetary Union, and on the definition of residence and economic sector.

A clear but flexible view of the need for harmonisation, which need not mean an identical approach, must be maintained. In some areas of close concern to the ECB, a reasonable comparability across countries in the prospective Monetary Union may suffice, in particular since the structure and functioning of national financial markets may (still) differ significantly. However, where statistics have to be aggregated, and especially where cross-border consolidation is necessary, a close fit is required. Such considerations will influence the priority given to individual tasks of harmonisation.

With respect to further work, sections of the stated requirements remain to be examined, e.g. central banks' balance sheets, interest rates, financial market statistics and financial accounts, mutual funds and the international investment position. These, together with technical issues such as aggregation procedures, will receive early attention. Furthermore, while it is the European Commission's responsibility to provide the data required for the application of the convergence criteria, the EMI must take a close interest in order to report on them, as it is required to do under the Treaty; increased effort will therefore be devoted to the examination of the statistics required for the assessment of convergence.

Although the statistical work of the EMI must focus on the operational need for statistics arising from the conduct of a single monetary policy in Stage Three (and from the co-ordination of monetary policies in Stage Two), the EMI accepts international and European Union statistical standards while seeking to influence their development. Moreover, the EMI is conscious of the costs incurred by reporting institutions in supplying statistics and wants to avoid imposing additional burdens as far as possible. The EMI thus attaches great importance to close co-operation, not only with the statistical authorities in member countries, but also with the European Commission (EUROSTAT) and with international organisations in statistical matters. This is promoted through participation in the Committee on Monetary, Financial and Balance-of-Payments Statistics, comprising representatives of the EEA central banks and statistical institutes, the European Commission and the EMI, and through membership of other international committees, working parties and task forces.

2.4 Payment systems

One of the main tasks of the EMI is to prepare the framework to enable the ESCB to promote the efficiency and soundness of cross-border payments from the start of Stage Three. In this respect, the Treaty does not distinguish between large-value and retail payments. However, preparatory work up to now has focused on large-value payments, which are the core elements of payment systems in modern economies. Less attention has been devoted to retail payments (since the level of risk involved is lower) and, so far, to securities settlement systems.

Analysis of the implications of the move to Stage Three in the field of payment systems was begun under the aegis of the Committee of Governors in 1992 and has been continued by the EMI. In November 1994 the EMI issued a note on "The EMI's intentions with regard to cross-border payments in Stage Three" which was communicated through the central banks to the national banking communities.

At present, payment relations between EU countries rely mainly on correspondent banking. Although the traditional drawbacks in terms of rapidity and risk have diminished (and may continue to decrease in parallel with technological progress and the careful monitoring of risks), correspondent banking alone will not suffice to handle future large-value interbank payments or those stemming from the monetary policy operations of the ESCB.

As with the present national systems, it must be possible to make large-value payments within the EMU area in central bank money through systems which meet very high standards of security, speed and efficiency. In accordance with the principles adopted at the national level, a high proportion of large-value payments in Stage Three will be effected in central bank money on a real-time gross basis in order to minimise the risks for participants and the payment system as a whole. An EMU-wide system will have to be established in order to enable the impact of monetary policy decisions to be transmitted quickly and efficiently to all participants in the unified money market which will cover all Member States participating in EMU.

It is apparent that the time and resources required to design and implement any new system are such that preparatory work must start several years in advance. The EMI and the EU central banks should provide the private sector with guidelines to enable it to make choices and plan its investments in the run-up to Stage Three.

The development of an EMU-wide real-time gross settlement (RTGS) system should follow three basic principles which derive from the Treaty on European Union: efficiency, market-orientation and decentralisation. New payment arrangements offered by the ESCB should, in particular, enhance technical efficiency, minimise systemic risk and, as far as possible, be cost-effective. To be market-oriented, participation in the EMU-wide RTGS system will not be compulsory for credit institutions. Only transactions related to monetary policy operations will have to be processed through the proposed TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) system. Other systems will remain for retail payments and may also remain for large-value ones, provided that these meet adequate safety standards which are not significantly lower than those of the EMU-wide RTGS system. Finally, following the decentralisation principle, the future system will be organised around infrastructures and settlement accounts to be maintained at the level of the national central banks.

In accordance with these principles, the EU central banks and the EMI have adopted a strategy based on a minimum harmonisation of national systems and a common infrastructure necessary to implement a new payment arrangement for Stage Three - the TARGET system. It will include one RTGS system in each country and an "interlinking" system - a web of infrastructures and procedures to be used to connect RTGS systems in order to process cross-border payments.

The operational features of the system will be defined in the course of 1995 by the EMI in close co-operation with EU central banks and other parties (such as credit institutions) which are involved in these issues.

2.5 Preparation of European banknotes

In the third stage of EMU a single currency will be issued by the ESCB, in particular in the form of banknotes that will replace the existing national ones. The EMI has the specific task of supervising the technical preparation of these banknotes.

The process of printing and issuing banknotes is a lengthy one, comprising a considerable lead time before a new banknote series is ready to be introduced as a replacement for an existing one. The replacement of all banknotes denominated in national currencies by a series of single-currency banknotes is a far more extensive undertaking, in terms of timing and problems to be addressed. As an indication, there were 12 billion banknotes in circulation at the end of 1994 in the fifteen Member States, with a further 8 billion notes held in store. In 1994 6.5 billion new notes were printed for EU central banks.

A few issues related to the preparation of European banknotes have already been addressed by the EMI, in particular with respect to the number and value of denominations and the boundary between coins and banknotes denominated in the single currency. First, with respect to the note/coin boundary, a consensus has been reached that the highest value for coins would be ECU 2 and that ECU 5 would be the smallest denomination of banknote. This view is shared by the Mint Directors' Working Group, with which the EMI has been co-operating closely. Second, with respect to the sequence, number and value of denominations of banknotes, the agreed working assumption is the sequence 1:2:5 and seven notes from ECU 5 to ECU 500. Third, the range of options regarding the appearance of European banknotes has been narrowed down to two: a completely identical banknote to be issued throughout the single monetary area; and banknotes which are identical on one side, but which have a limited national feature on the other.

Further work is planned regarding the legal, institutional and organisational aspects of the issuing and post-issue handling of notes. Work has also started on the selection of themes on which to base the design of a banknote series. For this, the EMI has set up an advisory committee consisting of experts in history, psychology and graphic design.

European banknotes will have a technical specification incorporating the most advanced security features to prevent counterfeiting and to assist different user groups in readily recognising counterfeits. The specific purpose of each security feature will be carefully considered in order to integrate into the design those which will optimise the security effectiveness of the single-currency banknotes.

Preparatory work is also continuing on the practical aspects of the launching of the new European banknotes. Several options are being examined, taking into account such matters as timing, technical feasibility, costs, public acceptability and political considerations. Since this is an area of crucial importance for the credibility and acceptability of the single currency, the EMI is seeking close collaboration with the other competent bodies.

2.6 Establishment of the ESCB

The establishment of the ECB and the ESCB requires considerable preparatory work in several technical and institutional areas. One area where work has already started is that concerning the harmonisation of accounting procedures to make possible the construction of a consolidated balance sheet of the ESCB from the start of Stage Three. Indeed, harmonisation of accounting rules and standards is an indispensable prerequisite for the conduct of the single monetary policy and for the application of the ESCB Statute's provisions on the allocation of the monetary income of national central banks and on foreign exchange transfers.

As a first step, an inventory of the accounting methodologies applied by EU central banks was made. This work laid the basis for the development of an accounting methodology for the EMI. This methodology elaborated on, inter alia, the principles for the valuation of assets and liabilities and for the recognition of income, a chart of accounts, capitalisation and depreciation rules, accounting techniques and control procedures.

Work is now under way on preparing the ground for the harmonisation of accounting rules and standards in the ESCB. In developing an appropriate framework of accounting principles due regard must be given to the analytical and operational requirements for the proper functioning of monetary policy while also taking into account that an adaptable and transparent framework is desirable for all national central banks. Consideration has also been given to the legal issues involved in implementing the recommended harmonised accounting rules and standards in each Member State. Preparatory work is under way on the method of calculation of monetary income to ensure an equitable, controllable and transparent system.

The time schedule for the preparatory work leaves sufficient room for national central banks to implement the recommendations endorsed by the EMI Council including, if need be, through changes in domestic legislation.

Another field where preparatory work for the establishment of the ESCB has started is the information and communications system needed between the ECB and the national central banks. A number of tasks of the ECB and ESCB have been identified for which information and communications systems need to be prepared.

First, a flexible and effective teleconference facility will be required for the conduct of all ESCB activities in Stage Three. The present facility available to the EMI is limited primarily by a lack of expansion capabilities. Second, the information systems need to be able to support the exchange of non-statistical information within the ESCB, such as that necessary for policy decisions by the ECB and for ensuring the effective operation of the single monetary policy in Stage Three. They also need to be able to support the exchange of statistical information, such as data from monetary and foreign exchange policy operations as well as data concerning accounting and note issue functions and the financial and economic data required to conduct the common monetary policy. Third, technical analysis has to be conducted on the extent to which the execution of open market operations and foreign exchange market intervention can be decentralised; the information systems for the conduct of such operations will have to be designed accordingly. Fourth, an adequate information systems architecture is needed for the ECB's foreign exchange management and foreign exchange operations. Finally, in order to be able to process large-value payments safely and efficiently in Stage Three - in particular those stemming from the implementation of the single monetary policy - adequate information and communications systems will have to be implemented to support the TARGET system, to be established by interlinking national RTGS systems.

With the exception of the study on replacing the teleconference facility, specific development work on all the projects mentioned above can only commence when the relevant user requirements have been identified. It is intended that these functional requirements will be determined by the relevant EMI sub-committees and working groups as soon as possible.

3. Use of the ECU and oversight of the ECU Clearing and Settlement System

3.1 Use of the private ECU in 1993 and 1994

The use of the private ECU in 1993 and 1994 was strongly influenced by developments in the economic, legal and institutional environment. The tensions in the ERM in the first half of 1993 created uncertainty over the development of interest rates and exchange rates of the basket components and therefore over those of the ECU, both in the immediate future and in the longer term. The widening of the ERM fluctuation bands to ±15% on 2nd August 1993 heightened the markets' awareness of such risks. However, the ensuing gradual return to more orderly market conditions and the return of most currencies to levels within, or very close to, their former limits contributed to more stable market expectations.

At the legal and institutional level, the end of the uncertainties surrounding the ratification of the Treaty on European Union, and its entry into force as of 1st November 1993, brought the prospects for EMU back to the fore. In accordance with Article 109g of the Maastricht Treaty, the composition of the ECU basket was frozen as from the coming into effect of the Treaty, reducing uncertainty about the future value of the ECU. In April 1994 the European Commission adopted three legal documents aimed at reassuring markets about the current and future legal status of the ECU in financial and other contracts. The package included a proposal for a Council Regulation consolidating existing legislation on the currency composition of the ECU basket, subsequently adopted by the Council, a Commission Recommendation on the legal treatment of the ECU and of contracts denominated in ECUs, and a Commission Explanatory Note on new clauses in its bond issue prospectuses ensuring legal continuity between the basket ECU and the future single currency.

Notwithstanding the progress made on the legal and institutional framework, remaining uncertainties and adverse developments in bond markets world-wide for most of 1994 prevented a return to the more favourable conditions which had been enjoyed before the ERM turmoil. However, on the whole, the ECU markets have shown some resilience in the face of the difficult period of ERM tensions, the changing market perceptions regarding the timetable for EMU and, more recently, world-wide depressed bond markets.

Table 11 **ECU financial markets**

(Outstanding stocks at end-period; in billions of ECUs)

	1991	1992	1993	1994			
	Q3	Q3	Q3	Q1	Q2	Q3	Q4
Bonds	111.4	130.3	126.5	125.1	125.4	124.4	124.6
of which:							
- International	72.3	86.3	80.2	75.6	73.5	71.6	70.6
- Domestic	39.1	44.0	46.3	49.5	51.9	52.8	54.0
(National) Treasury bills	7.9	6.9	8.3	6.2	5.4	4.7	3.5
Euro-CPs and Euro-notes	9.5	8.6	6.5	6.1	6.1	6.4	6.7
Estimated bank lending [(a)]	60.7	66.5	66.6	65.4	61.9	59.9	...
Total:	189.5	213.3	207.9	202.8	198.8	195.4	...
Estimated double-counting [(b)]	-20.0	-20.0	-20.0	-20.0	-20.0	-20.0	...
Estimated total market size	169.5	193.3	187.9	182.8	178.8	175.4	...
Bank assets of which:	175.7	198.0	196.0	188.2	182.4	176.4	...
- vis-à-vis non-banks [(c)]	46.1	61.6	61.0	59.0	55.4	54.6	...
Bank liabilities of which:	180.9	200.7	191.9	186.3	180.3	173.1	...
- vis-à-vis non-banks [(c)]	28.7	34.9	30.9	28.4	27.5	26.9	...
Memorandum items:							
Central banks' holdings of private ECUs	28.8	18.9	19.1	24.1	24.8	24.0	23.7
Turnover of ECU securities [(d)]	1143.7	1473.6	333.6	370.3	395.0	402.0	...
% of total turnover in all currencies	*16.0*	*13.3*	*6.1*	*5.5*	*6.6*	*6.9*	...

Source: BIS, Euroclear and Cedel.

(a) *Final lending and lending to banks outside the reporting area.*

(b) There is an overlap between the securities and banking markets owing to the role of banks as issuers and holders of ECU securities. In the absence of comprehensive data, this overlap may only be estimated.

(c) Identified non-banks only.

(d) Primary and secondary market. Euro and domestic straight bonds, convertibles, floating rate notes, CDs, short and medium-term notes.

After declining by 2.8% between September 1992 and September 1993, the estimated overall size of the ECU financial markets further contracted (by 6.6%) over the twelve months to September 1994. From the peak reached in September 1992, the ECU financial markets shrank by 9.2%, although they were still 3.5% larger than in September 1991.

In the banking sector, ECU lending and borrowing activity has not yet recovered from the decline experienced in the second half of 1992. After having stagnated throughout the first three quarters of 1993, total outstanding amounts of ECU-denominated international bank assets and liabilities fell by 9.9% and 9.7% respectively in the year up to end-September 1994. Interbank transactions remained predominant, accounting for almost 70% of outstanding ECU-denominated assets and nearly 85% of banks' liabilities. Given the expansion in international lending and borrowing activity, the ECU's market share dropped to 2.7%, compared with 3.0% at end-September 1992. This downward movement occurred despite a sizable build-up of central banks' private ECU holdings.

The ECU bond market also suffered from the ERM turmoil in 1992 and 1993. However, issuing activity, which had almost dried up in late 1992 and early 1993, resumed again thereafter. Led initially by EU Member States and institutions committed to developing the ECU markets and to maintaining satisfactory liquidity conditions, issuing activity has more recently also involved private sector participants. Nevertheless, activity remained subdued compared with the levels reached before the ERM crisis. Gross issuing fell slightly short of redemptions during 1993 and 1994, leaving the total outstanding stock stagnating just below the end-September 1992 level. Secondary bond market liquidity, which had suffered in the second half of 1992, recovered partly thereafter. The number of market-makers in ECU bond transactions fell as a result of depressed market conditions. Only a few large ECU bond issues could be regarded as truly liquid by end-1994. Investors either shifted the maturity of their ECU holdings towards shorter maturities or closed their ECU positions to switch to other more liquid bond markets, particularly those in Deutsche Mark, French francs and US dollars.

