EUROPEAN MONETARY INSTITUTE

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* *Convention used in the tables:*
"-" Not applicable
"." Not available
"..." Nil or negligible

* *Convention used in the Report:*
Aggregate EU-15 figures in this report are generally constructed using purchasing parity exchange rates in order to weight the individual national data. However, trade data use actual exchange rates in 1993. Rates and indices (except CPI) are based on 1993 GDP weights, while CPI is based upon consumer spending weights.

This report was finalised in early May 1998.

Abbreviations

Countries*

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

€	euro
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

* *In accordance with Community practice, countries are listed in this Report using the alphabetical order of the national languages.*

Back row (left to right): A. Fazio, P. Jaans, M. O'Connell, U. Bäckström, A. de Sousa, A. Verplaetse, J.-C. Trichet, N. Wellink, L. Papademos, K. Liebscher, E. George.

Front row: H. Tietmeyer, S. Hämäläinen, W. Duisenberg (President), L. Rojo (Vice-President), B. Andersen.

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A. Lamfalussy (until 30 June 1997) W. Duisenberg (as of 1 July 1997)	*President of the EMI*
L. Rojo	*Banco de España and* *Vice-President of the EMI*
A. Verplaetse	*Nationale Bank van België/* *Banque Nationale de Belgique*
B. Andersen	*Danmarks Nationalbank*
H. Tietmeyer	*Deutsche Bundesbank*
L. Papademos	*Bank of Greece*
J.-C. Trichet	*Banque de France*
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EUROPEAN MONETARY INSTITUTE

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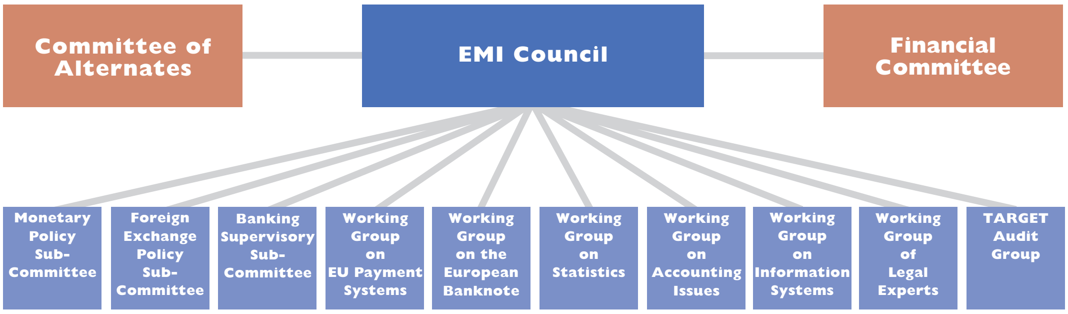
H. K. Scheller	*Secretary General,* *Head of General Secretariat*
G. J. Hogeweg	*Head of Monetary, Economics and* *Statistics Department*
P.-W. Schlüter	*Head of Administration Department*
J. Etherington	*Head of Information and Communications* *Systems Department*
L. Hoogduin	*Adviser to the President*

Back Row (left to right): J. Etherington, P.-W. Schlüter, G. J. Hogeweg, L. Hoogduin
Front Row: R. Raymond, W. Duisenberg, H. K. Scheller



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J.-C. Trichet H. Tietmeyer	(until 31 August 1997) (as of 1 September 1997)	*Banque de France* *Deutsche Bundesbank*
E. George M. O'Connell	(until 31 August 1997) (as of 1 September 1997)	*Bank of England* *Central Bank of Ireland*

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Foreword

The Annual Report of the European Monetary Institute (EMI) for 1997 is the fourth and last such document to be published by the Institute. The final phase of the transition to Stage Three started with the confirmation by the Heads of State or Government on 2/3 May 1998 of the Member States which fulfil the necessary conditions for the adoption of the single currency and the pre-announcement of the bilateral exchange rates to be used in determining the irrevocable conversion rates for the euro. Since the beginning of 1994 the EMI, in close collaboration with national central banks of the European Union (EU), has undertaken the necessary technical preparations for the establishment of the European System of Central Banks (ESCB), the conduct of the single monetary policy for the euro area and the creation of the single currency. This task will be completed by its successor, the European Central Bank (ECB).

As in past years, the Report describes the economic, monetary and financial situation in the EU in 1997, outlines the activities of the EMI and includes its annual accounts.

As regards the overall macroeconomic situation in the EU, the recovery appears to be gathering strength, and the crisis in Asia has not apparently had a significant adverse effect on economic growth to date. It is particularly encouraging to see that domestic demand is picking up across the EU and is making a major contribution to real GDP growth. That said, it is disappointing to note that fixed investment growth remains historically weak in a number of countries, despite favourable underlying fundamentals. Moreover, the performance of the EU labour market is still unsatisfactory. The high levels of youth and long-term unemployment, as well as the lack of sustained job creation, point to the structural nature of a major part of EU unemployment and the need for countervailing structural measures to increase market flexibility.

Meanwhile, the rate of inflation in the EU in 1997 was at its lowest level for many years, with an increasing number of countries recording inflation of 2% or less. By and large, the first stage of the upturn is not giving rise to significant inflationary pressures, thus enabling low interest rates to be broadly maintained in the majority of EU countries and significant declines in interest rates to occur in a number of others. For the countries adopting the single currency, it will be essential to maintain this environment of broad price stability and to ensure that the emerging common level of short-term interest rates is consistent with price stability in the euro area as a whole.

As highlighted in the EMI's recent examination of macroeconomic convergence, further challenges for the future relate to fiscal policy. In particular, with regard to the future euro area, it is imperative that all Member States should re-establish as soon as possible a degree of budgetary flexibility which will allow them to respond to adverse cyclical developments. Such flexibility will be ensured by achieving a fiscal position close to balance or in surplus over the medium term. In some cases substantial and persistent overall fiscal surpluses will also be necessary in order to reduce the burden arising from very high ratios of debt to GDP, render national budgets less vulnerable to changes in interest rates and prepare for the impact on public finances of the ageing of the population.

Preparatory work for Stage Three proceeded as planned in 1997 in strict compliance with the timetable. From among the many areas in which we achieved significant results, I should like to mention the following in particular:

- in the field of strategy, progress with regard to the identification of suitable candidate strategies for Stage Three (elaborating an agreed set of key elements which will characterise the ESCB's strategy) and the development of the analytical and econometric infrastructure necessary to support monetary policy decision-making;

- definition of the technical specification for the ESCB's operational framework and the setting-up of the tools and IT systems necessary for the implementation of the future monetary policy of the ESCB;

- marked progress towards the implementation of the statistical requirements for the conduct of the single monetary policy in Stage Three, thus enabling data compiled in line with the new agreed basis to be made available to the ECB during the course of 1998;

- finalisation of a draft agreement on the ERM II, to be endorsed by the ECB;

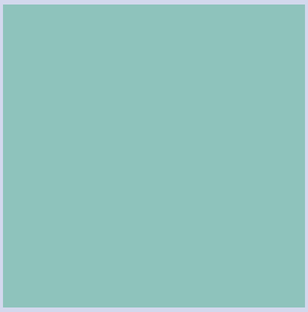
- progress with regard to organisational aspects, implementation and testing of the ESCB's IT infrastructure and the TARGET system; and

- publication of the final designs for the euro banknotes.

In its short life the EMI has carried out thorough technical preparations for Stage Three of EMU which now enable us to look forward with confidence to the introduction of the single currency at the beginning of 1999. The solid foundations laid by the EMI should help the ESCB/ECB to develop into a strong institution which will pursue its primary objective of maintaining price stability in the euro area in a determined manner, thereby providing the conditions necessary for sustained economic growth.

Frankfurt, 5 May 1998

Wim Duisenberg
President



Executive summary

Executive summary

The Annual Report 1997 is the last report to be published by the European Monetary Institute (EMI). As in the previous three Annual Reports, the EMI aims to provide an overview of all aspects related to its tasks as set out in the Treaty establishing the European Community.[1] In accordance with Article 11 of the EMI Statute, the Report covers both economic, monetary and financial conditions in the Community up to the end of 1997 and the activities of the EMI; it also presents the Institute's annual accounts. As in the past, the material presented in this year's Report draws to a significant extent on earlier, more extensive EMI publications. In particular, in March 1998 the EMI published its Convergence Report in fulfilment of Article 109j (1) of the Treaty. Moreover, the "Second progress report on the TARGET project" was published in September 1997 and in the same month "The single monetary policy in Stage Three: General documentation on ESCB monetary policy instruments and procedures" was issued. A list of documents published by the EMI in 1997 and early 1998 is provided at the end of this Report.

The confirmation on 2/3 May 1998 by the Heads of State or Government of the Member States which will adopt the single currency heralded the start of the final phase of the transition to Stage Three, which includes the establishment of the ESCB and the ECB and the liquidation of the EMI.

1 Economic, monetary and financial conditions in the European Union

Economic and financial background in 1997

Global economic conditions continued to be broadly favourable in 1997, with the notable exception of developments in Asia during the latter half of the year. Initially, *real GDP growth* in the EU followed the pattern of subdued developments also observed in early 1996. However, the pace of economic activity quickened thereafter and, from the second quarter onwards, the growth rate was significantly higher than in the comparable period of 1996. The crisis in Asia did not have a significant adverse impact on growth in 1997. Average real GDP growth for the EU is estimated to have been 2.7%, which is significantly higher than the rate of 1.7% recorded in 1996. The acceleration in activity was widespread, with stronger growth being recorded in almost all EU countries, although there continued to be differences in the strength of economic activity.

For the Union as a whole, the improved real growth performance in 1997 was principally due to domestic demand. For the fourth successive year, net trade in goods and services provided a positive, albeit small, stimulus to growth, underpinned by subdued growth in relative unit labour costs and, as a result, improvements in competitiveness. The rise in domestic demand was linked to an improvement in investment growth and an increase in stockbuilding, while growth in private consumption was unchanged and government consumption was weaker than in 1996. However, continuing the pattern

[1] *References to the Treaty are references to the Treaty establishing the European Community, unless indicated otherwise. References to the EMI Statute or the ESCB/ECB Statute are references to Protocol No. 4 on the Statute of the European Monetary Institute and Protocol No. 3 on the Statute of the European System of Central Banks and of the European Central Bank respectively. These Protocols are attached to the Treaty and form an integral part thereof.*

observed since the early 1990s, fixed investment growth in 1997 - although stronger than in the previous year - continued to be below the levels typical of past decades, despite satisfactory profit margins and a high level of industrial confidence, as well as relatively high capacity utilisation rates for the manufacturing sector. Both exports and imports grew considerably more strongly than in 1996, partly reflecting the resurgence of growth within the EU (which increased intra-EU trade) and buoyant economic conditions globally.

Against the background of strengthening economic growth in the EU as a whole, employment has increased only marginally, while *unemployment* has remained stubbornly high. The unemployment rate for the EU as a whole (measured on the basis of EUROSTAT data) fell slightly during the course of 1997, from 10.8% in the fourth quarter of 1996 to 10.5% in the fourth quarter of 1997. Of particular concern are the much higher levels of youth and long-term unemployment. The concentration of unemployment in these categories as well as the persistence of subdued employment creation point to the structural nature of a major part of EU unemployment and to the continued need for structural measures.

Concerning *achievements in macroeconomic convergence,* in accordance with Article 109j (1) of the Treaty, at the end of March 1998 the EMI presented its report to the EU Council on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of Economic and Monetary Union. This Convergence Report included an examination of the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the convergence criteria, as set out in the Treaty. It therefore covered the performance of individual EU countries in terms of the degree of price stability, government debt and deficit positions, long-term interest rates and exchange rates. The summary of the examination of convergence by the EMI, which included developments in 1997, is provided in an annex to this Annual Report.

Monetary policies in Member States

As regards monetary policies, the economic and financial environment in 1997 allowed for a continuation of the convergence of short and long-term interest rates and broadly stable exchange rates. The majority of EU countries (namely Belgium/ Luxembourg, Denmark, Germany, France, the Netherlands, Austria, Finland and Sweden) broadly maintained low interest rates. This mirrored a situation of price stability against a background of narrowing - but generally still negative - output gaps, benign wage behaviour and the consolidation efforts of fiscal authorities. Official and key interest rates remained at low and closely aligned levels, although they were raised to a small extent in the autumn in response to inflation risks. The concerted nature of these policy actions strengthened the cohesion among those countries with closely aligned interest rates.

Several other Member States (Spain, Italy, Portugal and initially also Greece) were able to continue the process of reducing interest rates in line with the degree of convergence of their overall economic fundamentals, notably in respect of the achievement of price stability, with the countries referred to in the paragraph above. Short and long-term interest rates in these countries thus tended to follow a downward trend, progressively converging towards the lower level of the closely aligned countries. Monetary policy in the two remaining EU countries (namely Ireland and the United Kingdom) was tightened, albeit to differing degrees, in response both to buoyant economic and monetary growth and to heightened inflation risks against a background of continued sound fundamentals. The widening of short-term interest rate differentials against Germany was accompanied by a further strong appreciation of the respective currencies vis-à-vis the Deutsche Mark. Later in the year, however, short-term interest rates in Ireland began to decline relative to Germany and the Irish pound moved closer to its central rates in the ERM grid.

Economic prospects and challenges

Economic forecasts released by major international organisations in spring 1998 suggest that *growth prospects* for the EU in 1998 and 1999 are favourable, as domestic demand should strengthen further, offsetting to some extent an expected deterioration in the external environment due to, inter alia, the crisis in Asia. The continuation of stability-oriented monetary policies combined with wage moderation, with the latter partly reflecting the persistence of relatively high rates of unemployment, and still negative output gaps in certain countries are expected to limit inflationary pressures. In addition, the decline in oil prices, provided that it is by and large sustained, and the counter-inflationary impact of the Asian crisis - arising from a depreciation of certain Asian currencies and the moderation of global growth - should contribute to dampening inflationary pressures from the outside. Risks to the inflation outlook relate to, inter alia, the possibility of a faster than expected pick-up in aggregate demand in the EU and thus to a closing of output gaps, the development of wages, a further appreciation of the US dollar and, in the light of the latest OPEC agreement, a sustained reversal of the recent decline in oil prices. The main uncertainty with regard to the above outlook stems from the external environment. World output and trade growth are expected to be weaker in 1998 and 1999 than in 1997 owing to a sharp decline in real GDP growth in parts of Asia, a modest slowdown in the US growth rate and a deterioration in the economic and financial situation in Japan. The extent of the weakness in the external environment arising from the turmoil in Asia will depend on the scope and timing of the adjustment of macroeconomic policies in the countries affected and on the extent to which financial reforms are implemented. The possibility of further spillover effects cannot yet be ruled out. The contractionary impact of the Asian crisis on EU growth may be partly offset by two factors: first, the decline in long-term interest rates in the EU as well as in the United States - which is linked to, inter alia, investors' reassessment of the risk in emerging markets; and, second, the marked decline in commodity prices, which may contribute to a further rise in real incomes.

With regard to *convergence*, an excerpt from the EMI's Convergence Report, published in March 1998, is provided in an annex to this Report. Therein, it is stated that, notwithstanding recent achievements, further substantial consolidation is warranted in most Member States in order to achieve lasting compliance with the fiscal criteria and the medium-term objective of having a budgetary position that is close to balance or in surplus, as required by the Stability and Growth Pact. This applies in particular to Belgium, Germany, Greece, Spain, France, Italy, the Netherlands, Austria and Portugal, where deficits in 1998 are forecast to be between 1.6 and 2.9% of GDP. For most of these countries, these consolidation requirements also apply when comparing the fiscal deficit ratios as projected in the Convergence Programmes for 1999-2000 with the medium-term objective of the Stability and Growth Pact. Taking a broader view on the sustainability of fiscal developments, the case for sustained consolidation over an extended period of time, requiring substantial fiscal surpluses, is particularly strong for those countries with debt ratios of above 100% (Belgium, Greece and Italy). This compares with significant overall deficits in 1997 and the years before. In countries with debt ratios of significantly above 60% but below 80% of GDP, keeping the deficit ratio at current levels would in most cases not bring down the debt ratio to below 60% within an appropriate period of time, which indicates the need for further, in some cases substantial, consolidation.

In *the remaining months of Stage Two*, the primary objective of the monetary policies of the countries selected to participate in the euro area is to ensure that the current environment of broad price stability is maintained for the euro area as a whole, thereby providing the ESCB with a favourable starting position. The majority of countries selected to participate in the euro area have already achieved short-term interest rates which are closely aligned at a low level. The conditions in the first part of 1998 have allowed this common position to be firmly consolidated and the remaining members have been able to maintain the downward trend in their key interest rates. This suggests that a de facto common monetary policy stance is tending to emerge in the selected euro area countries, against a background of broadly stable prices and exchange rates. By the end of 1998 at the latest, those countries' short-term interest rates will have converged to a common level which will be consistent with the objective of maintaining price stability in the euro area. This overall pattern of convergence in short-term interest rates is consistent with a situation on the eve of Stage Three in which market exchange rates between the countries selected to participate in the euro area are equal to the pre-announced bilateral exchange rates which will be used in determining the irrevocable conversion rates for the euro. These pre-announced bilateral exchange rates are consistent with economic fundamentals and are compatible with sustainable convergence.