The relatively small market for ECU-denominated short and medium-term paper in the Euro-market was broadly flat in absolute terms throughout the reporting period, compared with well-sustained activity in other currencies, which led to a fall in market share. Outstanding amounts in domestic ECU Treasury bills were constant in the United Kingdom and declined in Italy.

The evolution of the ECU derivatives markets mirrored developments in the underlying markets. Turnover in the MATIF long-term interest rate ECU bond futures contract had already settled down in early 1993 from its peak in 1992 and was again approaching the levels seen before the ERM turmoil by the second quarter of 1994 before stabilising thereafter. In the LIFFE, three-month interest rate futures contracts recorded historically high turnover in the months preceding and following the widening of the ERM fluctuation bands. Thereafter, turnover fell back again but stabilised in the second half of 1994 around levels well above those recorded before the ERM tensions.

In contrast with the second half of 1992, the ERM tensions in the first half of 1993 did not result in the emergence of a significant spread between the theoretical basket value and the market exchange rate of the ECU, except in the period before and after the widening of the ERM fluctuation bands when the spread rose to 150 basis points. The gradual return to calmer exchange market conditions helped to narrow spreads substantially towards the end of 1993. From the second quarter of 1994 onwards, spreads widened again to 50 basis points and remained around this level until end-September 1994. In the last quarter of 1994 the spread was partly reabsorbed. The above-mentioned sell-off of ECU bonds in rather illiquid market conditions may help to explain this latter development.

The spreads between the market and theoretical interest rates remained within a comparatively narrow range throughout 1993 and 1994. For short-term maturities (three-month Euro-deposit rates), the spread was alternatively positive and negative, remaining within a range of 50 basis points. For longer-term maturities, changes in the spread between market and theoretical yields traced contemporaneous developments in short-term interest rate spreads more closely than in the past. Until the first half of 1994, market rates were slightly below theoretical yields (in a range of 10 to 50 basis points); in the second half of 1994, virtually no spread was observed.

Regarding the legal status of the ECU, a survey carried out by the former Committee of Governors in November 1993, following a comprehensive review by the EU Commission on the existence of regulatory obstacles to the use of the ECU, confirmed that in all but two EU Member States the ECU is formally regarded as a foreign currency. Furthermore, the lifting of remaining exchange restrictions on capital flows has reduced the differential treatment of foreign currencies, including the ECU, in relation to national currencies.

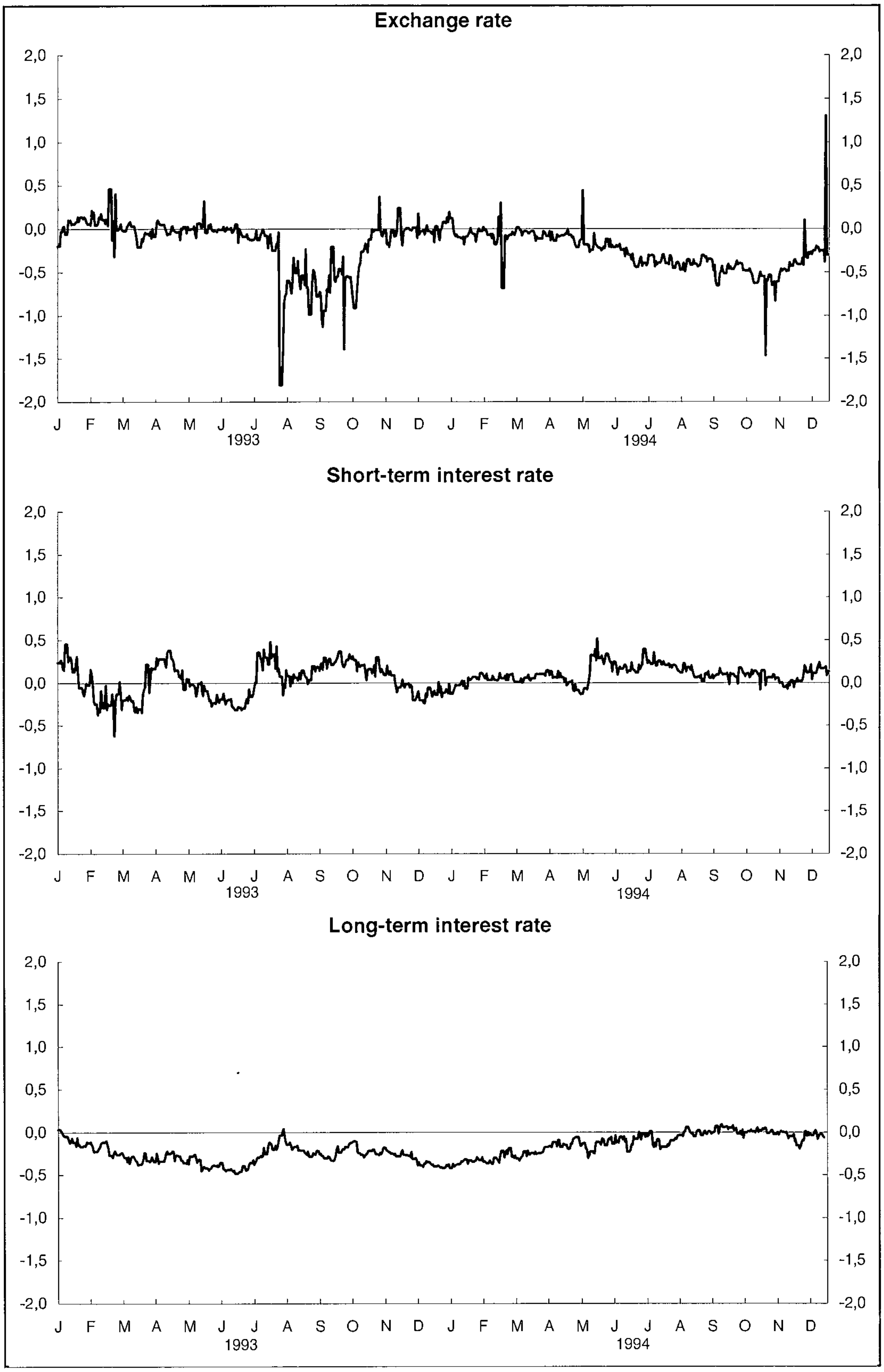
Recently, several initiatives have been undertaken to improve the statistical coverage of the use of the ECU in non-financial transactions, the denomination of financial flows within the EU budget, and ECU-denominated transactions in balance-of-payments statistics. As one of these initiatives, in late 1994, the European Commission conducted a survey based on an analysis of the transactions which give rise to settlements processed through the ECU Clearing and Settlement System. The sample results suggest that the total yearly value of non-financial ECU transactions is equivalent to around ECU 88 billion, which accounts for approximately 1% of all ECU transactions settled through the ECU Clearing and Settlement System.

3.2 Oversight of the ECU Clearing and Settlement System

The ECU Clearing and Settlement System was set up in February 1986 and became fully operational in April 1987. It is a private system conceived and developed in order to replace the old clearing scheme for the settlement of ECU balances based on mutual settlement accounts denominated in the basket component currencies, which had been set up in 1982 by a small group of commercial banks active in the ECU market. It is the only system which processes and settles transactions in ECUs. Participating clearing banks process their own payment orders and those executed on behalf of their correspondent banks which maintain ECU accounts with them. Clearing banks settle their multilateral net positions through accounts held at the Bank for International Settlements.

Chart 9 **Difference between market and basket ECU rates**

(in percentage points)



Source: National data.

In 1994, 45 clearing banks participated in the System, which processed about 6,000 transactions per day with an average daily turnover of ECU 50 billion. The ECU Clearing and Settlement System is the third-largest automated net settlement system in the European Union after the EAF in Germany and CHAPS in the United Kingdom.

The oversight of the ECU Clearing and Settlement System started in 1992 within the framework of the Committee of Governors. As of January 1994, the EMI took over this responsibility by virtue of the tasks assigned by the Treaty. The oversight of the ECU Clearing and Settlement System has the fundamental objective of assuring EU central banks that: (a) the operations of the clearing do not pose unacceptable systemic risks either to the ECU market or to EU domestic markets; (b) the risks run by the banks by virtue of their participation in the system are controlled.

Within this framework the EMI seeks to ensure that the ECU Banking Association (EBA), which manages the System, takes action to reduce substantially the level of systemic risks involved. This policy is consistent with the risk reduction policies which are being followed by the EU central banks in their own countries. Through regular contacts with the EBA Secretariat, the EMI receives information on the functioning of the clearing on a regular basis and keeps EU central banks informed of its findings. Direct discussions between the clearing banks and their respective central banks complement the action of the EMI.

Over time there has been an intensive dialogue with the EBA and a series of steps have been taken towards improving compliance with the safety standards laid down in the 1990 Report on Interbank Netting Schemes. The first measure, implemented in 1993, is a system of limits for the multilateral net positions which participants are allowed to incur at the end of each working day. The purpose of this measure is to encourage the banks to manage their payment flows better in order to reduce the risks they run and those they generate for other participants. These limits provide the basis for a liquidity sharing and loss sharing agreement designed to ensure the end-of-day settlement of the clearing, even in the event that the largest debtor bank is unable to settle its obligations at the end of the day.

The present arrangements provide only for financial sanctions when limits are breached, but do not prevent the System from accepting a payment which would lead one clearing bank to exceed its limits. The EBA has therefore accepted the need to introduce binding intraday limits which will be enforced by June 1996 on a continuous basis during the working day. Moreover, although the technical facility for intraday limits will not be fully implemented before June 1996, the capacity to monitor intraday positions will be in place sooner and should allow for an earlier voluntary agreement by the clearing banks not to exceed the limits. In addition to these measures, the EMI Council has also drawn the attention of the EBA to the need to introduce collateral facilities in the settlement process and to the need to improve the legal basis of the clearing through contractual arrangements.

Concerning the future of the ECU Clearing and Settlement System in Stage Three of EMU, the System may continue to operate in Stage Three as a private net settlement system in parallel to and competing with other systems provided that it complies with acceptable safety standards.

4. Co-operation between central banks

4.1 Payment systems

Co-operation between the national central banks in the field of payment systems has focused on three main issues: (a) the co-operative oversight of payment systems; (b) the achievement of minimum common features in domestic payment systems; and (c) prepaid cards.

Co-operative oversight in the field of payment systems

The central banks of the Member States oversee developments in their domestic interbank markets and in the payment and settlement systems which support these markets. This task stems directly from their primary function of provider of central bank money, the ultimate means of payment in the economy. The main objective of oversight is to seek to ensure the smooth functioning of payment systems and to protect the financial system from possible "domino effects" which may occur when one or more participants in the payment systems incur credit or liquidity problems. In contrast with banking supervision, payment systems oversight aims at a given system (e.g. a funds transfer system) rather than at individual participants.

Principles for co-operative oversight of cross-border participation in domestic payment systems were established by EU central banks as a response to the challenges arising from the implementation of the Second Banking Co-ordination Directive (2BCD) adopted by the EC Council in 1988. The Directive laid down principles according to which primary responsibility for the supervision of branches of credit institutions authorised in another EU country was to be given to the authorities of the "home country" (i.e. the Member State in which the credit institution has been incorporated), while limited competence was to be left to authorities of the "host country" (i.e. the Member State where the payment system is located). As of end-November 1994, 162 branches of foreign credit institutions participated directly in other EU large-value funds transfer systems, including 107 branches of banks of other EU countries and 55 branches of non-EU banks. Without co-operative oversight, the "host" central banks could have lacked the information needed for the purpose of overseeing their country's payment system, which was previously obtained from the direct supervision of those foreign branches.

Arrangements for co-operation among the various authorities were established in 1993 within the framework of the Committee of Governors. They consisted of general agreements governing the exchange of information between central banks and other banking supervisors within the limits of the secrecy obligations of supervisors. It was agreed that under normal circumstances the exchange of information across borders would only take place between central banks or between bank supervisors, and that an "Observatory" of EU Payment Systems would be established at the EMI.

The Observatory, which was created in September 1994, collects and despatches information with a low degree of confidentiality, and keeps up-to-date records on: the operational rules of member countries' interbank funds transfer systems; the list of senior managers at EU central banks who may be contacted should problems arise in the field of payment systems, in order to facilitate the flows of information between central banks especially in the event of crisis situations; and cross-border participants (and remote participants, if any) in EU interbank funds transfer systems.

Definition of the minimum common features for EU payment systems

A comparative analysis of payment systems in the EU was conducted by the Committee of Governors in 1992 and is contained in a report, published in September 1992, on "Payment Systems in EC Member States", also known as the "Blue Book" (a new edition of which will be published in 1996). The report revealed significant differences among EU countries' large-value funds transfer systems, especially in terms of access conditions, risk control measures, legal and technical aspects, pricing policies and opening hours.

Differences between domestic interbank payment systems can affect the smoothness of cross-border payments and distort competitive conditions. They may also create risks for the integrity and stability of domestic and cross-border payment arrangements since the integrity of the system as a whole depends on its weakest element. Finally, differences may create opportunities for regulatory arbitrage, inducing participants to effect their payments through less costly but possibly insufficiently protected systems. The effects of these distortions may increase in a unified monetary area. To avert these risks, it is necessary that interbank funds transfer systems share certain minimum common features on which the integrity and security of the systems as a whole depend. The EU central banks' objectives in this field are described in the report on "Minimum common features for domestic payment systems", published by the Committee of Governors in November 1993. The report sets out ten principles for the harmonisation of domestic systems, relating to access, risk control and legal, technical and operational characteristics.

The most important line of action, with a view to minimising the systemic risk inherent in interbank payment circuits, is to establish in all member countries a real-time gross settlement (RTGS) system for large-value payments. This type of system makes it possible to eliminate the risks stemming from the delay between payment message transfer and settlement inherent in net settlement systems. In addition, it provides an important facility not only for the ultimate settlement of obligations arising from transactions routed via other netting systems but also for a variety of different forms of delivery-versus-payment arrangements in securities markets and in foreign exchange markets. Furthermore, real-time gross settlement systems will be linked so as to build an EMU-wide RTGS system for Stage Three.

A second line of action is to allow large-value net settlement systems, which settle via central bank accounts, to continue operating in parallel with RTGS systems, provided that they settle on a same-day basis and meet fully the safety standards set out in the Report on Interbank Netting Schemes, published by the Bank for International Settlements in 1990.

A third line of action emphasises the need to set standards to control access to payment systems. Access to interbank funds transfer systems should be strictly restricted to credit institutions subject to supervision, as defined in the 2BCD, some public entities and some adequately supervised financial institutions, because only these institutions are able to meet appropriate standards in terms of financial strength, management skills and the ability to provide liquidity within a very short period of time. No discrimination between home-based credit institutions and credit institutions authorised in other EU countries should exist in this field. Moreover, transparent requirements for access, as well as procedures for excluding or suspending participants from a system, should be set out in a public document. Finally, other principles concerning the legal basis of domestic payment systems, the need for compatible banking standards and efficient channels of communication between domestic payment systems, central banks' pricing policies and the operating hours of the major EU payment systems are discussed in the above-mentioned report.

With the help of EU central banks, the EMI conducted a general assessment of the main features of EU interbank funds transfer systems vis-à-vis the principles set out in the November 1993 report. The main results are contained in a report on "Developments in EU payment systems in 1994", which represents the follow-up to the 1993 report and was released to the banking communities in February 1995.