During the remainder of Stage Two, the Governing Council and the Executive Board of the ECB will finalise the preparations needed for the conduct of the single monetary policy in the euro area as of 1 January 1999. In the meantime, the participating national central banks will retain their national monetary powers. The institutional changes entailed in the establishment of the ESCB and the ECB provide a suitable framework within which the participating national central banks will be able to engage in close co-operation with a view to co-ordinating their national monetary policies in order to achieve the primary objective of maintaining price stability in the euro area. Furthermore, in accordance with Article 44 of the ESCB/ECB Statute, the ECB is to take over the tasks of the EMI which still need to be performed in Stage Three of EMU, given the existence of Member States with a derogation. The General Council of the ECB is to assume responsibility for relations with the national central banks of the non-euro area Member States.

2 Preparatory work for Stage Three

Monetary policy

In publishing its report on the "The single monetary policy in Stage Three - Elements of the monetary policy strategy of the ESCB" in February 1997, the EMI, having reviewed a number of alternatives, identified two strategies - intermediate monetary targeting and direct inflation targeting - as potential candidates for Stage Three. It also indicated that, regardless of the final choice made in this respect by the ESCB, the strategy would be characterised by five key elements which are an indispensable part of any strategy: the announcement of a quantified definition of the final objective of price stability and the announcement of specific targets against which its performance can be assessed; the use of a broad set of indicator variables in the setting of policy; a privileged role for monetary aggregates and, finally, the ESCB having at its disposal its own forecasts of inflation and other variables. Following the publication of this report, work at the EMI in the field of strategy concentrated on the development of the infrastructure necessary to support monetary policy decision-making, including the development of various econometric tools and procedures for preparing policy decisions.

After the conceptual phase, which was concluded at the end of 1996, the preparatory work dealing with the instruments and procedures necessary for implementing the single monetary policy was devoted to defining the technical specifications for the ESCB's operational framework and to the setting-up of the ESCB tools necessary for the implementation of the future monetary policy of the ESCB.

The main developments in terms of the technical features of the monetary policy operations in 1997 relate to the procedures, time frame and calendar for ESCB tenders; to the settlement modalities of open market operations; and to the implications of the end-of-day procedures for the use of standing facilities. The preparatory work necessary to enable the ESCB to apply minimum reserve requirements as from the start of Stage Three, if the Governing Council of the ECB decides in favour of having such a system, is currently being carried out. This included the further elaboration of the draft EU Council Regulation on minimum reserves, the main operational mechanisms of the minimum reserves system and the specification of the potential reserve base. Common eligibility criteria have been defined for the counterparties and the eligible assets to be used in monetary policy operations with the ESCB. The risk control measures to be applied in the use of these assets have also been specified, taking into account market practices.

As monetary policy operations will be implemented on a decentralised basis, the main preparatory work for the implementation of monetary policy instruments has been undertaken by the NCBs, for the technical infrastructure as well as for the legal requirements. An ESCB internal infrastructure is being prepared for the execution of open market operations, and the EMI is developing the systems required to establish and publish the lists of individual eligible assets, possibly with the exception of certain categories of non-marketable assets, and eligible counterparties. Another crucial project for the implementation of the single monetary policy is the setting-up of an effective system of liquidity management relying on the exchange of an integrated daily flow of information between the NCBs and the ECB.

Foreign exchange policy

In the context of future foreign exchange policy co-operation between Member States participating in the euro area and other EU countries, work has been conducted in 1997 at the level of both the ECOFIN Council and the EMI, in accordance with the broad lines defined in a report the EMI submitted on this issue to the Dublin meeting of the European Council in December 1996. The European Council held in Amsterdam in June 1997 approved a Resolution relating to the new exchange rate mechanism to be introduced in Stage Three of EMU. In parallel, the EMI has finalised the draft agreement between the ECB and future non-euro area central banks, which lays down the operating procedures for the ERM II; the draft agreement will be submitted to the ECB for endorsement following its establishment.

Implementation work on the conduct of potential foreign exchange intervention focused on aspects related to the required operational framework and information systems support, which will make it possible for the ESCB to execute intervention. Work has been undertaken in order to facilitate the decision on the amount and the modalities of the initial transfer of foreign reserve assets from the NCBs to the ECB at the beginning of Stage Three, in accordance with Article 30.1 of the ESCB/ECB Statute. Work has also been initiated to prepare complementary Community legislation which will enable the ECB, in accordance with Article 30.4 of the ESCB/ECB Statute, to make further calls on the NCBs' foreign reserve assets beyond the limit of E50 billion set in Article 30.1. A monitoring framework has been designed for market transactions conducted by the NCBs with foreign reserve assets in excess of those transferred to the ECB with a view to ensuring consistency with the euro area single monetary and foreign exchange rate policies. A similar monitoring framework will be put in place for transactions performed by euro area Member States and changes in their foreign exchange working balances. The EMI has also conducted work to prepare procedures for the computation and publication of reference exchange rates for the euro.

The Luxembourg European Council held in December 1997 stated in its conclusions that "the bilateral exchange rates which will be used to determine the conversion rates of the euro will be announced on 3 May 1998 for those Member States participating in the euro from the start". The Joint Communiqué issued on 2 May 1998 by the Ministers and central bank governors of the EU Member States participating in the euro area, the European Commission and the EMI, as the forerunner of the ECB, clarifies that these rates are the ERM bilateral central rates and the method to be used on 31 December 1998 for setting the irrevocable euro rates will be the regular daily concertation procedure. The euro area NCBs stand ready to ensure the equality between the market exchange rates ascertained in the concertation procedure and the pre-announced ones. The exchange rates of the official ECU vis-à-vis the currencies of the euro area Member States set through this procedure will be adopted by the Council as the irrevocable conversion rates for the euro on and with effect from 1 January 1999.

Statistics

Wide-ranging statistical requirements for the conduct of policy in Stage Three were set out in documents released by the EMI in July 1996. Much of 1997 was spent in implementing these requirements and clarifying points of detail where necessary. Though some areas of difficulty remain, the introduction of the necessary statistical changes has proceeded smoothly on the whole, and data on the new agreed basis covering the future single currency area will become available to the EMI/ECB during the course of 1998. Further consideration has been given to the organisation of statistical work at the European level, in particular in areas where the EMI/ECB and the Commission (EUROSTAT) will share responsibility; the legal framework for statistics in Stage Three has been further developed; and by the end of 1997 most of the work on electronic data transmission within the ESCB had been done, with progress also in the development of the internal systems to handle data in the ECB.

Payment systems

In the field of payment systems, the EMI's "Second progress report on the TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) project" which was released in September 1997 provided further information on the progress made with regard to organisational aspects and the implementation of the system. In particular, it addressed the following issues: 1) operating time; 2) pricing policies; 3) intraday liquidity to non-euro area NCBs; 4) the role of the ECB in TARGET; and 5) TARGET implementation. TARGET testing is well on track. A brochure describing the main features of the TARGET system was released in May 1998 and a TARGET operating days calendar will be published in August 1998.

In the field of securities settlement systems (SSSs), preparatory work focused on two main aspects: the establishment of standards for the use of SSSs in ESCB credit operations and the implementation of short-term solutions for the cross-border use of collateral. The standards and the underlying analysis are described in the EMI's report entitled "Standards for the use of Securities Settlement Systems in ESCB credit operations", which was released on 8 January 1998. These standards cover three main areas: legal issues, settlement and custody risks, and operational issues. Moreover, in July 1997 the EMI Council decided to adopt the correspondent central banking model (CCBM) as an interim solution before the establishment of appropriate links between SSSs in order to facilitate the cross-border use of collateral in ESCB operations (monetary policy and intraday credit operations).

Preparation of euro banknotes

The draft designs for the euro banknotes which were chosen by the EMI Council in December 1996 were developed into final designs in the course of 1997. Illustrations of the revised designs were published in July 1997. These form the basis for the origination work, in the context of which the designs are being transformed into printing plates in the first half of 1998. In 1997, in order to identify potential problems at the earliest possible stage, all the techniques which will be used for euro banknote production were tested within the context of a test banknote project. The project revealed that all the participating printing works should be in a position to produce all the euro banknote denominations to an equal standard of quality and with an identical appearance. With regard to protection of the euro banknotes, the EMI Council has agreed to use the copyright © symbol on the euro banknotes and, to increase efficiency in combating counterfeiting, to set up a joint investigation centre and a database on counterfeit euro banknotes. The date for the launch of the euro banknotes and coins has been fixed at 1 January 2002. With regard to Article 52 of the ESCB/ECB Statute, which commits the Governing Council of the ECB to take the necessary measures to ensure that banknotes denominated in currencies with irrevocably fixed exchange rates are exchanged by the NCBs at their respective par value, a majority of the members of the EMI Council has reached a basic agreement on the mechanisms which will be involved in exchanging and repatriating national banknotes between 1999 and 2002.

Accounting issues

The preparatory work on the accounting framework to be used for the ESCB was largely completed in 1997. This framework will form the basis for the internal and external reporting of the ESCB and serve to ensure that liquidity management and statistical requirements are met. The transition to Stage Three was also examined and the necessary principles and techniques were developed. In addition, work is continuing on the method for allocating monetary income in order to prepare the decisions to be taken by the Governing Council of the ECB.

Information and communications systems

In the field of information and communications systems, the teleconference replacement project was successfully implemented. It enables several audio conferences to take place in parallel between the connected institutions. Furthermore, its underlying physical infrastructure will serve as the main network platform for the data transfers needed for the majority of ESCB-wide information systems applications. An ESCB-wide communications infrastructure providing secure end-to-end file transfer and robust messaging services was developed and became operational in May 1998. In 1997 significant progress was made in the development of several ESCB-wide software applications which will support the conduct of monetary policy operations, foreign exchange market interventions and the management of the ECB's foreign reserve assets. All these applications will be implemented by mid-1998. The second half of 1998 will be devoted to undertaking the testing of all the systems and procedures between the ECB and the NCBs. The EMI Council approved a framework for a security policy for the information systems of the ESCB, aiming at guaranteeing an adequate and co-ordinated level of security.

Banking supervision and financial stability

The EMI has examined how in Stage Three of EMU the ESCB can contribute to the smooth conduct of the policies pursued by the competent authorities in the fields of banking supervision and the stability of the financial system, under Article 105 (5) of the Treaty. Two main forms of contribution of the ESCB can be envisaged. First, the ESCB and, in particular, the ECB will promote co-operation among the supervisory authorities and between them and the ESCB on relevant prudential supervisory issues, such as those of a macro-prudential nature with a bearing on the stability of financial institutions and markets. Second, the ESCB will provide supervisory authorities with information stemming from its basic activity which could be useful for the supervisory function. Conversely, banking supervisors will be ready to give supervisory information to the ESCB which could be valuable for the ESCB to perform its tasks as laid down in the Treaty and the ESCB/ECB Statute. Moreover, Article 25 (1) of the ESCB/ECB Statute contemplates a specific and optional advisory task of the ECB on the scope and implementation of the Community legislation on banking supervision and the stability of the financial system. In addition, Article 105 (4) of the Treaty, which provides for a mandatory advisory task of the ECB on draft Community and national legislation falling within the ECB's field of competence, is likely to apply to, inter alia, certain legislation on banking supervision and the stability of the financial system. Finally, Article 105 (6) of the Treaty envisages the possibility of conferring upon the ECB specific tasks concerning policies relating to prudential supervision. In this respect, it is felt premature at this stage to envisage any transfer of supervisory competencies from national authorities to the ECB.

Legal issues

In the legal area, the EMI further elaborated its views on the adaptation of national legislation under Article 108 of the Treaty with a view to Treaty and ESCB/ECB Statute requirements for Stage Three in a report which was published in October 1997. In doing so, it gave guidance to national legislators in this adaptation process and at the same time laid the basis for its 1998 Convergence Report in which, inter alia, the compatibility of national legislation, including the statutes of the NCBs, with the Treaty and the ESCB/ECB Statute was assessed.

Changeover to the euro

During 1997 preparatory work for the changeover to the single currency gathered considerable speed. The EMI continued to keep track of developments as regards the changeover, in order to assess whether differing changeover preparations across Member States, owing to differences in the local organisational and infrastructural environments, might have implications for the single monetary policy to be conducted as from January 1999 onwards.

In the financial area, the EMI and the NCBs have encouraged market operators to consider market-driven standardisation within Monetary Union. The EMI also provided assistance in the establishment of common market standards in the euro area-wide money markets and foreign exchange markets. It furthermore recognised the need for a distinctive codified symbol for the single currency and expressed its support for the symbol E, proposed by the European Commission, as the logo for the euro. With a view to assisting all those involved in preparing for the changeover, the EMI has improved the distribution of relevant information, inter alia through its Web site.

Public information

Since its establishment on 1 January 1994 the EMI has fulfilled its reporting obligations in accordance with Articles 7 and 11.3 of the EMI Statute by publishing reports on the state of the preparations for Stage Three of EMU, its activities and monetary and financial conditions in the Community. A list of EMI documents published since the beginning of 1997 and the EMI's Web site address are provided at the end of this Report. The EMI recognises that there is a need for the ESCB to ensure the transparency of its objectives and policies in Stage Three and to foster knowledge of its operations and tasks, thus enabling the financial community and the general public to both understand and support its policies. To this end, the EMI is developing an external communication policy - to be presented for consideration by the Governing Council of the ECB - on the most effective ways in which to disseminate information concerning the activities of the ESCB.

3 Other tasks of the EMI

Oversight of the ECU Clearing and Settlement System

The EMI's main focus has been to ensure that adequate action is taken to improve the system's compliance with the safety standards laid down in the 1990 G-10 Report on Interbank Netting Schemes.

The EMI monitored in particular the preparatory work conducted by the EBA on its Euro Clearing and Settlement System for Stage Three of EMU (EURO 1). In addition, the EBA - in co-operation with the EMI - is finalising the settlement arrangements in accordance with an EMI Council decision to allow the EBA to open a central settlement account at the ECB. It may also open other settlement accounts with those NCBs which agree to provide such accounts. Only the Banque de France has indicated its intention to open a local settlement account for the EBA (by June 1999).

Electronic money

In 1997 the EMI carried out a further study of the impact on EU economies of the emergence of electronic money. It took particular account of new market developments and conducted a thorough analysis of their implications for monetary policy. The results of the study provided the basis for the "Opinion of the EMI Council on the issuance of electronic money" of 2 March 1998, the text of which is reproduced in Box 3 of this Report.

Co-operation in the field of banking supervision and financial stability

The EMI held consultations on a number of issues falling within the competence of national central banks and affecting the stability of financial institutions and markets. First, a survey was conducted on a wide range of issues of potential relevance to the stability of the EU banking systems by focusing on the current trends and possible developments which are likely to occur in these systems in the medium and long term, both in general and with regard to the establishment of EMU. Second, an investigation was carried out on the possible use of macroeconomic data in the supervisory process and the links between macroeconomic developments and fragility in banking systems as a whole and at the level of individual institutions. Third, the most recent developments in industry practice for bad and doubtful loans - with particular focus on the new approaches based on statistical methods - were examined with a view to assessing the main prudential supervisory implications. Fourth, a first examination was undertaken of the possible impact of the establishment of EMU on the current EU prudential supervisory regime for credit institutions' liquidity. Finally, co-operation among the EU credit registers continued with a view to pursuing the objective of the opening-up of the respective registers on a cross-border basis.

Administration of EMS mechanisms and Community loans

Greece joined the ERM with effect from 16 March 1998, which entailed compulsory participation in the ECU swap mechanism from that date. Since the Bank of Greece had been participating in the mechanism on a voluntary basis since January 1986, ERM membership had no implications for the EMI's ECU swap operations.

In 1997 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.

Advisory functions

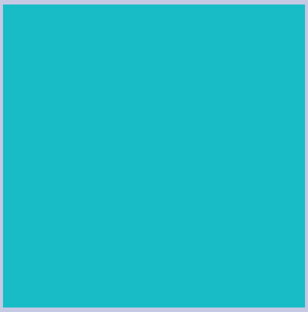
In the framework of its advisory functions, during 1997 and the first quarter of 1998 the EMI delivered opinions in fifty-two consultation procedures under Article 109f (6) and Article 5.3 of its Statute, in many cases on adaptations of statutes of NCBs under Article 108 of the Treaty.

Monitoring of compliance with the prohibition on monetary financing and on privileged access

In 1997 the EMI continued to monitor NCBs' fulfilment of their obligations under Articles 104 and 104a of the Treaty and related Council Regulations and concluded that the Treaty requirements continue to be respected by the EU NCBs. Remaining imperfections which had appeared in the transition to the new arrangements, as well as technical problems which had occurred in the implementation of new regulations, were finally corrected at the beginning of 1997.

Co-operation with other institutions

The EMI has continued its close co-operation with other bodies of the European Union in a number of forms and at various levels. With regard to contacts with institutions outside the Community, the "concertation procedure" has remained a valuable forum for exchanging data among foreign exchange experts. Important links have been retained with the Bank for International Settlements, the OECD and the central banks of the associated Central and Eastern European countries. The International Monetary Fund visited the EMI several times during the year and the future relationship between the ESCB and the IMF was one of the main topics on which an exchange of views took place.