The report confirms that the most important work currently in progress in the field of payment systems is the design and implementation of RTGS systems in all EU countries. Although RTGS systems are in operation in only six countries and most large-value payments are settled through net settlement systems, it is now envisaged that RTGS systems for large-value payments will be in operation in all EU countries but two by end-1996. In nine EU countries RTGS systems are expected to process all large-value payments by that time. Therefore, co-operation should continue between credit institutions and central banks in order to avoid delays in the implementation of these systems, in particular in view of the realisation of the TARGET system in Stage Three.

Risk control measures have been introduced in some net settlement systems. In some countries such systems are likely to disappear, at least for large-value transfers, when RTGS systems are fully operational. Moreover, new fields of action for the EMI and EU central banks have been envisaged. First, the conditions under which credit institutions which have no physical presence in a Member State can become direct participants in that country's payment system (the "remote access" issue) requires further study. Second, work will continue in order to ensure that the legal basis of domestic payment systems is sound and enforceable. Work is currently in progress in order to eliminate by 1996 current uncertainties within, and inconsistencies between, domestic legal systems.

Finally, closer attention will be paid to the issues related to retail payments, in keeping with the provisions of the Maastricht Treaty, which entrust the EMI with the task of "promoting the efficiency of cross-border payments" ahead of Stage Three. In particular, the EMI will encourage the banks to avoid the proliferation of non-compatible standards.

Prepaid cards

The multi-purpose prepaid card (or electronic purse) is a plastic card which contains effective purchasing power for which the customer has paid in advance. Cards which can be used for one purpose only (e.g. telephone cards) or for a limited range of services (e.g. within the premises of a corporation) are not considered as being in this category. Although developments in the field of electronic purses are only at an early stage, there is a real possibility of the proliferation of such cards in the future. In particular, if electronic purses were used in a great number of retail outlets, they would become a direct competitor not only to other cashless payment instruments but also to banknotes and coins issued by central banks and other monetary authorities.

Given the potential of prepaid cards to attain widespread acceptance, the matter has been analysed by the EMI and the EU central banks. A report on prepaid cards was released to the banking community and to the other interested institutions in May 1994. The analysis set out in the report had two objectives: (a) to check that the introduction of this new payment instrument would have no adverse effect on public confidence in the payment system and in payment media; and (b) to evaluate the practical implications of the possible developments of prepaid cards on central banks' activities.

The most important conclusion of the analysis is that the right to issue electronic purses should be limited to credit institutions in order to: (a) protect consumers from the consequence of the failure of the issuers; (b) protect the integrity of retail payment systems; (c) facilitate the conduct of monetary policy; and (d) ensure fair competition between issuing institutions.

In the case of prepaid card schemes already in operation before May 1994, the respective national central bank may agree that electronic purse issuers do not have to be fully-fledged credit institutions provided that: first, they provide only domestic payment services; second, they are subject to appropriate regulations, in particular with respect to liquidity requirements; and, third, they are supervised by the national authority responsible for supervising credit institutions.

Under the aegis of the EMI, EU central banks will continue to exchange information on any major prepaid card scheme and monitor the development of this new payment instrument.

4.2 Banking supervision

According to the EMI Statute, it is a primary task of the EMI to "hold consultations concerning issues falling within the competence of the national central banks and affecting the stability of financial institutions and markets". While responsibility for executing prudential supervision remains within the competence of national authorities, the EMI is entrusted with the task of promoting co-operation on issues of a macro-prudential nature having a bearing on the stability of financial institutions and markets. To fulfil this duty the EMI is assisted by the Banking Supervisory Sub-Committee, which is composed of representatives of central banks and specialised supervisory bodies. In

1993-94 the consultations among national supervisory authorities dealt with a number of issues including: (a) the implementation of the Second Banking Co-ordination Directive; (b) crisis management; (c) insolvency; (d) financial fragility; (e) central credit registers.

Second Banking Co-ordination Directive (2BCD)

On 1st January 1993 the 2BCD was implemented, thereby setting up the Single Market for the banking sector. This Directive provides EU-based credit institutions with the freedom to supply financial services throughout the European Union via the establishment of branches and on a cross-border basis. In this context, supervisory activity is based on the principle of "home country control", according to which the responsibility for supervision rests primarily with the authorities of the Member State where the credit institution has been authorised. This principle is also applicable to credit institutions which have been authorised by countries which are parties to the EEA Agreement (except in cases where different reciprocity provisions vis-à-vis third countries exist).

The implementation of this principle requires close co-operation between the home and the host country supervisory authorities. This objective has been pursued by means of bilateral agreements (memoranda of understanding) between the supervisory authorities of the Member States. The consultations among supervisory bodies have devoted considerable attention to the analysis of several policy aspects related to the practical implementation of the Directive that have arisen in particular in the course of the completion of the memoranda of understanding.

Crisis management

Against the background of the implementation of the 2BCD and the difficulties faced by some international banks, consideration has been given to issues related to the origin of banking crises and their management from the perspective of the supervision of EU-based credit institutions. In particular, the exchange of views focused on the need for both the sharing of information among banking supervisors and the co-ordination of supervisory action in an emerging crisis situation, given that the memoranda of understanding deal mainly with exchanges of information on an ongoing basis and to a lesser extent with co-operation in the management of banking crises.

Although every crisis has unique features and has to be managed in the light of the particular circumstances, it was deemed to be worthwhile to draw up a set of principles to assist banking supervisors who are confronted with an emerging crisis involving a bank with a multiple presence in the European Union. One of the main principles is that the home country supervisor should be the co-ordinator ("lead supervisor") of the information flows and any supervisory action. To be fully effective these principles have to take account of the action of non-EU supervisors in cases where credit institutions engage in operations outside the European Union.

In the context of the management of banking crises, the interface between the banking supervisory activity and the "lender of last resort" function has been analysed with the aim of providing a descriptive survey of the current situation in the Member States.

Insolvency issues

Consultations dealt with aspects relating to the orderly liquidation of a bank with a multiple presence in the European Union. It was recognised that the different judicial arrangements and insolvency procedures in each Member State may create difficulties for the co-ordination of supervisory action.

First, there is the question of the consistency between the principle according to which the main responsibility for the prudential supervision of branches rests with the home supervisor and insolvency proceedings, which remain subject to national legislation. In particular, the EU countries' supervisors, as host authorities, do not all have identical powers to initiate action against a branch of a foreign bank, which could represent an obstacle to the co-ordination of activity with supervisors in other Member States. Second, insolvency proceedings initiated against a bank in the home country may not be recognised in other jurisdictions where this bank has branch operations. Third, the existence of various liquidation regimes which entail a different treatment of assets (the single-entity and separate-entity approaches) may result in discrimination among depositors in the Member States.

These issues were submitted to the Council of the European Communities by the Chairman of the Committee of Governors, who urged that work be continued as a matter of priority on the proposal for a Winding-Up Directive with a view to establishing harmonised insolvency arrangements across the European Union. Given the fact that insolvency proceedings may involve countries outside the European Union, the parallel work carried out in this field by the Basle Committee on Banking Supervision was also taken into account.

Financial fragility

The financial fragility of credit institutions (the existence of actual or prospective pressures which could undermine the financial soundness of an institution), is at the core of the supervisory function. Difficulties experienced by an individual institution may affect other banks in a way which could threaten the banking system as a whole (systemic risk). In the context of the consultative process, a survey has been conducted on the ways in which financial fragility manifests itself in the banking system and the related effects. One of the main findings which emerges from this analysis is that the degree of fragility within the banking system may have increased significantly over the past few years. Particular attention has been devoted to the fact that credit risk remains the principal category of risk to which credit institutions are exposed and has been the primary source of losses.

In a changing operating environment, credit institutions are confronted with intensified competitive pressures, not only within the banking system itself but also, to some extent, from non-bank financial institutions. Traditional lending activities are carried out in a more competitive context and this may be leading to a longer-term weakening of credit institutions' profitability. Moreover, the competitive pressures, along with technological developments, induce credit institutions to move away from traditional banking business and to search for profit opportunities in new areas of activity (securities, derivatives, non-financial instruments, etc.), which expose them to a wide range of potential risks.

The rapid evolution of the financial system poses new challenges for the supervisory function, which is required to assess the adequacy of the credit institutions' strategy in the light of their management resources and overall market conditions. In this respect, the above-mentioned survey highlights some supervisory concerns which arise from an analysis of the banks' responses to market forces.

In the light of the outcome of the survey, it was decided to undertake further work in this field, focusing on the changes which have occurred over the past few years in the ways in which banks manage their credit risk, with particular regard to their risk selection, pricing and monitoring activities. In future, attention will be given to the early warning signals of financial fragility and the factors which could affect the competitive viability of banks in the long term.

Central credit registers

An analysis of the features and functions of central credit registers (CCRs) in the Member States and the impact of the Second Banking Co-ordination Directive on their potential effectiveness represented another issue for discussion.

In 1994 a six-month experiment was conducted among the credit registers of five countries (Belgium, France, Germany, Italy and Spain) to exchange information on borrowers for supervisory purposes. The experiment proved successful and it was therefore decided to continue the sharing of information on a permanent basis; this will include the other two EU countries which maintain credit registers (Austria and Portugal), as soon as they overcome a number of legal problems.

In order to allow Member States which do not have a credit register to assess the usefulness of such an instrument, these countries will be permitted as an experiment to have access - free of charge, for a limited period of six months and only for supervisory purposes - to the data held in the registers; in return, these countries will have to provide data on large exposures, if requested to do so by their counterparties.

Most of the CCRs are designed to provide data for the reporting banks, since this is deemed to be an integral part of the supervisory process. The information contained in the registers may actually be used by banks to improve their credit risk management procedures. Therefore, the technical and legal problems which prevent the reporting banks from having access to the registers on a cross-border basis are being analysed with a view to finding some solutions.

5. Other tasks

5.1 Operational tasks (EMS/EMCF)

Pursuant to Article 109f (2) of the Treaty, the EMI took over the tasks previously performed by the European Monetary Co-operation Fund (EMCF) with effect from 1st January 1994. These tasks relate to the administration of the mechanisms of the European Monetary System (EMS) (the Very Short-Term Financing mechanism, the Short-Term Monetary Support mechanism, the creation of ECUs for the purpose of implementing the EMS Agreement), and the administration of borrowing and lending operations concluded by the Community under the Medium-Term Financial Assistance mechanism.

In accordance with Article 1.3 of the Statute of the EMI, all assets and liabilities of the European Monetary Co-operation Fund (EMCF) were automatically transferred to the EMI with effect from 1st January 1994. However, the administrative aspects of the EMI's operational functions have so far been performed by the BIS on the basis of an agreement between the latter and the EMI. As from May 1995 this administrative function will be fully taken over by the EMI.

EMS mechanisms

The EMI carries out operations associated with the creation, utilisation and remuneration of official ECUs. This involves, in particular, swap operations with the EU central banks participating in the Exchange Rate Mechanism (ERM), or contributions of reserve assets against official ECUs on a voluntary basis. As a result of these swaps, official ECUs are issued to participating central banks against the contribution of 20% of their gold holdings and gross US dollar reserves. These swap operations are renewed every three months, which allows for the necessary adjustments to be made in order to: first, ensure that each central bank's contribution to the EMI continues to represent at least 20% of its gold and US dollar reserve holdings at the end of the month preceding the renewal date; and, second, take account of changes in the price of gold and in the US dollar exchange rate vis-à-vis the ECU. The results of these operations are shown in the Annual Accounts enclosed with this Report.

The amount of official ECUs issued by the EMI under the last three-month swap transaction within the period of reference, which took place on 11th October 1994, reached ECU 56.6 billion. Compared with end-1993, the stock of ECUs created through swaps rose by more than ECU 3 billion. This increase was primarily due to a rise in contributing central banks' US dollar assets and in the price of gold, while a decrease in the US dollar/ECU exchange rate was a negative contributory factor.

Given their status of "Other Holders" of ECUs, the Oesterreichische Nationalbank and the Swiss National Bank acquired ECUs through swap operations with some EU central banks; at end-1994 the official ECUs held by the two central banks amounted to ECU 60 and 63.5 million respectively.

Following the accession of Austria, Finland and Sweden to the EU on 1st January 1995, the Oesterreichische Nationalbank, Suomen Pankki and Sveriges Riksbank became parties to the Agreement of 13th March 1979 laying down the operating procedure for the European Monetary System (EMS) and the Agreement of 9th February 1970 setting up the Short-Term Monetary Support mechanism (STMS). The Oesterreichische Nationalbank became a member of the ERM, with effect from 9th January 1995, which entailed its participation in the ECU swap mechanism from that date; its status of "Other Holder" was consequently terminated. While Suomen Pankki and Sveriges Riksbank decided not to participate for the time being in the ERM, they expressed their intention to make voluntary contributions of gold and US dollars against ECUs to the EMI. Suomen Pankki made its initial voluntary contribution on the occasion of the quarterly renewal of swaps on 11th January 1995.

In addition to the creation of official ECUs, the EMI also deals with the utilisation of the participating central banks' ECU holdings. This involves transfers of official ECUs between the central banks' ECU reserve accounts, in particular in respect of the settlement of debts and claims arising from intervention funded through the Very Short-Term Financing mechanism (VSTF), voluntary transactions between the central banks participating in the EMS, the payment of interest calculated on central banks' net ECU positions and operations under the ECU mobilisation mechanism. The latter mechanism has not been activated since 1986.

The EMI records in its books - in ECUs - the debts and claims vis-à-vis the EMI of the EU central banks participating in the ERM, which arise from intervention carried out by those central banks in other member countries' currencies and funded through the VSTF. It also records the settlement of these balances under the VSTF. No use was made of the VSTF in 1994. Following an early repayment by the Banque de France, all remaining debtor and creditor accounts were closed in January 1994.

The EMI enters in its books the operations carried out in the framework of the Short-Term Monetary Support mechanism (STMS), which was established to enable a participating central bank to apply for short-term financial support in case of need as a consequence of a temporary balance-of-payments deficit, due to unforeseen difficulties or to conjunctural divergences. However, this facility has not been activated since 1974.

Community loans

In accordance with Article 10 of Council Regulation (EEC) No. 1969/88 of 24th June 1988, the EMI administers the borrowing and lending operations concluded by the Community under the Medium-Term Financial Assistance mechanism. The mechanism provides for loans to be granted to Member States which are experiencing or are seriously threatened with difficulties in their balance of payments (current or capital account). The EMI effects payments arising from these borrowing and lending operations. It verifies the maturity dates laid down in the borrowing and lending contracts for the payment of interest and repayment of the principal and reports to the Commission on the operations carried out for the account of the EU.

In 1994 the EMI continued to receive from borrowers, namely Greece and Italy, and to pay to creditors vis-à-vis the Community, the sums due in respect of interest, commission and expenses on outstanding loans. The following table shows, as at 31st December 1994, the total of outstanding Community lending operations.

Table 12 **Outstanding Community loans**
(at 31st December 1994 in millions)

	Outstanding amounts in Deutsche Mark	Outstanding amounts in ECUs	Total outstanding amounts in ECUs
Greece	536	740	1,021
Italy	3,900	1,975	4,022
Total	4,436	2,715	5,043

Source: EMI

5.2 Advisory functions

Article 109f (6) of the Treaty establishing the European Community and Article 5.3 of the Statute of the EMI require that the EMI be consulted by the Council of the European Union or the responsible national authorities, as appropriate, on any proposed Community or national legislation within its field of competence. The limits and conditions of consultations on draft legislation by national authorities are set out in Council Decision 93/717/EEC of 22nd November 1993. Article 1 of this Decision states that "Member States shall consult the EMI in particular on:

- currency legislation, the status of the ECU and means of payment;
- the status and powers of national central banks and the instruments of monetary policy;
- the collection, compilation and dissemination of monetary, financial, banking and balance-of- payments statistics;
- clearing and payment systems, in particular for cross-border transactions;
- rules applicable to financial institutions, insofar as they influence the stability of financial institutions and markets".

Twelve requests for consultations were received in 1994: five came from the Council of the European Union and seven originated from national authorities.

The consultations from the Council of the European Union concerned: a Council Regulation on the consolidation of the existing Community legislation on the definition of the ECU following the entry into force of the Treaty of the European Union; a Council Regulation on Community action in the field of statistics; an amendment of a Directive on a solvency ratio for credit institutions as a result of the acceptance of various forms of (bilateral) contractual netting; an amendment of a Directive on Undertakings for Collective Investments in Transferable Securities (UCITS); and an amendment of a Council Decision establishing a Committee on Monetary, Financial and Balance-of-Payments Statistics.

Out of the seven consultations by national authorities, four dealt with the status and powers of national central banks or instruments of monetary policy, whilst in two cases the stability of financial institutions and markets was involved.

The EMI's benchmark for the assessment of the consultations was primarily the compatibility of the proposed legislation with the Treaty establishing the European Community, whilst the potential impact on future arrangements for Stage Three of EMU and, in appropriate cases, the question as to whether the stability of financial institutions and markets would be affected by the legislation were also examined.

5.3 Co-operation with other institutions

In the performance of its tasks the EMI co-operates with other bodies of the European Union in a number of forms and on an number of levels. According to Article 11.1 and 11.2 of the Statute, the President of the Council of the European Union and a member of the European Commission may participate in the EMI Council meetings, without the right to vote. In turn, the President of the EMI shall be invited to attend meetings of the Council of the European Union whenever matters relating to the objectives and tasks of the EMI are discussed. This includes the President's attendance at informal ECOFIN Council meetings, normally held twice a year. The President of the EMI may also appear before the competent committees of the European Parliament at the request of the European Parliament or on his own initiative.

At the working level, the EMI is invited to attend the meetings of the Monetary Committee as an observer. Co-operation linkages exist also with the European Commission, including EUROSTAT (its statistical office) and through the Committee on Monetary, Financial and Balance-of-Payments Statistics. Furthermore, the EMI co-operates with the national Mint Directors, representing the institutions which are responsible for producing the coins which will be circulated alongside the single European banknotes in Stage Three.

Contacts also exist with several institutions outside the Community. For example, within the framework of the "concertation procedure", which provides for an exchange of data on exchange market developments, intervention and other official foreign exchange transactions, the Foreign Exchange Sub-Committee regularly exchanges information with non-EU central banks - essentially central banks which are members of the Group of Ten countries.

The linkages with the central banks of Norway and Switzerland that had been established under the Committee of Governors have been continued and consultations on matters of common interest have been held regularly. Furthermore, bilateral swap agreements with the central bank of Norway, which were concluded for the first time in

December 1990 in order to provide access to short-term funds for the implementation of Norway's exchange rate policy, were extended for a further one-year period at the end of 1994.

The EMI maintains a range of important links with the Bank for International Settlements (BIS), which since 1964 has provided the human and technical resources for the functioning of the Secretariat of the Committee of Governors and provided technical support for the setting-up of the EMI. After the move of the EMI to Frankfurt, the co-operation has continued, in particular in the statistical field. The BIS has continued to perform the function of Agent for the EMI on an interim basis (see Section 5.1 above).

The EMI has also established contacts with the Bretton Woods institutions: the EMI has been invited to attend the Annual Meetings of the International Monetary Fund (IMF) and the World Bank as an observer. At the technical level, co-operation between the IMF and the EMI takes place in the field of statistics and in the framework of the IMF's increasing emphasis on regional surveillance.

CHAPTER III

INSTITUTIONAL FEATURES OF NATIONAL CENTRAL BANKS

INTRODUCTION

The Treaty implies that several institutional features of national central banks have to be modified in the course of the realisation of EMU. In accordance with Article 108 of the Treaty, each Member State shall ensure, at the latest at the date of the establishment of the ESCB, that its national legislation including the statute of its national central bank is compatible with the Treaty and the Statute of the ESCB.[1] Article 109e (5) stipulates that the process leading to the independence of central banks should start during Stage Two. The prohibition on central banks extending overdrafts or any other type of credit to the public sector provided for in Article 104 of the Treaty applies as from the start of Stage Two (see Article 109e (3) of the Treaty).[2] Furthermore, any measure granting privileged access by public bodies to financial institutions should have been eliminated by 1st January 1994.

A. STATUTES AND INDEPENDENCE

Before the start of Stage Three, the statutes of the central banks of the Member States have to be adapted in order to be compatible with those of the ESCB, in particular in respect of the provisions concerning independence and the primary objective of promoting price stability. Progress towards compatibility with the Treaty is a matter on which the EMI is required to report to the Council of the European Union in accordance with Article 109j (1). The EMI envisages producing a first report of this kind in the autumn of 1995 under Article 7 of the EMI Statute.

The Treaty on European Union lays down a clear mandate for the ESCB to maintain price stability. To fulfil this mandate, it is important that the decision-making authorities of the ESCB are not subject to directives from other bodies which could conflict with this objective.

In consequence, the Statute of the ESCB lays down a number of provisions to ensure that the System will be independent in the performance of its assigned tasks. In particular, the Statute specifies that the ECB, the national central banks and any member of their decision-making bodies shall act without receiving instructions from national or Community authorities. Moreover, the Statute guarantees that members of the decision-making bodies are provided with assured tenure to carry out their duties. In addition to the provisions specifying political or institutional independence, the economic or practical independence of the System is confirmed by functional, operational and financial provisions embodied in the Statute.

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[1] This provision does not apply to the United Kingdom as long as it does not participate in the third stage of EMU (see Sections 5 and 11 of the Protocol on certain provisions relating to the United Kingdom). Furthermore, the Decision taken by the Heads of State or of Government at their Edinburgh Summit meeting on 11th and 12th December 1992 implies that Denmark (which has given notification that it will not participate in Stage Three of EMU) will retain its existing powers in the field of monetary policy according to its national laws and regulations, including the powers of Danmarks Nationalbank in the field of monetary policy.

[2] Subject to Section 11 of the Protocol on certain provisions relating to the United Kingdom, which grants the Government the right to maintain its "ways and means" facility with the Bank of England as long as the United Kingdom does not participate in Stage Three of EMU. The Protocol on Portugal also provides for a temporary exemption for the interest-free overdraft facility of the Autonomous Regions of Azores and Madeira with the Banco de Portugal.

1. Highlights of institutional changes in 1993 and 1994

The 1992 Annual Report of the Committee of Governors (Chapter III and Annex II) contained a description of the institutional features of the central banks with particular focus on their independence. A summary of these features was given in Table 7 of that Report. Since 1992, various national central banks have undergone changes in their institutional features in preparation for Stage Three in order to comply with the requirements of the Treaty.

The two most important examples are the Banque de France and the Banco de España. The legislation regarding the National Bank of Belgium, the Deutsche Bundesbank, the Banca d'Italia and the Nederlandsche Bank was also adjusted.

The legal regime of the Banque de France was amended by Acts 93-980 of 4th August 1993 and 93-1444 of 31st December 1993, which came into effect on 1st January 1994. These new laws deal with independence in the conduct of monetary policy and the prohibition of central bank financing of public institutions. The formulation and implementation of monetary policy is the responsibility of the "Conseil de la politique monétaire", which must not seek or receive instructions from the Government. A representative of the Government may attend meetings of the Conseil, but without voting or vetoing rights. Members of the Conseil are subject to exclusivity and secrecy rules, and their appointment and substitution are precisely defined. The Conseil deals purely with monetary policy decisions, whilst a "Conseil Général" exercises all other management responsibilities at the Banque de France. The "Conseil Général" comprises the members of the "Conseil de la politique monétaire" plus one Government representative and one representative of the staff.

The status of the Banco de España was amended by Act 13/1994 of 1st June 1994 on the Autonomy of the Banco de España. This law had the explicit purpose of introducing the provisions of the Treaty on European Union on monetary policy and the independence of central banks. The law, therefore, sets price stability as the primary objective of monetary policy and gives the Bank full capacity and independence to define and implement monetary policy. In particular, the law explicitly forbids the Government or any other public authority from giving instructions to the Bank regarding either the objectives or the implementation of monetary policy. Other provisions referring to the appointment, term of office and termination of the appointment of the Governor and Council members also reflect generally accepted requirements for the independence of decision-making bodies of central banks. The law also addresses other substantive matters: a new legal regime is laid down for the acts and decisions of the Bank and for its budgetary status; the responsibilities and functions of the Bank are determined in detail, with particular regard to the formulation and implementation of monetary policy and the Bank's relationship with the Government with respect to exchange rate policy; payment systems and issues concerning banknotes are also provided for. In other areas, however, the law does not entail significant changes in the status of the other functions that current legislation assigns to the Bank. In particular, the Bank's supervisory functions will still be regulated by Law 26/1988 of 29th July 1988 on Discipline and Intervention of Credit Institutions, and other applicable legislation.

In Italy, Law 82 of 7th February 1992 vested the authority to determine the discount rates in the Governor of the Banca d'Italia (prior to this Law, discount rates were fixed by the Minister of the Treasury). Furthermore, Law 483 of 26th November 1993 cancelled the permanent credit line granted to the Treasury by the Banca d'Italia and gave to the Banca d'Italia the responsibility for setting bank reserve requirements within given limits.

In Belgium, a law of 22nd March 1993 introduced provisions adjusting the competence of the Government in controlling the decisions and operations of the National Bank of Belgium. Prior to this law, while there was no right of instruction from political authorities, the Government Commissioner and the Minister of Finance each had the right of suspension and the right to oppose any decision of the Bank which was contrary to the interests of the State, the law or the statutes of the Bank. The new law restricted these suspension and opposition rights in matters concerning the definition and implementation of monetary policy, the conduct of foreign exchange operations, the holding and management of official foreign reserves, and the promotion of the smooth operation of payment systems. Such rights can now only be exercised when decisions in these matters are not in conformity with the law and the statutes of the Bank. Thus a high degree of autonomy of the Bank has been established in the field of monetary policy.

In the Netherlands, a law of 9th December 1993 introduced a provision requiring the Government to obtain the advice of the Nederlandsche Bank in decisions concerning exchange rate arrangements or changes in central rates and to make such advice public. A law of 15th December 1994 entrusted the supervision of exchange offices to the Nederlandsche Bank.

2. Present features of European Union national central banks

The 1992 Annual Report of the Committee of Governors included a detailed description of the institutional features of the national central banks of the Community Member States at the time. Table 13 below contains the basic institutional features of national central banks of the European Union. According to Article 7 of the EMI Statute, a special report of the EMI will analyse the institutional features of the national central banks and will assess the progress towards convergence in the statutory requirements to be fulfilled for national central banks to become an integral part of the ESCB.

Table 13 — Institutional features of European Union central banks

	NATIONAL BANK OF BELGIUM	DANMARKS NATIONALBANK	DEUTSCHE BUNDESBANK	BANK OF GREECE	BANCO DE ESPAÑA
PRINCIPAL STATUTORY OBJ ECTIVE	None, although safeguarding the currency implicit	To maintain a safe and secure currency system	To safeguard the currency	To control currency in circulation and credit	To ensure price stability
LEGAL AUTHORITY FOR: 1- Exchange rate regime 2- Setting targets for: - monetary growth - inflation 3- Changing key interest rates	 1 - Government 2 - Central bank [a] Central bank [a] 3 - Central bank	 1 - Government 2 - Central bank [a] Central bank [a] 3 - Central bank	 1 - Government 2 - Central bank Central bank [a] 3 - Central bank	 1 - Government 2 - Central bank Government [a] 3 - Central bank	 1 - Government after consulting the central bank 2 - Central bank [b] Central bank 3 - Central bank
RESPONSIBILITIES: 1- Execution of monetary and exchange rate policy 2- Issue of banknotes 3- Payment system services 4- Bank of banks and government 5- Supervision of financial institutions 6- Safeguard financial stability 7- Official reserve management	 1 - Yes 2 - Yes 3 - Yes 4 - Yes 5 - No 6 - Yes 7 - Yes	 1 - Yes 2 - Yes 3 - Yes 4 - Yes 5 - No 6 - Yes 7 - Yes	 1 - Yes (2-week suspension of *decisions possible at request* of Gov't but never been used) 2 - Yes 3 - Yes 4 - Yes 5 - No 6 - Yes 7 - Yes	 1 - Yes 2 - Yes 3 - Yes 4 - Yes 5 - Yes 6 - Yes 7 - Yes	 1 - Yes 2 - Yes 3 - Yes 4 - Yes 5 - Yes 6 - Yes 7 - Yes
GOVERNING BODIES	- Governor - Board of Directors - Council of Regency - Board of Censors - General Council	- Board of Governors - Board of Directors - Committee of Directors - Royal Bank Commissioner	- Central Bank Council - Directorate - Managing Boards of Land Central Banks	- General Council - Governor (- Deputy Governors)	- Governor - Deputy Governor - Governing Council - Executive Commission
APPOINTMENT OF GOVERNOR By: Term:	 - Crown on proposal of the Government - 5 years (renewable)	 - Crown on proposal of the Government - No fixed term	 - Federal President on proposal of Federal Government after consultation of Central Bank Council - Normally 8 years, minimum 2 years (renewable)	 - President of the Republic on a proposal of the Government after being nominated by the Council - 4 years (renewable)	 - Crown on proposal of President of Government - 6 years (non-renewable)
RECENT AND PLANNED CHANGES	Legislation to ensure central bank independence on monetary policy decisions was adopted on *22nd March 1993.*	None	None	The Bank of Greece has proposed to Government legislative changes which aim to increase its degree of independence and to make its Statute fully compatible with the Treaty on European Union.	Law 13/1994 of 1st June 1994 on the Autonomy of the Banco de España introduced the provisions of the Treaty on European Union relating to central banks.

(a) No targets set at present. (b) No targets set at present; only monitoring ranges/rates used.