Chapter I

Economic, monetary and financial conditions in the European Union

1 Economic and financial background in 1997

1.1 Major developments outside the EU

External environment remained robust

Global economic conditions continued to be broadly favourable in 1997, with the notable exception of developments in Asia during the latter half of the year. The volume of world trade in goods and services increased sharply, at an estimated rate of 9.4% in 1997, compared with 6.6% in 1996. World output growth in 1997 amounted to 4.1% and output in the OECD countries is estimated to have risen by 3.0%. Among the industrialised countries, the most noteworthy features were the relative weakness of the Japanese economy and the continued strength of demand in the United States. In parallel to several years of sustained growth in a number of OECD countries, inflation continued to be remarkably low and stable, with CPI inflation for the group (excluding the so-called high inflation countries[2]) falling to 2% on average, the lowest figure for over three decades. This benign outcome for inflation was underpinned by a decline in oil prices during the course of the year and broadly stable non-oil commodity prices.

The United States continued to enjoy robust output and employment growth. Output growth accelerated to 3.8% (see Chart 1), prompting a further decline in the unemployment rate to a trough of 4.6% in November 1997, its lowest level since 1973. At the same time, inflationary pressures remained moderate, with CPI inflation declining over the course of the year to reach an average of 2.3%. Rising productivity and falling import prices, owing to, inter alia, the strength of the US dollar, were the main underlying factors, together with a modest tightening of monetary policy in the spring by the Federal Reserve. The federal fiscal deficit was almost eliminated in 1997, partly due to a growth-induced surge in tax revenues.

Whereas growth in Japan appeared to gain momentum during 1996, it stalled during 1997. Output fell sharply in the second quarter, reflecting a decline in private spending as the fiscal stance was tightened. Consumer confidence later deteriorated further owing to the financial turmoil in other Asian countries (see Box 1) and the bankruptcies of certain Japanese financial institutions. As a consequence of weak growth, the rate of unemployment rose to 3.4%. The only stimulus to output growth was provided by the external sector, reflecting the Japanese yen's depreciation against the dollar and buoyant foreign demand. The Bank of Japan's accommodating monetary policy stance was maintained, with the official discount rate remaining at a record low level of 0.5% against the background of growth slowing to around 0.9%, while average CPI inflation remained relatively subdued throughout the year, rising to 1.7%.

Financial turbulence emerged in Thailand in mid-1997; it quickly spread to a number of other countries in South-East Asia, eventually also reaching the Republic of Korea. Economic growth in eastern and southern Asia slowed as the financial turmoil in the region increased uncertainty (see Box 1). In China, however, a high rate of output growth was sustained, while inflation remained subdued; meanwhile, activity weakened moderately in both Australia and New Zealand.

The transition economies as a group experienced positive output growth in 1997 for the first time since the beginning of the 1990s, albeit of less than 2% on average. The Baltic States, Poland and Hungary all experienced strong growth rates, while

[2] *Defined as those countries which have recorded an average rate of inflation of 10% or more thus far in the 1990s (source: OECD Economic Outlook, December 1997).*

Russia's output appears to have grown modestly. In the Czech Republic growth slowed sharply and the currency was devalued as a result of foreign exchange market pressures. The pace of economic growth in the developing countries was maintained at slightly below 6% in 1997, albeit with below-average growth in Africa of around 3%. Economic growth in Central and South America, however, picked up considerably. Inflation in the developing countries as a whole slowed to 8.5%, and in the transition economies it fell below 30%.

Shifts in global foreign exchange markets

1997 was characterised by a strong appreciation of the US dollar against both the Deutsche Mark (by 15.2% to DEM 1.79) and the Japanese yen (by 11.8% to JPY 130). The year was also marked by a substantial depreciation of certain Asian currencies (see Box 1).

Against the Deutsche Mark, the dollar appreciated from DEM 1.55 to DEM 1.79 in the course of the year. This pattern reflected favourable prospects for the US economy compared with Germany and expectations of the maintenance or widening of interest rate differentials, for instance when the US Federal Reserve tightened monetary policy in late March 1997. The overall upward trend was temporarily interrupted between mid-August and early November as expectations of a further tightening by the Federal Reserve faded, while incipient price pressures in Germany prompted markets to expect a monetary tightening (which indeed took place on 9 October). Thereafter, expectations of further tightening in Germany diminished, enabling the dollar to recommence its ascent. During 1997 the dollar also appreciated markedly against the Japanese yen, from JPY 116 to JPY 130. Overall, the evolution of the dollar-yen rate reflected a pessimistic economic outlook in Japan and, later in the year, the negative repercussions on Japanese competitiveness and financial stability of the turmoil in South-East Asia and the Republic of Korea as well as safe-haven flows into US dollars in connection with the Asian crisis (see Box 1). Reflecting a short-lived improvement in sentiment regarding economic recovery in Japan, the depreciation of the Japanese yen was temporarily interrupted in mid-year, when the yen appreciated sharply to levels close to those recorded at the beginning of the year.

In respect of changes in nominal effective exchange rates, the nominal effective exchange rate of the dollar against twenty-six trading partners appreciated by 13% in 1997, while those of the Deutsche Mark and the yen depreciated by 2.6% and 1.9% respectively. In the case of the United States, the large change in the nominal effective exchange rate reflected the strengthening of the dollar against both the yen and the Deutsche Mark and also the depreciations of currencies in South-East Asia and the Republic of Korea. The relatively small effective depreciation of the yen reflected an offsetting movement against the South-East Asian currencies and the Korean won. In the case of Germany, the depreciation of the Deutsche Mark against the dollar contrasted with broadly stable exchange rates vis-à-vis the European currencies, which carry a far greater aggregate weight than the non-European currencies in the overall effective exchange rate index.

International bond yields declined

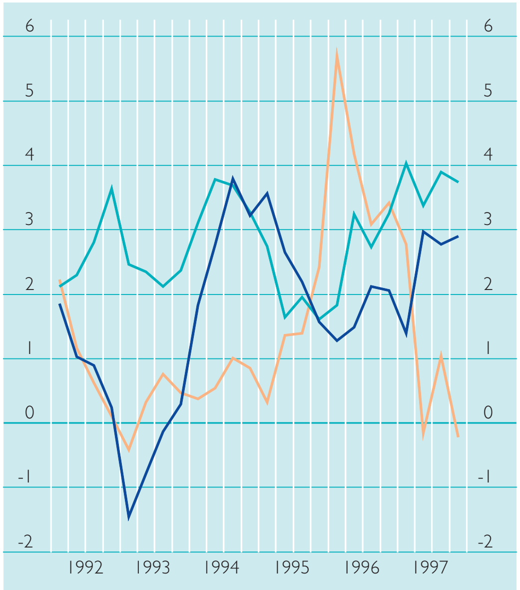
In 1997 US bond yields fell by 68 basis points from 6.43 to 5.75%, a development which masks two distinct phases during the year. By mid-April yields had risen by almost 60 basis points to reach a peak of 6.98% against the background of a further tightening of labour market conditions and accelerating growth. The associated expectations of an increase in inflation

Chart 1

Main developments in major industrialised economies

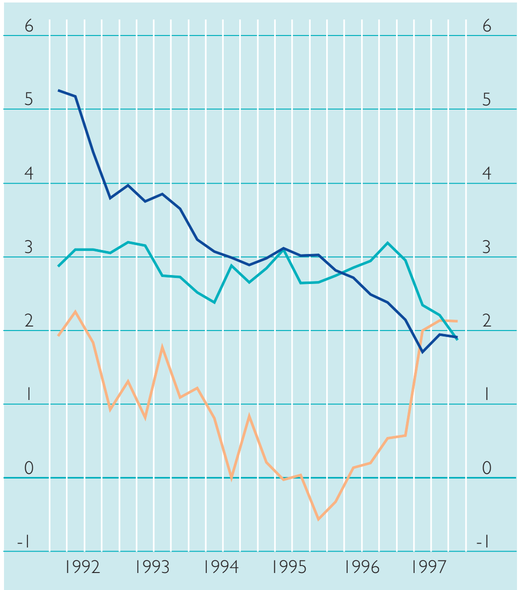
Output growth
(quarterly data; annual percentage changes)

EU-15 — United States — Japan



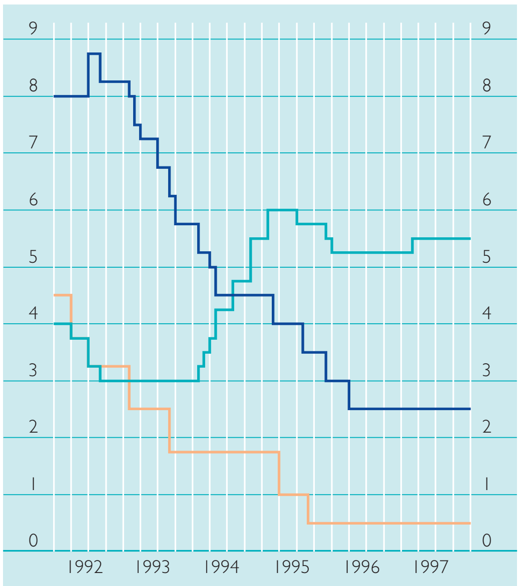
Inflation rates[(a)]
(quarterly data; annual percentage changes)

EU-15 — United States — Japan



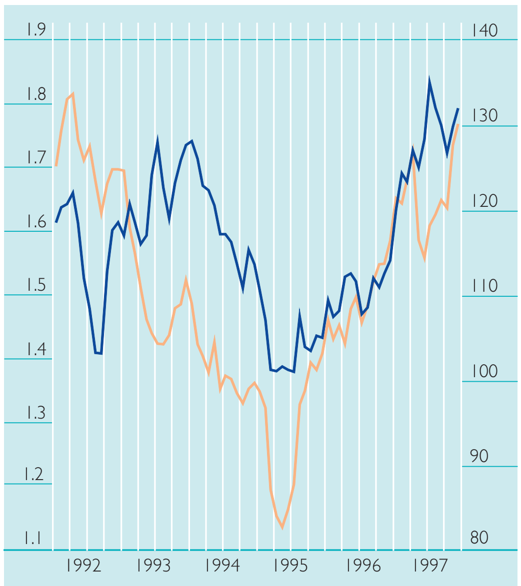
Official interest rates[(b)]
(end-month data; in percentages)

Germany — United States — Japan



Exchange rates[(c)]
(end-month data)

DEM/USD (LHS) — JPY/USD (RHS)



Source: National data.

(a) EU-15 calculated using western Germany up to end-1993, unified Germany thereafter. Italy: Cost-of-living index. United Kingdom: CPI excluding mortgage interest payments (RPIX).

(b) For Germany and Japan discount rate, for the United States federal funds target rate.

(c) Deutsche Mark per dollar and Japanese yen per dollar.

were reflected in a steepening of the slope of the US yield curve and prompted a rise of 25 basis points in the Federal funds rate towards the end of March, the first since February 1995, taking the rate to 5.5%. However, the upward movement in long-term interest rates turned out to be short-lived as inflation outturns improved and it became evident that inflationary pressures had remained subdued despite buoyant real economy developments. The virtual elimination of the public sector deficit in the United States and the decline in the debt ratio in 1997 further supported the decline in long-term interest rates. Towards the end of the year, the fall in yields accelerated as the Asian financial crisis motivated safe-haven flows out of the region and into relatively less risky assets such as US bonds. By this time, the crisis was also leading to expectations that official interest rates in the United States would not be raised, owing to the disinflationary impact of the turmoil as well as possible concerns regarding global financial stability.

Long-term interest rates in Japan declined by 91 basis points during the year to reach 1.66%, an unprecedentedly low level by both domestic and international historical standards, while real long-term interest rates measured ex post became significantly negative towards the end of the year and the slope of the yield curve became less steep. This overall development reflected expectations that official interest rates would remain low despite an uptick in inflation; the latter was regarded as temporary given the concomitant deceleration in the pace of economic activity. The Asian financial crisis also led to safe-haven flows out of the Japanese equity market and into bonds.

Box 1

Evolution of the Asian crisis in 1997

1997 witnessed unprecedented currency and financial market turmoil in a number of Asian countries. Those most severely affected were Thailand, Indonesia, Malaysia and the Republic of Korea, although others were not immune. One factor common to most of the affected countries prior to the crisis was a loss of competitiveness arising from the peg to the US dollar and reflected in the persistence of current account deficits (although other signs of macroeconomic disequilibrium were absent). Other common features were fragile, poorly regulated and over-exposed financial systems and high levels of short-term foreign currency denominated borrowing by the private sector, which was frequently used to finance long-term investment, thus creating a significant maturity mismatch as well as a currency mismatch.

Severe pressures on the Thai baht led to the floating of the currency in July 1997, ending a 13-year peg to a dollar-dominated basket. As a result of the loss of competitiveness, pressures emerged on the currencies of other countries in the region, which led to major depreciations of the Philippine peso, the Malaysian ringgit and the Indonesian rupiah in the same month. The crisis deepened in October, as a stock market crash in Hong Kong led to widespread turbulence in capital markets. Even though the Hong Kong dollar's peg to the US dollar was maintained, the substantial fall in equity prices led to further pressures on Asian currencies, including the Korean won, which had until then been relatively unscathed. The marked subsequent depreciation of the Korean won against the US dollar in November (and December) led to a further weakening of the currencies of the region.

Looking at developments in the second half of 1997 as a whole (see table), a number of common characteristics were discernible. First, with the exception of the Hong Kong dollar, currencies depreciated by significant margins vis-à-vis the US dollar. The large depreciations took on an almost self-perpetuating character as increasing debt-service costs for the private sector and decisions to hedge external liabilities only intensified exchange rate pressures. Second, short-term interest rates were raised by substantial amounts in an effort to maintain currency pegs, and although interest rates subsequently declined at the end of 1997, they remained above early July levels, reflecting expectations of further substantial exchange rate depreciations. An increase in uncertainty was also evident from the significant increase in implied volatility in over-the-counter option prices on these currencies. Third, stock market indices collapsed by substantial amounts ranging from 10% to almost 50%. Besides reflecting monetary conditions, lower expectations of future earnings and notably adverse financial conditions for firms, this development was linked to the higher returns required by international investors in the face of heightened risk. The fall in currencies and stock indices implied a general downgrading of the affected region by international investors, with contagion and spillover effects operating in addition to changes in fundamentals.

In late 1997 the IMF offered substantial loan facilities to Thailand, Indonesia and the Republic of Korea. The associated reform programmes require a tightening of monetary and fiscal policies and the restructuring and strengthening of financial systems. These measures are aimed at restoring confidence in the region by avoiding excessive currency depreciations, containing inflation and creating conditions for the build-up of international reserves.

A number of channels may be discerned via which macroeconomic effects on these Asian economies may be transmitted. These include: an income or *wealth effect*, operating through a contraction of domestic demand in Asia as a result of falling share prices and exchange rates and a tighter monetary and fiscal policy (but also influenced by effects resulting from a higher debt-service burden in US dollars, the cutting of credit lines, capital outflows and higher interest rates); a confidence effect, whereby a decline in the stock market and/or exchange rate can also prompt a more generally pessimistic view of future prospects and thereby trigger still further reductions in demand; a long-term interest rate effect linked to investors' reassessment of risk in emerging markets and the prospects for higher inflation following currency depreciation; and a price effect, which entails an increase in Asian competitiveness tending to boost net exports, thus mitigating the contractionary effects of lower domestic demand.

The magnitude of the direct impact or effect on countries outside the region will depend on the share of their trade with the Asian economies concerned and on the importance of trade in relation to overall output (openness). Incomes, profits and demand will be reduced through a deterioration in the external balance as exports to the region fall. There may also be adverse wealth and confidence effects and an effect operating through the balance sheets of the banking system, depending on individual institutions' exposure to the region. However, long-term interest rates may benefit from lower inflation expectations. The final effect on the economies outside Asia, which may take some time to be felt, will depend not only on the direct effect via trade and financial markets, but also on the appropriateness and timeliness of any policy response which may be required and, not least, on the flexibility of the real side of the economy, especially the labour market. The implications of the crisis for monetary and economic developments in the EU are discussed further in Section 3.

Asset price changes in Asian markets

(in percentages)

1 July 1997 to 31 December 1997

	Equity market	USD exchange rate
Hong Kong	-29.4	0.0
Indonesia	-45.1	-55.0
Malaysia	-44.9	-35.0
Republic of Korea	-46.6	-47.7
Singapore	-22.8	-15.0
Thailand	-34.5	-47.8

Source: Reuters.

1.2 Macroeconomic developments in the EU

Real GDP growth in the EU accelerated

Initially, real GDP growth in the EU in 1997 followed the pattern of subdued developments also observed in early 1996 as unusually severe weather conditions again tended to depress construction in the first quarter. However, the pace of economic activity quickened thereafter and, from the second quarter onwards, the growth rate was significantly higher than in the comparable period of 1996. The crisis in Asia did not have a significant adverse impact on growth in 1997. Average real GDP growth for the EU in 1997 is estimated to have been 2.7%, which is significantly higher than the rate of 1.7% recorded in 1996. The acceleration in activity was widespread, with stronger growth being recorded in almost all EU countries (see Table 1), although there continued to be differences in the strength of economic activity. In Italy and Sweden output growth, although higher than in 1996, remained below 2%, while in Belgium, Germany, France and Austria the rate was between 2% and 3%. Real GDP growth in the remaining nine EU Member States was above 3%. Growth in Ireland was again the strongest in the Union in 1997 at 10.3%. In Finland real GDP growth also accelerated sharply to reach almost 6%.