Table 13 (cont'd) Institutional features of European Union central banks

	BANQUE DE FRANCE	CENTRAL BANK OF IRELAND	BANCA D'ITALIA	INSTITUT MONÉTAIRE LUXEMBOURGEOIS	NEDERLANDSCHE BANK
PRINCIPAL STATUTORY OBJECTIVE	Ensuring price stability	To safeguard the integrity of the currency	None, although safeguarding the currency implicit	Includes the promotion of the stability of the currency	To safeguard the value of the currency
LEGAL AUTHORITY FOR: 1- Exchange rate regime 2- Setting targets for: - monetary growth - inflation 3- Changing key interest rates	 1 - Government 2 - Central bank Central bank 3 - Central bank	 1 - Government 2 - Central bank [a] Central bank [a] 3 - Central bank	 1 - Government 2 - Jointly with Government Government 3 - Central bank	 1 - Government 2 - Central bank [a] Jointly with Government [a] 3 - Central bank [a]	 1 - Government 2 - Central bank[a] Central bank [a] 3 - Central bank
RESPONSIBILITIES: 1- Execution of monetary and exchange rate policy 2- Issue of banknotes 3- Payment system services 4- Bank of banks and government 5- Supervision of financial institutions 6- Safeguard financial stability 7- Official reserve management	 1 - Yes 2 - Yes 3 - Yes 4 - Yes 5 - Yes, through Commission Bancaire 6 - Yes 7 - Yes	 1 - Yes 2 - Yes 3 - Yes 4 - Yes 5 - Yes 6 - Yes 7 - Yes	 1 - Yes 2 - Yes 3 - Yes 4 - Yes 5 - Yes 6 - Yes 7 - Yes (together with the Italian Exchange Office)	 1 - Yes (partly) 2 - Yes 3 - Yes 4 - No 5 - Yes 6 - Yes 7 - Yes	 1 - Yes (a right of instruction of Gov't still formally exists but has never been used) 2 - Yes 3 - Yes 4 - Yes 5 - Yes 6 - Yes 7 - Yes
GOVERNING BODIES	- Monetary Policy Council - General Council	- Board of Directors	- Governor, Director-General, 2 Deputy Director-Generals (Directorate) - Board of Directors	- Management - Council	- Governing Board - Supervisory Board
APPOINTMENT OF GOVERNOR By: Term:	 - Council of Ministers - 6 years (renewable)	 - President, on the advice of Government - 7 years (renewable)	 - Board of Directors with approval of Government - Life	 - Grand-Duke on proposal of Council of Ministers - 6 years (renewable)	- Nominated by joint meeting of Governing Board and Supervisory Board and appointed by Crown on proposal of Council of Ministers - 7 years (renewable)
RECENT AND PLANNED CHANGES	Laws of 4th August and 31st December 1993 on the Statute of the Banque de France introduced the provisions of the Treaty on European Union relating to central banks.	A number of adjustments of a minor nature will be included in forthcoming legislation.	None	A bill to effect the changes in legislation required by the Treaty on European Union is pending in Parliament.	The law of 9th December 1993 introduced provisions of the Treaty on European Union relating to central banks. Final adjustments in order to comply with the Treaty are under consideration.

(a) No targets set at present.

Table 13 (cont'd) Institutional features of European Union central banks

	OESTERREICHISCHE NATIONALBANK	BANCO DE PORTUGAL	SUOMEN PANKKI	SVERIGES RIKSBANK	BANK OF ENGLAND
PRINCIPAL STATUTORY OBJECTIVE	To maintain the internal and external value of the Austrian currency	To maintain internal monetary stability and the external solvency of the currency	To maintain a stable and secure monetary system and to assist and facilitate the circulation of money in Finland	None, although safeguarding of the currency implicit	None, although safeguarding the currency implicit
LEGAL AUTHORITY FOR: 1- Exchange Rate Regime 2- Setting targets for: - monetary growth - inflation 3- Changing key interest rates	1 - Central bank in co-operation with Government 2 - Central bank [(a)] Central bank [(a)] 3 - Central bank	1 - Government after consulting the central bank 2 - Central bank [(a)] Central bank [(a)] 3 - Central bank	1 - Government on proposal of the central bank 2 - Central bank [(b)] Central bank 3 - Central bank	1 - Central bank 2 - Central bank [(a)] Central bank 3 - Central bank	1 - Government 2 - Government [(b)] Government 3 - Government
RESPONSIBILITIES: 1- Execution of monetary and exchange rate policy 2- Issue of banknotes 3- Payment system services 4- Bank of banks and government 5- Supervision of financial institutions 6- Safeguard financial stability 7- Official reserve management	1 - Yes 2 - Yes 3 - Yes 4 - Yes 5 - No 6 - Yes 7 - Yes	1 - Yes 2 - Yes 3 - Yes 4 - Yes 5 - Yes 6 - Yes 7 - Yes	1 - Yes 2 - Yes 3 - Yes 4 - No 5 - No 6 - Yes 7 - Yes	1 - Yes 2 - Yes 3 - Yes 4 - Yes 5 - No 6 - Yes 7 - Yes	1 - Yes 2 - Yes 3 - Yes 4 - Yes 5 - Yes 6 - Yes 7 - Yes (as agent for the Government)
GOVERNING BODIES	- Governing Board - Board of Executive Directors	- Governor - Board of Directors - Board of Auditors - Advisory Board	- Parliamentary Supervisory Council - Board	- Governing Board - Governor	- Court of Directors
APPOINTMENT OF GOVERNOR By: Term:	- President of the Federal Republic on nomination by the Federal Government - 5 years (renewable)	- Council of Ministers on proposal of Minister of Finance - 5 years (renewable)	- President of the Republic on a proposal of the Parliamentary Supervisory Council - Indefinite	- Governing Board - 5 years (renewable)	- Crown on proposal of Prime Minister - 5 years (renewable)
RECENT AND PLANNED CHANGES	None	Amendments to reinforce the independence of the central bank in line with Articles 109e(5) and 108 of the Treaty on European Union are under consideration.	Legislation in order to comply with the requirements of the Treaty on European Union is under consideration.	Legislation in order to comply with the requirements of the Treaty will be proposed during the current legislative period.	None. Changes will be needed if the United Kingdom participates in Stage Three.

(a) No targets set at present. (b) No targets set at present; only monitoring ranges/rates used.

3. Prospective changes in legislation

In Luxembourg, a draft Law on the Institut Monétaire Luxembourgeois (IML) was submitted to Parliament in December 1993, the enactment of which is still pending.

The draft states in its "Exposé des Motifs" its purpose of implementing all Treaty provisions concerning Stage Two and also of introducing some features for national central banks which are to be set in place before Stage Three. The principal objective of the IML is to ensure price stability and its secondary objective to support the economic policy of the Luxembourg Government. A clear definition of the competences of the IML is also given, which include the definition and implementation of monetary policy. The IML is to conduct its affairs in accordance with the principle of a market economy. However, the monetary association between Belgium and Luxembourg will remain unchanged during Stage Two.

The draft reflects Article 107 of the Treaty and provides for the independence of the IML from Government by prohibiting instructions or guidelines from public authorities. Article 24 of the draft introduces the content of Article 104 of the Treaty into national legislation by prohibiting all financial facilities to public administrations. Other articles of the draft reflect the contents of the system provided for in the Treaty for the ESCB, thus adapting national legislation to the requirements of Stage Three. The draft declares that additional legislation will be required in due time for Stage Three.

Preliminary work has been undertaken in Finland to prepare a law introducing some provisions of the Treaty concerning national central banks, namely autonomy in monetary matters and the prohibition of monetary financing of the public sector. A draft is being examined by the Finnish Government and has not yet been submitted to Parliament. The draft law defines the primary objective of the Bank of Finland as being to "safeguard the value of the money" and the secondary objective as the attainment of other economic policy targets. It also provides for independence from Government, both by institutional amendments and by stating that no instructions may be requested or accepted from governmental authorities.

The Nederlandsche Bank is currently investigating, in co-operation with the Ministry of Finance, which Treaty provisions require further elaboration in, or adjustment of, national legislation. Similar investigations are currently being carried out at the National Bank of Belgium. In Portugal, preliminary work is being undertaken to prepare amendments to the Statute of the Banco de Portugal in order to reinforce its independence. In Ireland, although no significant institutional changes are envisaged, a number of adjustments of a minor nature will be included in forthcoming legislation. The Swedish Government has announced that legislative changes which are necessary in order to comply with the requirements of the Treaty will be proposed during the current parliamentary period.

B. MONETARY FINANCING AND PRIVILEGED ACCESS

1. General remarks and the role of the EMI

Historical as well as recent experience has shown that a monetary policy oriented towards price stability may be jeopardised by the involvement of central banks in financing government budgets. Therefore, prohibiting the public sector from receiving monetary financing or having privileged access to financial institutions is a central aspect of the institutional framework underlying EMU (Articles 104 and 104a of the Treaty).

Central bank financing and privileged access to financial institutions are prohibited not only in Stage Three but also in Stage Two of EMU, since they are considered incompatible with the process of convergence towards monetary stability.[3] Therefore, these prohibitions have applied from 1st January 1994 (see Article 109e (3) of the Treaty). The definitions for the application of these prohibitions are specified in the related secondary legislation (Council Regulations (EC) No. 3603/93 and No. 3604/93 of 13th December 1993). The provisions prohibiting monetary financing cover, inter alia, the abolition of overdraft facilities and other types of credit facilities to the public sector as well as of direct purchases of public sector debt instruments. "Other types of credit facilities" include a wide range of other forms of central bank financing arising through various transactions or services which the central banks perform for the public sector.[4] The provisions concerning privileged access by the public sector prohibit any legal instrument which obliges financial institutions to acquire or hold liabilities of the public sector, or any indirect measures such as tax advantages which may benefit only financial institutions or financial advantages which do not comply with the principles of a market economy in order to encourage the acquiring or the holding by those institutions of such liabilities. Departure from this principle may be justified only on the basis of prudential considerations.

In accordance with Article 169 of the Treaty, it is the task of the European Commission to ensure the legal compliance of Member States with the provisions of the Treaty, whereas, under Articles 109f (9) and 180 (d) of the Treaty, the EMI has been entrusted with the task of monitoring central banks' compliance with the Treaty.

The Committee of Governors examined this issue prior to the start of Stage Two and was involved in the preparation of the secondary legislation. In 1994 the EMI set up a regular procedure to monitor central banks' fulfilment of their obligations under Articles 104 and 104a of the Treaty and the related secondary legislation. This monitoring is carried out at quarterly intervals.

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[3] See footnote 2.

[4] In the case of Italy the national Foreign Exchange Office (Ufficio italiano dei cambi) is to be considered, for this purpose, jointly with the Banca d'Italia.

2. Compliance with the prohibition on the provision of central bank credit to the public sector

Most of the Member States anticipated the requirements set out in Article 104 and Council Regulation (EC) No. 3603/93 and adapted their respective national legislation before the beginning of Stage Two. The monitoring procedure carried out by the EMI in 1994 suggests that the measures necessary for ensuring compliance with the prohibition have to a large extent already been taken. A few minor adjustments are still under consideration.

The Council Regulation allows stocks of public debt to be held by national central banks as long as the claims were acquired before 1st January 1994 and are of a fixed maturity, irrespective of the date of maturity and whether or not the claims are remunerated at a market rate. Most outstanding non-negotiable claims have been converted into fixed-term assets. In a few Member States, some residual claims of the central bank against the public sector remain to be converted; these matters are currently under review. Table 14 provides an overview of the outstanding stocks of non-negotiable claims of central banks against the public sector at end-1994.

Table 14 Central bank claims against the public sector*

(Situation as at end-December 1994)

	BE	DK	DE	GR	ES	FR	IE	IT	LU	NL	PT	UK
Total amount of claims (as % of GDP)	...	-	0.3	27.8	3.3	0.5	0.4	4.8	1.5	-	1.4	...
of which: claims without fixed maturity	...	-	-	-	-	0.2	-	-	1.5	-	0.03 (a)	... (b)
Longest fixed maturity	(c)	-	2033	2023	2023	2003	2000	2043	(c)	-	2002	(c)
Interest rates applied on claims with a fixed maturity (% per annum)	(c)	-	0-1	0-10	0-11	5	5.3-5.5	1	(c)	-	1.3-10.5 (d)(e)	(c)

Source: National central banks

* Non-negotiable claims and claims which are not subject to market conditions excluding coins, float arising from cheque clearing, and claims against publicly owned credit institutions acquired outside the context of the supply of reserves by central banks.

(a) The Treaty Protocol on Portugal provides for an exemption for the interest-free overdraft facility of the Autonomous Regions of Azores and Madeira with the Banco de Portugal.

(b) The Treaty Protocol on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland provides for an exemption for the "ways and means" facility of the Government of the United Kingdom.

(c) No non-negotiable claim has a fixed maturity.

(d) Rates (partly) linked to market rates.

(e) Interest rate linked to market rate: in the first year (1993) the interest rate applied was 10% of the Treasury bill annual base rate announced by the Banco de Portugal (i.e. the annual weighted average rate of the last twelve issues of Treasury bills); this percentage will increase 10 percentage points each year until maturity. In 1993 the interest rate applied was 1.3%. On 31st December 1994, the Treasury bill annual base rate announced by the Banco de Portugal was 10.5%.

The prohibition of overdraft facilities of the public sector with the national central banks has generally been respected. Occasional overdrafts have been observed in some cases, mainly caused either by imperfect transitions to new arrangements or by delayed payments by third parties. However, these were considered by the respective central banks as not being of a structural nature and as having no impact on the conduct of monetary policy. Steps are being envisaged to abolish these anomalies.

No primary market purchases of debt instruments issued by the domestic public sector were observed in 1994. The acquisition of debt instruments of the public sector on the secondary market is in compliance with the Treaty to the extent that it is not used to circumvent the objective of Article 104. In 1994 significant amounts of secondary market purchases of government debt were carried out by a few central banks; such purchases were deemed not to be incompatible with the ban on direct purchases of public sector debt instruments.

In performing the role of fiscal agents for the public sector, central banks must not provide any form of credit to public entities. The Council Regulation provides for a few exceptions to this general rule and permits, inter alia, within certain limits or under certain conditions, intraday credit to the public sector and credit arising from the collection of cheques on behalf of the public sector and from central bank holdings of coins issued by the public sector. These exceptions are granted on the grounds that a complete prohibition of claims arising from these practices would be unnecessary from an economic point of view and might prove very costly to implement.[5]

Intraday credits are permitted by the Regulation as they assist the smooth operation of payment systems. Therefore, intraday credit is compatible with the objective of Article 104 of the Treaty provided that no extension to the following day is possible. Against this background, in those Member States where the possibility of intraday credit exists, provisions have been implemented in order to prevent intraday credit from becoming overnight credit. For example, some governments are holding relatively large deposits with the central banks so as to avoid the risk of a debit position on the government's accounts at the end of each business day, or governments have arranged overdraft facilities with commercial banks that they can use at the end of each business day.

Central banks' cheque collection procedures may result in a temporary and interest-free credit to the public sector if cheques are credited to the public sector's account before they are collected. The Council Regulation therefore sets strict limits on credits arising from cheque clearing on behalf of the government by only permitting "exceptional" credits "which are of a small amount and average out in the short term". In most Member States the collection of cheques had ceased to result in any float in favour of the public sector by the end of 1994.

[5] The financing by central banks of obligations falling upon the public sector vis-à-vis the IMF or resulting from the implementation of the medium-term financial assistance facility of the European Union is also exempted unconditionally.

Finally, credit to the public sector may also arise if a central bank holds coins issued by the public sector and credits these coins to the account of the public sector. The Council Regulation has set an upper limit on such credits. It has determined that the amount of central bank holdings of coins which were issued by the public sector and credited to the public sector's account shall be less than 10% of the amount of coins in circulation.[6] This provision was generally respected in 1994, although in the first four months of the year the limit was exceeded in one case.

3. Compliance with the prohibition on granting privileged access to financial institutions

As with the prohibition on monetary financing, most Member States anticipated the requirements set out in Article 104a and Council Regulation (EC) No. 3604/93 on the prohibition on granting privileged access to financial institutions by the public sector. The Member States revoked measures which could be construed as a form of privileged access even before the ratification of the Maastricht Treaty. This took place against the background of: firstly, the Directive on the liberalisation of capital movements, which had entered into force for the majority of the Member States on 1st July 1990; and, secondly, the growing competition in the financial services sector, which had increased the exposure of the public sector's funding activities to the rules of market forces, including the requirement to pay interest at market rates.

The prohibition on granting privileged access is principally aimed at the relationship between the public sector and financial institutions. According to the Council Regulation, national central banks are neither considered to be financial institutions nor to form part of the public sector. Nevertheless, central banks are affected by the Regulation, most notably as regards their rules on the mobilisation or pledging of debt instruments. However, an examination of these rules by the EMI did not suggest that these rules currently grant any form of privileged access.