The acceleration in activity during 1997 was to a large extent underpinned by a continuation of the favourable factors which had also characterised 1996: economic expansion in North America remained robust (see also Section 1.1) and the price

Table 1

Recent developments in real GDP growth
(percentage changes)

	Annual rates[(a)]								Quarterly rates[(b)]				
	1995	1996	1997[(c)]	1996	1997				1996	1997			
				Q4	Q1	Q2	Q3	Q4	Q4	Q1	Q2	Q3	Q4
Belgium	2.1	1.5	2.8	2.0	2.4	2.9	2.9	.	0.7	0.6	1.3	0.5	.
Denmark	3.1	3.5	3.4	3.1	2.0	4.3	2.6	4.4	-0.8	0.9	2.0	0.5	1.1
Germany	1.8	1.4	2.2	1.8	1.0	3.0	2.4	2.4	0.3	0.4	0.9	0.7	0.3
Greece	2.1	2.7	3.5	-	-	-	-	-	-	-	-	-	-
Spain	2.7	2.3	3.4	2.8	3.2	3.4	3.5	3.6	0.8	0.9	0.8	0.9	0.9
France	2.1	1.5	2.4	2.3	1.3	2.6	2.7	3.2	0.3	0.3	1.1	0.9	0.8
Ireland	10.4	7.7	10.3	-	-	-	-	-	-	-	-	-	-
Italy	2.9	0.7	1.5	-0.2	-0.9	1.9	2.2	2.8	-0.4	0.0	1.9	0.6	0.2
Luxembourg	2.7	3.5	4.8	.	.	.	.	.	.	.	.	.	.
Netherlands	2.3	3.3	3.4	3.5	2.6	3.1	2.9	3.6	0.8	0.7	0.9	0.7	1.0
Austria	2.1	1.6	2.5	.	.	.	.	.	.	.	.	.	.
Portugal	2.4	3.6	3.9	-	-	-	-	-	-	-	-	-	-
Finland	5.1	3.6	5.9	6.0	4.0	7.1	6.4	6.2	1.4	0.0	3.1	1.7	1.1
Sweden	3.9	1.3	1.8	1.3	-1.2	2.9	2.0	3.3	0.6	-0.2	0.4	1.0	2.2
United Kingdom	2.7	2.2	3.3	2.8	3.1	3.5	3.6	2.8	1.2	0.8	0.8	0.8	0.3
EU-15	2.5	1.7	2.7	2.1	1.4	3.0	2.8	2.9	0.5	0.4	1.2	0.8	0.5

Source: National data.
(a) Annual rates: Percentage change over the same period a year earlier.
(b) Quarterly rates: Percentage change over the previous quarter, seasonally adjusted (for some countries also adjusted for working day variations); not annualised.
(c) Provisional.

competitiveness of most EU countries improved against that of their major non-EU trading partners. Within the EU, low or declining inflation enabled most Member States to pursue policies characterised by relatively low short-term nominal interest rates (see Section 2), intra-EU exchange rates remained generally stable and bond yields declined still further. Consumer confidence improved to around its long-term average, though the level and scale of improvements varied significantly across countries. Industrial confidence also improved sharply and by the end of the year was well above its long-term average.

Stronger domestic demand, net exports remained positive

For the Union as a whole, the improved real growth performance in 1997 was principally due to domestic demand, which rose by 2.2%, compared with 1.5% in the previous year. For the fourth successive year, net trade in goods and services provided a positive, albeit small, stimulus to growth, underpinned by subdued growth in relative unit labour costs and, as a result, improvements in competitiveness. The rise in domestic demand was linked to an improvement in investment growth and an increase in stockbuilding, while growth in private consumption was unchanged and government consumption was weaker than in 1996 (see Table 2). Whereas domestic demand rose by 3% or more in many countries (Denmark, Greece, Ireland, Luxembourg, the Netherlands, Portugal, Finland and the United Kingdom), in Germany, France, Austria and Sweden growth in domestic demand was below 1.5%.

Private consumption growth in the EU has been broadly constant since the 1992-93 recession and has remained in the range of 1½-2%. On the one hand, low growth of real household disposable income combined with the negative effects on confidence of high unemployment in some countries and uncertainty about the pattern of further fiscal consolidation have tended to restrain consumer spending. On the other, consumer confidence has improved as economic prospects have brightened and wealth gains from equity and, in some cases, property prices have accrued. The balance between these factors varied sharply, as is illustrated by the fact that in 1997 private consumption grew at 3% or more in Denmark, Spain, Ireland, the Netherlands, Portugal, Finland and the United Kingdom, while in Germany, France and Austria it grew by less than 1%. In the United Kingdom private consumption grew by 4.5% in 1997, the highest rate since 1988, partly spurred on by temporary factors (notably windfall gains arising from the demutualisation of mortgage lending institutions).

Reflecting the continued efforts of fiscal authorities to restrain spending in the light of the need for consolidation, government consumption in the EU increased by 0.5% in 1997, thus resulting in a decline in the ratio to GDP. In Germany, Greece, Italy, Finland and Sweden government consumption fell, while in Spain and the United Kingdom it rose only marginally. By contrast, general government consumption rose by 2.9% in Denmark, by 3.9% in Luxembourg, by 3.3% in the Netherlands and by 3.0% in Portugal.

Continuing the pattern observed since the early 1990s, fixed investment growth in 1997 - although stronger than in the previous year - continued to be below the levels typical of past decades, despite satisfactory profit margins and a high level of industrial confidence, as well as relatively high capacity utilisation rates for the manufacturing sector. At the individual country level, investment growth in 1997 stood at over 10% in Greece, Ireland, Luxembourg, Portugal and Finland, but was also strong in Denmark and the Netherlands. By contrast, investment rose by around 1% or less in Germany, France and Italy and fell by 4.8% in Sweden.

Both exports and imports grew considerably more strongly than in 1996, partly reflecting

Table 2

Composition of growth in the EU in 1997*

(annual percentage change)

	Real GDP	Domestic demand					Trade	
			Consumption		Fixed investment	Stock changes(a)	Exports	Imports
			Private	General government				
Belgium	2.8	2.3	2.2	1.1	5.6	-0.3	6.1	5.5
Denmark	3.4	4.2	4.1	2.9	7.2	-0.2	4.5	7.0
Germany	2.2	1.2	0.2	-0.4	0.2	1.1	10.7	7.0
Greece	3.5	3.8	2.5	-0.1	10.9	-0.1	5.2	5.9
Spain	3.4	2.7	3.1	0.7	4.7	-0.4	12.9	10.1
France	2.4	1.0	0.9	1.5	0.2	0.1	11.3	6.6
Ireland	10.3	7.9	7.1	2.7	13.6	0.2	18.1	16.3
Italy	1.5	2.5	2.4	-0.7	0.6	1.0	6.3	11.8
Luxembourg	4.8	4.7	2.5	3.9	14.1	0.4	6.0	6.1
Netherlands	3.4	3.3	3.2	3.3	6.0	0.0	10.5	10.6
Austria	2.5	1.2	0.2	0.9	3.6	-0.7	8.0	5.4
Portugal	3.9	5.3	3.1	3.0	13.1	0.1	8.0	11.1
Finland	5.9	4.1	3.1	-0.3	11.3	0.3	13.5	9.3
Sweden	1.8	0.4	2.0	-2.1	-4.8	0.7	12.8	11.7
United Kingdom	3.3	3.6	4.5	0.5	3.9	0.1	7.8	8.4
EU-15(b)	2.7	2.2	2.1	0.5	2.4	0.4	9.5	8.5
Memo item:								
EU-15(b) (1996)	1.7	1.5	2.0	1.5	1.1	-0.3	4.9	3.7

Source: National data.
* Data partly estimated.
(a) As a contribution to growth.
(b) The trade figures are a weighted average of the EU-15 countries' data and, as such, do not exclude intra-EU trade.

the resurgence of growth within the EU (which increased intra-EU trade) and buoyant economic conditions globally. Exports from EU countries grew by 9.5% on average, while imports grew by 8.5%. European Commission figures show that trade and current account balances for the EU improved further in 1997 (see Table 3); the trade balance rose to 1.5% of EU GDP and the current account surplus increased to 1.2% of EU GDP. Current account balances (based on national data) improved strongly in France and the Netherlands as well as, although to a lesser extent, in Belgium, Germany, Spain, Finland and the United Kingdom. By contrast, Denmark experienced a marked deterioration. Overall, eleven Member States recorded current account surpluses. In general, these surpluses were linked to high and relatively stable net private saving (private saving less investment), while public sector positions tended to improve sharply, reflecting ongoing fiscal consolidation.