Another area where central bank rules could potentially grant the public sector privileged access is in the field of minimum reserves. Until recently, in some Member States, public debt instruments such as Treasury bills were considered eligible assets for meeting reserve requirements. Such rules did not comply with the respective provisions of the Treaty and the Council Regulation and have been adjusted accordingly.

[6] In the case of Germany, following unification, the permitted upper limit is 15% until the end of 1996.

ANNUAL ACCOUNTS OF THE EMI

ANNUAL ACCOUNTS OF THE EMI

Balance Sheet as at 31st December 1994

	ECU		ECU
I EMS-related assets		**I EMS-related liabilities**	
Holdings of gold	28.624.566.048	ECUs issued to EC Central Banks	56.575.849.005
Holdings of US dollars	27.951.282.957		
	56.575.849.005		56.575.849.005
II Other Assets		**II Other Liabilities**	
(1) Cash and bank sight accounts	499.203	*(1)* Creditors and other liabilities	3.639.743
(2) Securities	12.358.418	*(2)* Provision for pensions and similar obligations	377.803
(3) Tangible assets	6.595.995	*(3)* Other Provisions	3.566.464
(4) Other assets	1.277.793	*(4)* Revaluation Account	117.401
		(5) Contributions from National Central Banks (pursuant to Article 16.2 of the Statute)	13.029.998
	20.731.409		20.731.409
Total assets	56.596.580.414	**Total liabilities**	56.596.580.414
Memorandum item:		*Memorandum item:*	
Forward claims in ECUs (from revolving quarterly swap)	56.575.849.005	Forward liabilities in gold and US dollars	56.575.849.005

Profit and Loss Account for the year 1994

		ECU
Income		
Interest on Securities		341.956
Total income		**341.956**
Expenses		
Staff costs		3.388.001
Other administrative expenses		14.692.575
(including initialisation costs of:	*6.862.916)*	
Depreciation of tangible assets		231.382
Total expenses		**18.311.958**
Deficit for the year		**(17.970.002)**
Allocation of deficit		
Contributions from National Central Banks pursuant to Article 17.6 of the Statute		17.970.002

Frankfurt am Main,
31st January 1995

EUROPEAN MONETARY INSTITUTE

A.Lamfalussy

President

President and Council
of the European Monetary Institute

Frankfurt am Main

We have audited the accompanying financial statements of the European Monetary Institute. The Management of the European Monetary Institute is responsible for the preparation of the accounts. It is our responsibility to form an independent opinion on these accounts based on our audit, and to report our opinion to you.

We conducted our audit in accordance with International Standards of Auditing. An audit includes examinations, on a test basis, of evidence relevant to the amounts and disclosures in the accounts. It also includes an assessment of the significant estimates and judgements made in the preparation of the accounts, and of whether the accounting policies are appropriate to the European Monetary Institute's circumstances and adequately disclosed.

In our opinion, the financial statements, which have been prepared under accounting policies set out in Section 2 of the notes on the accounts of the European Monetary Institute, give a true and fair view of the financial position of the European Monetary Institute at 31st December 1994 and the results of its operations for the year then ended.

Frankfurt am Main, 14th February 1995

C&L TREUARBEIT
DEUTSCHE REVISION
Aktiengesellschaft

(Wagener)	(Kern)
Auditor	Auditor

1. Introduction

1.1 Under Article 16 of its Statute, the EMI shall be endowed with its own resources by the National Central Banks, and these resources are to be used to generate income deemed necessary to cover the EMI's administrative expenses. Pursuant to Article 16.2, these resources were to be paid up at the establishment of the EMI. It was not possible to decide on the precise level of the resources required for this purpose until the EMI had reached a level of operations that permitted a reasonable forecast of continuing levels of administrative expenses, and NCBs therefore made payments to enable the EMI to commence its operations, to equip its premises and recruit staff, and to cover recurrent day-to-day expenses. A total of ECU 31 million was paid during 1994, in three instalments (in accordance with the key specified in Article 29.1 of the Statute of the ESCB), by the twelve NCBs which were then full members of the EMI.

1.2 Of these initial contributions, ECU 18.3 million was used to cover current administrative expenses and provisions, of which ECU 6.9 million were one-time costs in connection with the acquisition and preparation of the premises and recruitment, relocation and installation of staff in Frankfurt am Main. The EMI started the year with no general reserve fund or income of its own, and that part of the NCB contributions used to cover these expenses - ECU 18.0 million net of interest income on cash balances - has been treated as a payment under Article 17.6 of the Statute, which provides for the funding of shortfalls of income compared to expenses.

1.3 The remaining ECU 13.0 million of the NCBs' 1994 payments has been treated as a contribution made under Article 16.2 of the Statute to the EMI's resources. Of this, ECU 6.6 million represents investment in fixed assets net of depreciation and ECU 6.4 million unearmarked working balances.

1.4 At its meeting on 3rd January 1995, the Council of the EMI was able to decide on the full level of resources required. Further contributions of ECU 602.5 million were paid by the NCBs on 17th January, using a key recalculated to take account of the new members of the Council (Oesterreichische Nationalbank, Suomen Pankki and Sveriges Riksbank) from 1st January 1995; Article 16.2 contributions made in 1994 were reallocated in accordance with the new key. The total contributions under Article 16.2 amount to ECU 615,573,495. Of these resources, ECU 597.2 million have been placed in time deposits to generate the income deemed necessary to cover the EMI's administrative expenses. The remainder comprises investments in tangible assets, and working balances.

2. Accounting Policies

2.1 The annual accounts were drawn up in accordance with accounting principles established by the Council of the EMI pursuant to Article 17.3 of its Statute, and are expressed in official ECUs.

2.2 Although the EMI, as a body of the European Communities, is not subject to national laws and regulations on accounting practices, its accounting policies follow internationally accepted accounting principles, unless specific EMI issues require otherwise. Notwithstanding the limited life of the EMI, the accounts have been prepared on a "going concern" basis.

2.3 EMS-related assets and liabilities are shown at cost. Short-term discount securities are shown at cost plus accrued interest. Securities other than short-term discount securities are shown at year-end market value. All other financial assets and liabilities are shown at nominal value.

2.4 Tangible assets are valued at cost less depreciation. Depreciation is calculated on a straight-line basis, beginning in the quarter after acquisition, over the expected lifetime of an asset.

2.5 Apart from EMS-related assets and liabilities, foreign currency translation of balance-sheet items into ECUs is based on the official rates published by the European Commission applying at 31st December 1994. Foreign currency transactions reflected in the Profit and Loss Account are valued at the average official rate for the period covered. For 1994, such transactions in the EMI's books took place with effect from 18th April.

2.6 Income and expenses are recognised on an accruals basis. Unrealised gains arising from the revaluation of assets vis-à-vis the purchase price are not recognised as income but taken into a revaluation account; unrealised losses are charged against previous unrealised gains in the revaluation account and any remaining losses charged against profit.

2.7 In accordance with Article 17.4 of the Statute, the Council has appointed C & L Treuarbeit Deutsche Revision as independent external auditors.

3. Notes on the Balance Sheet

3.1 EMS-Related Assets and Liabilities

These items relate to the three-month revolving swaps of official ECUs created in exchange for NCBs' contributions to the EMI of 20% of their gold and US dollar reserves. These operations are described in Chapter II B.5.1 of the Report. The respective assets and liabilities are shown in the EMI's books. The entries do not imply any interest payments or receipts. Interest on official reserves swapped for ECUs continues to accrue to the underlying owners. Interest on ECU holdings arising out of swaps only becomes due where a central bank's holdings exceed its forward ECU liabilities; in such cases, payments are covered by interest due from central banks whose forward liabilities in ECUs exceed their holdings of ECUs.

On 1st January 1994, the EMI took over the assets and liabilities of the European Monetary Co-operation Fund, each in the amount of ECU 56.96 billion. Of this, ECU 53.48 billion were in respect of the issue of ECUs to EC central banks against gold and US dollar reserves, and ECU 3.48 billion in respect of Very Short-Term Financing operations.

3.2 Other Assets

II *(1) Cash and bank sight accounts*: Cash balances were held on a current account in Deutsche Mark, in which currency almost all of the EMI's day-to-day transactions are payable. This account was used exclusively to deal with payments and receipts relating to the day-to-day administration of the EMI.

II *(2) Securities*: Excess cash balances were employed on a daily basis in Treasury bills of the Federal Republic of Germany. No other securities were held at 31st December 1994.

II *(3) Tangible assets*: These comprised, at year end:

Equipment	ECU	4,676,422
Computers and software	ECU	1,717,027
Other	ECU	202,546
Total	ECU	6,595,995

"Equipment" includes the capitalised costs of special installations in the EMI's quarters in the Eurotower building in Frankfurt am Main required to meet its particular operational needs. Items are shown net of depreciation totalling ECU 231,382, all of which was charged to the Profit and Loss Account for 1994.

II *(4) Other Assets*: This item principally represents a claim against the German Federal Ministry of Finance in respect of recoverable value added and other indirect taxes paid on goods and services. Such taxes are refundable under the terms of Article 3 of the Protocol on the privileges and immunities of the European Communities, which also applies to the EMI by virtue of Article 21 of its Statute.

3.3 Other Liabilities

II *(1) Creditors and other liabilities*: This item principally comprises payments due to suppliers, together with income tax deducted at source from salaries pending pay-over to the European Communities, and accumulated pension contributions with interest thereon repayable to staff. Under the provisional arrangements in force at the balance-sheet date, staff contribute to the pension scheme a percentage of their basic salary (matched by a contribution of twice that amount by the EMI - see II *(2)* below); the staff contribution is repayable at the termination of the employment contract together with accrued interest thereon.

II *(2) Provision for Pensions and similar obligations*: This item comprises the accumulated contributions of the EMI towards the staff pension scheme. These contributions are required to cover the eventual cost of severance grants and any ill-health pensions.

II *(3) Other provisions*: These comprise funds set aside in respect of restoration of the EMI's premises at the end of its lease (see notes on the Profit and Loss Account); the production of the Annual Report and the accounts for 1994; and payments that will be due to the Bank for International Settlements in respect of their work as Agent for the EMI.

II *(4) Revaluation Account*: The appreciation of the Deutsche Mark against the ECU during 1994 resulted in an unrealised gain in the net value of assets held in, or denominated in, Deutsche Mark, which has been taken into this account.

II *(5) Contributions from National Central Banks pursuant to Article 16.2 of the Statute*: These represent the balance of contributions made by the National Central Banks in 1994 that remains after the operating shortfall for the year has been covered (see Introduction above and note "Allocation of deficit" on the Profit and Loss account); the amount has been treated as a prepayment of the contributions to be made under Article 16 of the Statute.

4. Notes on the Profit and Loss Account

4.1 Income

This item represents interest earned on employment of excess cash balances in Treasury bills (see Other Assets, Note II (*2*)).

4.2 Expenses

Staff costs: This item relates to salaries and general allowances, and to employer's contributions to pensions and health and accident insurance, in respect of staff employed by the EMI. At 31st December 1994, the EMI's establishment consisted of the President and 126 staff, of whom five held senior management positions. Costs of staff employed by the BIS in Basle (mainly from the previous Secretariat of the Committee of Governors) before their relocation to Frankfurt am Main during November and December formed part of a general service agreement with the BIS pending the full establishment of the EMI at its seat, and are included under "Other Administrative Expenses". Salaries and allowances of staff, including emoluments of holders of managerial positions, are modelled in essence on, and comparable to, the remuneration scheme of the European Communities.

Other Administrative Expenses: These cover all other current expenses, viz. rents, maintenance of premises and equipment, goods of a non-capital nature, professional fees, and other services (including those provided temporarily by the BIS) and supplies. Of the total amount, "initialisation costs" comprise the extraordinary expenses of a non-capital nature incurred during the year in the process of establishing the EMI at its seat, in particular for refurbishment of the premises, agency fees in connection with leasing and fitting out, and the expenses involved in recruitment, relocation and installation of staff. These costs also include a provision against the contractual obligation of the EMI to restore rented premises to their normal condition at the end of its tenure.

4.3 Allocation of deficit

Since the EMI had no general reserve fund at the start of the year, the operating deficit was covered entirely out of the payments made during 1994 by the NCBs, in accordance with the provisions of Article 17.6 of the Statute.

ANNEXES

ANNEX 1

THE PRESENT STATE OF MONETARY POLICY STRATEGIES AND INSTRUMENTS IN INDIVIDUAL EU COUNTRIES

1. Strategies

There is agreement among EU central banks that the final target of monetary policy is the achievement and maintenance of price stability. However, as described in Chapter I.A.3.2, a variety of monetary strategies is currently employed in individual member countries (see Table 15). Within the ERM, most countries use an indirect strategy. This is based, in one country (Germany), on a monetary aggregate as the intermediate target, in some others, on exchange rate targets. One of these (France) simultaneously targets a monetary aggregate and monitors total debt, while another country (Spain) directly targets inflation and monitors money growth. EU countries outside the ERM, while continuing to attribute importance to exchange rate stability, make use of a monetary intermediate target or a direct inflation target.

These divergences should nevertheless not be exaggerated, as both the indirect and the direct approach have recently been implemented pragmatically. On the one hand, monetary aggregates and the exchange rate have been closely monitored in the countries using the direct approach. On the other hand, in those countries where an intermediate monetary target is used, central banks, to some extent, also assessed the relevance of changes in these aggregates in the light of other indicators of inflationary developments, taking into account labour costs, fiscal deficits, import prices or measures of the deviation of actual from potential GDP.

2. Instruments

The set of monetary policy instruments currently used by EU countries is broad. They can be grouped in three main categories: systems of compulsory reserves, standing facilities and open market operations. Under systems of compulsory reserves, banks are required to keep a minimum amount of reserves in deposit accounts with the central bank, which may or may not be remunerated; these minimum reserves are usually calculated as a percentage of the banks' monetary liabilities. Standing facilities represent standing offers by central banks to engage in certain types of operations (discount, refinancing, acceptance of deposits) at the initiative of commercial banks, but at conditions pre-announced by the central bank; access to these facilities by individual commercial banks may be subject to quotas. Open market operations are transactions carried out by the central bank at its own initiative with private market participants either to inject liquidity into or to absorb liquidity from the market; they may consist in either outright or reversed transactions, and may involve different types of financial assets (public debt, private paper, central bank paper and foreign exchange).

The specific features of the various instruments and their respective roles vary from country to country, as shown in Table 15.

For example, in some countries where the systems of required reserves (Germany, Spain, France, Italy, Austria and Portugal) or standing facilities (the Netherlands) contain averaging provisions (i.e. where the requirements or quotas apply to average amounts over a certain computation period), this can contribute to the stabilisation of short-term market interest rates. As a result, only a relatively low frequency of central bank intervention in the money market is required. Conversely, in countries where reserve requirements either do not exist or are not mainly designed to stabilise interest rates (e.g. Belgium, Ireland and the United Kingdom), this task falls more heavily on frequent fine-tuning operations by the central bank or on standing facilities. To limit the variability of short-term interest rates, most EU central banks also use varying combinations of standing facilities (marginal lending, deposit or discount facilities), through which liquidity can be absorbed or injected at the initiative of commercial banks at pre-announced rates set by the central bank. These rates usually also function as a signal of the monetary policy stance.

In several countries (Belgium, Germany, Greece, Ireland, Italy, Portugal, Finland and Sweden), two of the rates on the standing facilities form a corridor within which short-term market rates normally move. Although in some countries the quantitative importance of standing facilities in providing (or withdrawing) liquidity is relatively high, in most cases this role is now performed primarily by open market operations. Considerable differences across countries nevertheless exist with regard to the type of open market operations predominantly used (outright transactions in Greece and Finland, repurchase agreements in most other countries), as well as with regard to the type of assets involved, the auction procedures and the frequency of operations. However, some convergence can be observed. Overall, the share of open market interventions has grown in recent years, probably also reflecting the authorities' efforts to foster the development of markets and to rely increasingly on market mechanisms. Moreover, this tendency has been accompanied by the widespread recourse by national central banks to reversed transactions.

A more precise description of the main monetary policy instruments may contribute to a better understanding of the variety of operational frameworks in the EU.

2.1 Reserve requirements

In a majority of EU countries, reserve requirements are imposed on the banking system, usually with the aim of achieving a combination of different monetary policy purposes: (a) enlarging the banks' demand for reserves; (b) contributing to the stabilisation of short-term interest rates through the effect of averaging provisions, where they exist, thereby reducing the need for frequent central bank interventions; (c) stabilising and making more predictable the money multiplier; and (d) increasing the responsiveness of demand for money to interest rate movements by driving a wedge between the interest rates on monetary and non-monetary assets. The emphasis given to the various functions often differs across countries. In countries where reserve requirements do not exist (i.e. Belgium, Denmark and Sweden), or where their primary purpose is not related to monetary policy (the United Kingdom), some of the above functions are performed through other instruments, e.g. by adjusting the size and frequency of open market operations.

The technical features of reserve requirements also differ significantly across countries (see Table 16), reflecting in part the emphasis on different functions and in part structural differences between national financial systems. The main differences concern: (a) the definition of the bank liabilities that are subject to the reserve requirements (types of instrument, currency denomination, holding sectors); (b) the length of the computation and maintenance periods and the lag between the two; (c) the inclusion or otherwise of averaging provisions; (d) the level of remuneration (which is zero in some countries, positive and below market rates in others, and close to market rates only in the Netherlands); (e) the level and differentiation of reserve ratios on different types of liabilities; and (f) the range of institutions subject to such requirements. In recent years there has been a general tendency for reserve ratios to converge towards relatively lower levels, reflecting in part the need to reduce incentives for financial disintermediation and delocalisation, which, however, also depend on the extent to which required reserves are remunerated. Nevertheless, there are still important cross-country differences in the overall size of reserve requirements, both as a percentage of the liabilities base and as a ratio to GDP.

2.2 Standing facilities

Although standing facilities are nowadays used less intensively than in the past, they are nevertheless likely to continue to play an important role. All EU central banks, with the sole exception of the Banco de España, currently make use of standing facilities in the implementation of monetary policy. However, important differences exist across countries regarding the combination of facilities in use, their principal features and the functions assigned to them. Overall, there are three main types of standing facilities: (a) marginal refinancing facilities at a penalty rate, which exist in all EU countries but three; (b) lending facilities at below market rates, which exist in six EU countries; and (c) deposit facilities (or other facilities performing equivalent functions), which exist in six EU countries. Only in Belgium are all three types of facilities currently in use.

Marginal refinancing facilities usually play an important role in facilitating the operation of the payment system through the financing of end-of-day clearing imbalances, at a penalty rate. Similarly, deposit facilities are used to absorb excess liquidity. In countries where either of these facilities, or both, do not exist, these functions can be performed by open market operations. Lending facilities at below market rates, e.g. discount facilities, are used in several countries, although their quantitative importance in the overall refinancing varies across countries. Since this facility provides a subsidised form of refinancing, access to it by banks is normally subject to individual quotas.

2.3 Open market operations

Open market operations have grown in importance in most EU countries over the last decade, mirrored in the diminishing use of standing facilities to provide liquidity and a lowering of reserve requirements. Most EU central banks now use open market operations both on a regular basis and for fine-tuning purposes. An important advantage of open market operations from the point of view of the central banks is that they function in accordance with market principles, since they do not imply subsidies or implicit taxes and make use of market mechanisms in distributing liquidity and conveying policy signals. Another desirable aspect is that they are seen as conducive to the development of deep domestic money markets.

Reversed transactions in domestic securities are now used in all EU countries and, in most of them, constitute the most important monetary policy instrument. The maturity of operations lies mainly in the range of one day to one month; only in Greece is it up to six months. The attractiveness of these transactions stems from the fact that they can be implemented with great flexibility and that the central bank retains the initiative in deciding upon the frequency, timing, maturity and amount (or, alternatively, interest rate). Also, repurchase transactions may reduce to some extent the problem of having to assess the quality of the underlying asset and have less significant effects on the market price of this asset relative to other types of assets.

Outright open market transactions are currently used in five EU countries but are a major policy instrument only in Finland, Greece and the United Kingdom. These transactions are mainly carried out on government paper with a residual maturity of less than three months, except in Italy, where long-term securities are also involved, in Finland, where central bank paper and bank CDs are exchanged, and in the United Kingdom, where commercial bills are dominant.

Foreign exchange swap transactions (a combination of a spot and a forward transaction) can be used in most EU countries but are for the most part executed on an occasional basis for purposes of fine-tuning.

The issue of short-term paper by the central bank is possible in seven countries, but in only four (Denmark, the Netherlands, Finland and the United Kingdom) are these operations conducted on a regular basis. In four countries (Belgium, Greece, the Netherlands and Finland) the central bank can conduct lending and borrowing operations in the money market. In Ireland and Sweden, the central bank can offer fixed term deposits.

* * * * * * * *

This general overview of the current situation regarding the monetary policy strategies, instruments and procedures in use in EU countries indicates that, on the one hand, a certain degree of convergence is taking place towards greater reliance on market-based instruments, although considerable differences remain both in the combination of instruments used in each country and in the specific features of the individual instruments. On the other hand, the differences that exist in the monetary policy strategies followed by individual central banks are, in many cases, principally related to historical factors, differences in financial systems and underlying economic conditions, as well as to the different positions of the various countries in the context of the EMS.

Table 15 **Monetary Policy Strategies, Instruments and Procedures in EU Member**

	BE	DK	DE	GR	ES	
Monetary Policy Strategy[a]	XR	XR	MT (M3)	XR, MT (M3)	IT, XR	XI
Reserve Requirements for Monetary Policy Purposes	no	no	yes	yes	yes	
- Size (% of GDP)[b]	...	...	1.3	4.3	1.4	
- Remuneration	...	...	no	partly	no	
Standing Facilities[c]						
- Lending facilities at below or close to market rates	□	...	⊠	□	...	
(rate)	(below market)		(below market)	(below market)		
- Deposit facilities	□	□	...	...	...	
- Marginal refinancing	□	...	□	⊠	...	
Open Market Operations						
1. Types:[c]						
- Outright transactions[d]	□	■	...	■	...	
- Reversed transactions in domestic securities	■	■	■	□	■	
- Foreign currency swap transactions	⊠	□	□	□	□	
2. Frequency of operations:[e]	■	□	□	⊠	⊠	
3. Auction procedures:[c]						
- volume tender	⊠	■	⊠	...	...	
- interest rate tender	■	...	■	□	■	

Source: National data.

(a) Position at end-1994. XR = Exchange rate target; IT = Inflation target; MT = Monetary target. For countries pursuing monetary targets the targeted aggregate is shown in brackets.
(b) Required reserves held at the central banks to nominal GDP (mid-1994 figures, except Portugal for which end-1994 figures are shown).
(c) Importance in providing (or withdrawing) liquidity to (or from) the market: □ Low; ⊠ Intermediate; ■ High.
(d) These include issues of certificates of deposit by the central bank in the cases of Denmark, the Netherlands and Finland, fixed-term deposits in the case of Ireland and Sweden, and placing or accepting deposits in the interbank market in the case of Belgium, Greece, the Netherlands and Finland.
(e) □ About once a week; ⊠ Several times a week; ■ More than once a day.

IE	IT	NL	AT	PT	FI	SE	UK
XR	MT (M2)	XR	XR	XR	IT	IT	IT
yes	yes	yes	yes	yes	yes	no	no
1.3	6.7	3.7	2.8	1.8	1.3	...	...
close to market rates	partly	close to market rates	no	no	no	...	...
...	□ (close to market)	■ (close to market)	■ (close to market)	...	...	...	...
⊠	...	...	...	■	□	□	...
⊠	⊠	...	...	□	⊠	□	⊠
□	⊠	⊠	...	...	■	□	■
■	■	■	□	■	■	■	■
⊠	□	□	□	...	⊠	...	...
■	⊠	⊠	□	⊠	⊠	⊠	■
...	...	■	□	...	⊠	■	⊠
■	■	...	□	■	⊠	□	■

Table 16 **Features of Reserve Requirements in EU Member States***

(Situation as of end-1994)

	DE	GR
1. **Reserve ratios**	- Sight liabilities: 5% - Remaining eligible liabilities: 2%	- Domestic currer liabilities: 9% - Foreign currenc held by resident immigrants: up t
2. **Length of computation period**	1 month	1 month
3. **Length of maintenance period**	1 month	1 month
4. **Lag**(a)	15 days	60 days
5. **Averaging provisions**	yes	no
6. **Vault cash satisfies RRs**	yes(c)	yes
7. **Carry-over provisions**	no	yes(e)
8. **Remuneration**	no	yes(g)

	NL(l)	AT
1. **Reserve ratios**	Changed frequently according to money market conditions	- Sight liabilities: - Time/saving de < 1 year: 7% ≥ 1 year: 6% - Securities: < 2 y
2. **Length of computation period**	3 months(m)	1 month(n)
3. **Length of maintenance period**	variable	1 month
4. **Lag**(a)	variable	15 days
5. **Averaging provisions**	no	yes
6. **Vault cash satisfies RRs**	no	yes
7. **Carry-over provisions**	no	no
8. **Remuneration**	yes(p)	no

(a) Interval from end of computation period to end of maintenance period.
(b) Daily balances cannot be less than a given percentage (currently 91%) of the monthly average requirement.
(c) Credit institutions are allowed to deduct their average holdings of notes and coin over the maintenance perioc to a limit of 25% of the required reserves.
(d) Each credit institution is required to place a one-month deposit with the central bank on the 20th of each mon The deposit is equal to 3% of the institution's eligible liabilities on the last day of the preceding month less ist holdings of notes and coin on that day. With effect from March 1995 onwards, a limit of 20% will be placed on extent to which holdings of notes and coins may count towards a credit institution's reserve requirement.
(e) Only reserve deficiencies can be carried over.
(f) Up to 90% of reserve excesses can be carried over when the excess is below 2% of the requirement. Up to 7 of the amount of an excess above the latter percentage can be carried over. Reserve deficiencies cannot be carried over.
(g) Half of the required reserves are remunerated at a rate of 12.5%.

ES	FR	IE	IT
2%	- Sight deposits and passbook accounts: 1% - Remaining eligible liabilities: 0.5%	3%	15%
10 days	1 day	1-day	1 month
10 days	1 month	1 month	1 month
2 days	15 days	50 days	45 days
yes	yes	no	yes[(b)]
no	yes	yes[(d)]	no
no	yes[(f)]	no	no
no	no	yes[(h)]	yes[(i)]

PT	FI	UK[(k)]	BE/DK/LU/SE
2%	- Sight & time deposits: < 1 month: 2% - Other deposits: 1.5% - Other liabilities: 1 %	0.35%[(l)]	No reserve requirement system currently in use
7 days	1 day	6 months[(o)]	-
7 days	1 month	6 months	-
3 days	60 days	about 6 months	-
yes	no	no	-
no	no	no	-
no	no	no	-
no	no	no	-

(h) Required reserves are remunerated at a rate equal to 80% of the yield on selected short-term domestic government bonds with a remaining maturity of over six months and under three years and six months. The interest rate is adjusted at the beginning of each maintenance period. The interest rate on required reserves is normally below the one-month interbank rate. However, in the event of a steeply sloped positive yield curve, the rate can exceed the one-month rate.

(i) Required reserves are remunerated at 5.5%. Excess reserves are remunerated at 0.5%.

(j) The information in this column is on the money market cash reserve.

(k) The information in this column is on the cash ratio deposits.

(l) 0.25% for eligible liabilities of the Northern Ireland offices of banks for which Northern Ireland is the principal place of business in the UK.

(m) The amount of eligible liabilities is identical to the amount used by the central bank to determine the so-called "permissible borrowing" from the central bank. Permissible borrowing is set for each individual bank as an average borrowing over a period of three months and is calculated on the basis of an average of banks' liabilities over the previous three end calendar months.

(n) Required reserves are calculated on the basis of the average of the eligible liabilities on the 23rd and on the last day of the previous month and on the 7th and 15th of the reporting month.

(o) The level of an institution's required deposits is calculated twice a year (in April and October) as 0.35% of the average eligible liabilities reported at the previous six end calendar months.

(p) Weighted average of secured loans rate and special advances rate.

ANNEX 2

RULES OF PROCEDURE OF THE EMI

The Council of the European Monetary Institute, hereafter referred to as the "Council" and the "EMI" respectively,

- having regard to the Treaty establishing the European Community as amended by the Treaty on European Union, hereafter referred to as the "Treaty", and in particular Article 109f thereof,
- having regard to the Protocol on the Statute of the European Monetary Institute, hereafter referred to as the "Statute", and in particular Articles 9 and 10 thereof,

hereby adopts the following Rules of Procedure for the EMI:

Article 1 - Treaty and Statute

These Rules of Procedure shall supplement the Treaty and the Statute and the terms in these Rules of Procedure shall have the meaning which they have in the Treaty and the Statute. References to Articles are to those of the Statute, unless indicated otherwise.

Article 2 - Vice-President

The Vice-President shall be elected by the Council from among the Governors. Should the Vice-President not complete his/her term, the Council shall elect a new Vice-President for the remainder of the term.

Article 3 - Date and place of Council meetings

3.1 The Council shall meet at least ten times a year. The date of the meetings shall be decided by the Council on a proposal from the President.

3.2 The President may also convene meetings of the Council:

- whenever he/she deems it necessary; or
- at the request of a member of the Council, after consulting the other members.

The President shall convene a meeting of the Council if at least three members of the Council so request.

3.3 The Council shall in principle hold its meetings at the premises of the EMI.

3.4 In exceptional circumstances, to be determined by the President, meetings may also take place by way of teleconferences.

Article 4 - Attendance of Council meetings

4.1 Each Governor may be accompanied at Council meetings by the respective member of the Committee of Alternates referred to in Article 7 of these Rules of Procedure and by one additional representative from his/her institution. In special circumstances, a Governor may decide that the respective member of the Committee of Alternates be replaced by another senior representative of his/her choice of his/her central bank at the meeting or part thereof.

4.2 The President may be accompanied by the Director General, up to three Heads of Department and, as may be required by the agenda, up to three additional members of staff of the EMI.

4.3 The President of the Council of the European Union may be accompanied by the Secretary General of the Council of the European Union or his/her representative. The member of the Commission of the European Communities representing his/her institution may be accompanied by one member of the Commission's staff.

4.4 The Council may invite the Chairmen of the Sub-Committees and Working Groups referred to in Article 10 of these Rules of Procedure to its meetings, if it deems it appropriate to do so.

4.5 The Council may also invite other persons to its meetings, if it deems it appropriate to do so, and in particular the Chairman of the Monetary Committee referred to in Article 109c of the Treaty.

Article 5 - Voting

5.1 If a member of the Council is prevented from attending a meeting or part thereof, he/she shall nominate another representative of his/her institution to act and vote on his/her behalf. This shall be notified to the President.

5.2 In order for the Council to vote, there shall be a quorum of two-thirds of its members or of their nominees.

5.3 Decisions may also be taken by written procedure, unless at least three members of the Council object. Such decisions shall be recorded in the summary record mentioned in Article 6.2 of these Rules of Procedure of the following meeting of the Council.

5.4 Abstentions by members of the Council or by their nominees shall not prevent the adoption by the Council of acts which require unanimity.

5.5 In those cases in which the Council adopts an opinion acting by the majority requested by the Treaty and the Statute, the dissenting minority shall have the right to have their differing view reflected in a document annexed thereto.

5.6 Secret voting may only take place in the case of matters of a personal nature.

Article 6 - Organisation of Council meetings

6.1 The agenda for each meeting shall be adopted by the Council. A provisional agenda shall be drawn up by the President and shall be sent, together with the related documents, to the members of the Council and participants under Article 11 at least eight days before the meeting, except in emergencies, in which case the President shall act appropriately with a view to the circumstances. The Council may decide to remove items from or add items to the provisional agenda on a proposal from the President or from a member of the Council. An item shall be removed from the agenda at the request of at least three of its members if the related documents were not sent to the members in due time.

6.2 A summary record of the proceedings of the Council shall be submitted to its members for approval at the next meeting.

Article 7 - Committee of Alternates

7.1 A Committee of Alternates is hereby established which shall contribute to the preparation of the meetings of the Council and draw up its agenda accordingly.

7.2 The Committee of Alternates shall be composed of senior representatives of the central banks, appointed by their respective Governors. Each member of the Committee may be accompanied at meetings of the Committee by one additional representative of his/her institution.

7.3 The Committee of Alternates shall be chaired by the Director General. He/she may be accompanied by up to three Heads of Department and, as may be required by the agenda, up to three additional members of staff of the EMI. In the absence of the Director General, the Committee of Alternates shall be chaired by the most senior Alternate.

Article 8 - Organisation of the EMI

The Council, acting on a proposal from the President based on prior consultation of its members, shall decide on:

- the departmental organisation of the EMI;
- the appointment of the Director General and of the Heads of Department; and
- the conditions of employment of staff of the EMI.

Article 9 - Financial Committee

9.1 A Financial Committee is hereby established consisting of the Vice-President and the two most senior members of the Council. Their term of office shall be one year. At the expiry of their term of office, the two members of the Council ranking next in order of seniority shall become members of the Financial Committee.

9.2 Should a member of the Financial Committee not complete his/her term of office, the Council shall appoint a new member for the remainder of the term in accordance with the same rule unless the remainder of the term is less than six months. In the latter case, the new member shall serve the remainder of the term of his/her predecessor and an additional period of one year.

9.3 The Financial Committee shall be chaired by the Vice-President and shall:

- examine the President's proposals to the Council on the annual budget and the annual accounts as well as periodical statements of expenses incurred by the EMI during the financial year; and
- deliver its opinion thereon to the Council.

Article 10 - Sub-Committees and Working Groups

10.1 The Council, acting on a proposal from the President, may establish Sub-Committees and Working Groups in specific areas, lay down their mandates and appoint their Chairmen.

10.2 The provision laid down in Article 10.1 of these Rules of Procedure shall be without prejudice to the right of the President to authorise ad hoc meetings between the EMI and representatives of national central banks.

Article 11 - Confidentiality

11.1 The proceedings of the Council and of any committee or group established by the Council shall be confidential unless the Council, acting unanimously, authorises the President to make the outcome of their deliberations public.

11.2 Without prejudice to Articles 11.3 and 17.3, all documents drawn up by the EMI shall be confidential unless the Council decides otherwise.

11.3 The national central banks shall ensure that their representatives are bound, with respect to their activities in the framework of the EMI, to the same obligation of secrecy as the members of staff of the EMI.

Article 12 - Annual Report

The annual report of the EMI referred to in Article 11.3 shall be adopted by the Council in the first quarter of each subsequent financial year and shall be published in the official languages of the European Community in the course of the fourth month of such financial year.

Article 13 - Final Provision

The present Rules of Procedure may be amended from time to time as and when the need arises.

GLOSSARY

Act of Accession is the Treaty between the European Union and the applicant EFTA countries, Austria, Finland, Norway and Sweden, determining the terms and conditions of their accession to the EC. The enlargement negotiations were formally concluded in April 1994. The Act of Accession was signed at the occasion of the European Council meeting in Corfu in June 1994 and entered into force on 1st January 1995 for Austria, Finland and Sweden, the parliaments of these countries having ratified it.

Basle-Nyborg Agreement: agreement concluded in Basle by the Governors of the central banks of the Member States of the EEC on 8th September 1987, on measures to strengthen the operating mechanisms of the EMS (extension of the duration of the Very Short-Term Financing Mechanism, increased eligibility of intervention to financing mechanisms and greater usability of the ECU) and on the use of instruments (exchange rate flexibility within the band, changes in interest rates, intervention and timely adjustment of central rates) that are designed to counter market pressure. This agreement was endorsed by the EEC Ministers of Finance and central bank Governors at their informal meeting in Nyborg on 12th September 1987.

Basle Committee on Banking Supervision: committee of banking supervisory authorities which was set up by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basle.

Bilateral central rate: The official parity between any pair of ERM member currencies, around which the margin of fluctuation is defined.

Central credit register (CCR): information system designed to provide commercial banks, central banks and other supervisory authorities with data regarding the indebtedness of firms and individuals vis-à -vis the whole banking system.

Committee on Monetary, Financial and Balance-of-Payments Statistics (CMFB): established by the Council of Ministers to enhance co-operation in the field of statistics between the EEA statistical institutes and the European Commission on the one hand, and the EEA central banks and the European Monetary Institute on the other, and to provide opinions on statistical matters to all relevant parties.

Concertation Group: group composed of foreign exchange experts from the central banks of the EU Member States, Norway, Switzerland, Japan, Canada and the United States. This group exchanges information on foreign exchange market developments on a regular basis.

Concertation procedure: framework within which experts participating in the Concertation Group exchange information about market developments.

Correspondent banking: arrangement under which one bank provides payment and other services to another bank. Payments through correspondents are often executed through reciprocal accounts (so-called nostro and loro accounts), to which standing credit lines may be attached. Correspondent banking services are primarily provided across international boundaries.

Delivery-versus-payment (DVP): conditions which enable two or more operators to settle at the same time two transfer instructions relating to the same transaction. For instance, in the case of a securities transaction, DVP mechanisms will enable participants to settle both the securities and the related funds at the same time.

Direct participants (access) in IFTS: participants in an IFTS who are responsible to the settlement agent (or to all other direct participants) for the settlement of their own payments, those of their customers, and those of the indirect participants on whose behalf they are settling.

ERM fluctuation margins: Floor and ceiling of bilateral exchange rates, within which ERM currencies are allowed to fluctuate.

Fixed rate tenders: Auction of central bank credit at a pre-announced interest rate (as opposed to variable-rate tenders).

Funds transfer system (FTS): a formal arrangement, based on private contract or statute law, with multiple membership, common rules and standardised arrangements for the transmission and the settlement of money obligations arising between the members.

Interbank Funds Transfer System (IFTS): funds transfer systems in which most of (or all) participants are credit institutions.

Intervention at the limits: intervention carried out by central banks the currencies of which are respectively at the floor and ceiling of their bilateral fluctuation margins.

Intra-marginal intervention: intervention carried out by a central bank to support its currency the exchange rate of which is still within its fluctuation margins.

Large-value payments: payments, generally of very high amounts (typically well above ECU 100,000), which are mainly exchanged between banks or between participants in the financial markets and require urgent and timely settlement. For example, settlement operations for net settlement systems are considered as large-value payments, whatever their amount, because they need to be executed at a very precise moment.

Liquidity sharing rule (or liquidity sharing agreement): an agreement between participants in a clearing system regarding the allocation of any liquidity risk arising when one or more participants fail to fulfil their obligations; the arrangement stipulates how the liquidity risk will be shared among the parties concerned in the event the agreement is activated.

Loss sharing rule (or loss sharing agreement): an agreement between participants in a clearing system regarding the allocation of any loss arising when one or more participants fail to fulfil their obligations; the arrangement stipulates how the loss will be shared among the parties concerned in the event the agreement is activated.

Monitoring Group: group composed of foreign exchange experts from the EU central banks, who review current economic and monetary developments and policies in order to assess the functioning of the EMS.

Net settlement system (NSS): an IFTS in which payments are exchanged during the working day (or part of the working day) and settled on a net basis at the end of the day (or, less often, several times a day).

Official ECU: official ECUs are created through swap operations against 20% of the US dollar and gold assets held by the central banks participating in the EMS. The value of the ECU is calculated as a weighted average of the value of its component currencies. The currency composition of the ECU was frozen on 1st November 1993 when the Treaty on European Union entered into force.

Real-time gross settlement systems (RTGS): funds transfer systems in which payment orders are processed one by one as they arise and which provides for the immediate settlement of all payments provided that there are enough funds or overdraft facilities on the issuers' account with the settlement agent.

Realignments: Change in the ECU central rate and bilateral rates of one or several currencies participating in the Exchange Rate Mechanism of the EMS.

Remote access to IFTS: A credit institution has remote access to an IFTS if its main office or one of its branches has direct access to an IFTS located in another country without having a physical presence there.

Second Banking Co-ordination Directive: directive, adopted on 15th December 1989 (89/646/EEC), which deals with the co-ordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of EU-based credit institutions. It amends the First Banking Co-ordination Directive adopted in 1977 (77/780/EEC).

Settlement risk: a general term used to designate both credit and liquidity risk in a funds transfer system, i.e. the risk that a party will fail to meet one or more obligations to its counterparties or to a settlement agent or settlement institution.

Settlement agent: the institution initiating the final settlement of a clearing on behalf of all the participants.

Undertakings for Collective Investment in Transferable Securities (UCITS): in accordance with Directive 85/611/EEC, these are undertakings whose sole object is the collective investment in transferable securities of funds raised from the public. Units issued by UCITS are re-purchased or redeemed, directly or indirectly, at the request of holders out of the undertakings' assets.

Winding-up Directive: directive on the co-ordination of laws, regulations and administrative provisions relating to the reorganisation and the winding-up of credit institutions which was proposed by the European Commission on 11th January 1988 (amended proposal) and is still being negotiated in the EU Council.

Zero-hour clause: provision in the bankruptcy laws which retroactively renders transactions of a closed institution ineffective after 0.00 a.m. on the date it is ordered to be closed.

ABBREVIATIONS

Countries[1]

BE	Belgium
DK	Denmark
DE	Germany
GR	Greece
ES	Spain
FR	France
IE	Ireland
IT	Italy
LU	Luxembourg
NL	Netherlands
AT	Austria
PT	Portugal
FI	Finland
SE	Sweden
UK	United Kingdom
JP	Japan
US	United States of America

Currencies

BEF/LUF	Belgian/Luxembourg franc
DKK	Danish krone
DEM	Deutsche Mark
GRD	Greek drachma
ESP	Spanish peseta
FRF	French franc
IEP	Irish pound
ITL	Italian lira
NLG	Dutch guilder
ATS	Austrian schilling
PTE	Portuguese escudo
FIM	Finnish markka
SEK	Swedish krona
GBP	Pound sterling
JPY	Japanese yen
USD	US dollar

[1] In accordance with Community practice, countries are listed in the Report using the alphabetical order of the national languages.

Other Abbreviations

BIS	Bank for International Settlements
CHAPS	Clearing House Automated Payments System
CCR	Central Credit Register
EC	European Community
ECB	European Central Bank
ECOFIN Council	Council of the Economic and Finance Ministers
EBA	ECU Banking Association
EEA	European Economic Area
EEC	European Economic Community
EU	European Union
EUROSTAT	Statistical Office of the European Union
EMCF	European Monetary Co-operation Fund
EMI	European Monetary Institute
EMS	European Monetary System
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism of the European Monetary System
ESCB	European System of Central Banks
IFTS	Interbank Funds Transfer Systems
GDP	Gross Domestic Product
IMF	International Monetary Fund
IML	Institut Monétaire Luxembourgeois
LIFFE	London International Financial Futures Exchange
MATIF	Marché à Terme d'Instruments Financiers
OECD	Organisation for Economic Co-operation and Development
RTGS	Real-Time Gross Settlement system
STMS	Short-Term Monetary Support Mechanism
TARGET	Trans-European Automated Real-time Gross settlement Express Transfer system
VSTF	Very Short-Term Financing Mechanism
2BCD	Second Banking Co-ordination Directive

LIST OF EMI PUBLISHED DOCUMENTS*

"Recent developments in the use of the private ECU: statistical review", Foreign Exchange Policy Sub-Committee, March 1993

"Minimum common features for domestic payment systems", Working Group on Payment Systems, November 1993

"Recent developments in the use of the private ECU: statistical survey", Foreign Exchange Policy Sub-Committee, February 1994

"Prepaid cards", Working Group on Payment Systems, May 1994

"Information Booklet", October 1994

"Note on the EMI's intentions with regard to cross-border payments in Stage Three", Working Group on Payment Systems, November 1994

"Developments in EU payment systems in 1994", Working Group on Payment Systems, February 1995

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* Some of these documents were published in 1993 by the Committee of Governors of the EC central banks

MEMBERS OF THE COUNCIL OF THE EMI

A. Lamfalussy	President of the EMI
L. Rojo	Banco de España and Vice-President of the EMI [1]
A. Verplaetse	Nationale Bank van België/ Banque Nationale de Belgique
E. Hoffmeyer (until 31st December 1994) B. Andersen (as of 1st January 1995)	Danmarks Nationalbank
H. Tietmeyer	Deutsche Bundesbank
Y. Boutos (until 26th October 1994) L. Papademos (as of 26th October 1994)	Bank of Greece
J.-C. Trichet	Banque de France
M. Doyle (until 30th April 1994) [2] M. O'Connell (as of 1st May 1994)	Central Bank of Ireland
A. Fazio	Banca d'Italia
P. Jaans	Institut Monétaire Luxembourgeois
W. Duisenberg	De Nederlandsche Bank
M. Schaumayer (as of 1st January 1995)	Oesterreichische Nationalbank
M. Beleza (until 28th June 1994) A. de Sousa (as of 28th June 1994)	Banco de Portugal
S. Hämäläinen (as of 1st January 1995)	Suomen Pankki
U. Bäckström (as of 1st January 1995)	Sveriges Riksbank
E. George	Bank of England

[1] Since July 1994.
[2] Vice-President of the EMI from January to April 1994.

MEMBERS OF THE EMI MANAGEMENT

A. Lamfalussy	President
R. Raymond	Director General

Heads of Department

H.K. Scheller	Secretary General
G. J. Hogeweg	Monetary, Economic and Statistics Department
P. W. Schlüter	Administration Department
J. S. Etherington	Information and Communications Systems Department

FINANCIAL COMMITTEE

L. Rojo	Banco de España
E. Hoffmeyer (until 31st December 1994)	Danmarks Nationalbank
W. Duisenberg	De Nederlandsche Bank
A. Verplaetse (as of 1st January 1995)	Nationale Bank van België/ Banque Nationale de Belgique

CHAIRMEN OF THE SUB-COMMITTEES AND WORKING GROUPS

L. Papademos (until 6th January 1995) J.-J. Rey (as of 9th January 1995)	Monetary Policy Sub-Committee
F. Saccomanni	Foreign Exchange Policy Sub-Committee
B. Quinn	Banking Supervisory Sub-Committee
T. Padoa-Schioppa	Working Group on EU Payment Systems
A. Jarvis	Working Group on Printing and Issuing a European Banknote
K. Hanau	Working Group on Statistics
H. Heemskerk	Working Group on Accounting Issues
Y. Barroux	Working Group on Information Systems