Employment generation remained weak, high unemployment persisted

Against the background of strengthening economic growth in the EU as a whole, employment has increased only marginally, while unemployment has remained

Table 3

Trade and current account balances in the EU*

(as a percentage of GDP)

	Trade balance				Current account balance			
	1994	1995	1996	1997[a]	1994	1995	1996	1997[a]
Belgium[b]	.	4.1	3.9	4.4	.	4.2	4.2	4.9
Denmark	4.1	2.9	3.5	2.8	1.8	1.0	1.7	0.6
Germany	2.2	2.5	2.8	3.3	-1.0	-0.9	-0.6	0.0
Greece	-13.8	-15.0	-15.0	-15.1	-0.1	-2.5	-3.7	-4.0
Spain	-3.9	-4.3	-3.8	-3.6	-0.8	1.2	1.3	1.5
France	0.7	0.9	1.2	2.2	0.6	0.7	1.3	2.9
Ireland	15.5	19.3	20.0	22.8	3.6	4.1	3.2	2.8
Italy	3.5	4.1	5.0	4.1	1.4	2.5	3.4	3.2
Luxembourg[b]	-12.8	-12.0	-13.6	.	14.0	18.1	15.9	15.9
Netherlands	5.1	5.3	5.0	3.4	5.3	6.1	5.8	5.3
Austria	-5.2	-3.8	-4.2	-2.7	-0.9	-2.0	-1.8	-1.9
Portugal	-7.8	-6.8	-7.2	-8.1	-2.5	-0.2	-1.4	-2.0
Finland	6.6	8.6	7.7	8.5	1.3	4.1	3.8	5.1
Sweden	4.4	6.5	7.0	7.3	0.4	2.1	2.7	2.7
United Kingdom	-1.5	-0.4	-1.0	-1.2	-0.3	-0.7	-0.4	0.3
EU-15[c]	0.6	1.0	1.3	1.5	0.0	0.4	0.8	1.2

Source: National data.

* Surplus (+), deficit (-).

(a) Provisional.

(b) Corresponding figures for BLEU are: for the trade balance: 2.7, 4.1, 3.9, 4.2; and for the current account balance: 5.0, 5.1, 5.0, 5.3.

(c) European Commission data (spring 1998 forecasts); national accounts definition.

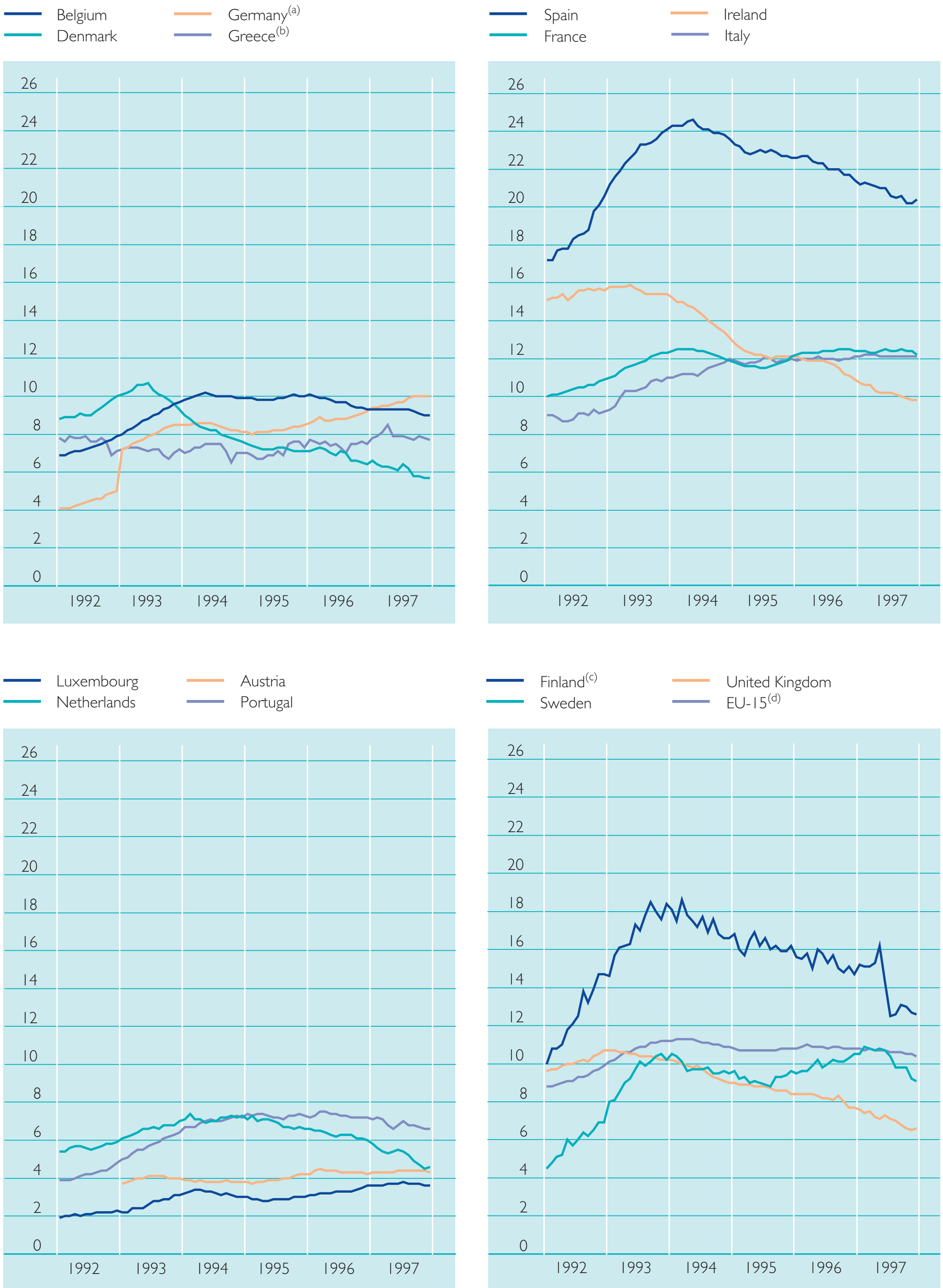
stubbornly high. Total employment in the EU, at around 147 million, has not increased significantly since the 1992-93 recession, despite EU-average real GDP growth over this period of 2.4%. For example, total employment is estimated to have risen by only around 0.5% in 1997, compared with increases of around 1% in Japan and over 2% in the United States. Moreover, the labour force participation rate, at around 67%, is lower than in either Japan or the United States. Unemployment in the EU, measured on a comparable basis, remained more than twice that in the United States and three times higher than in Japan. Of particular concern are the much higher levels of youth and long-term unemployment. The concentration of unemployment in these categories, as well as the persistence of subdued employment creation, point to the structural nature of a major part of EU unemployment and to the continued need for structural measures.

The unemployment rate for the EU as a whole (measured on the basis of EUROSTAT data) fell slightly during the course of 1997, from 10.8% in the fourth quarter of 1996 to 10.5% in the fourth quarter of 1997 (see Chart 2). Unemployment fell in most EU Member States, largely but not entirely in line with patterns of relative growth, with marked reductions being observed in Denmark, Spain, Ireland, the Netherlands, Finland and the United Kingdom. In Ireland the unemployment rate fell below the EU average for the first time in recent decades. In the Netherlands unemployment had fallen to 5% by the end of the year. Unemployment also fell, albeit to a lesser degree, in Belgium and Portugal. In contrast,

Chart 2

Unemployment rates*

(EUROSTAT definition; as a percentage of the labour force)



Source: EUROSTAT.

* Seasonal adjusted data.

(a) Unified Germany from January 1993 onwards.

(b) National definition, as no complete monthly data are available on a comparable basis.

(c) Revised definition from May 1997 onwards.

(d) Prior to January 1995, the aggregate EU-12 is shown.

Table 4

A comparison of national and EUROSTAT unemployment data
(as a percentage of the labour force)

	BE	DK	DE	GR	ES	FR	IE	IT	LU	NL	AT	PT	FI	SE	UK	EU
1996																
National definition	9.8	8.7	10.4	7.5	22.2	12.3	11.5	12.1	3.3	6.6	7.0	7.3	15.8	8.0	7.5	11.0
EUROSTAT	9.7	6.9	8.8	9.6	22.1	12.4	11.6	12.0	3.3	6.3	4.3	7.3	15.4	10.0	8.2	10.8
1997																
National definition	9.3	7.8	11.5	7.9	20.8	12.5	10.3	12.3	3.6	5.6	7.1	6.8	14.5	8.0	5.7	10.8
EUROSTAT	9.2	6.1	9.7	9.6	20.8	12.4	10.2	12.1	3.7	5.2	4.4	6.8	14.0	10.2	7.1	10.6

Source: National data and EUROSTAT.

there was a further increase in the rate of unemployment in Germany, largely reflecting developments in eastern Germany, where unemployment had risen to almost 20% by the end of the year. Ongoing weakness in construction activity and a contraction in employment promotion and vocational training schemes mainly underlie this development in eastern Germany. Overall, considerable differences continued to exist between the unemployment rates across the Union. In the fourth quarter of 1997 the rate remained at or above 10% in five countries: Germany, Spain, France, Italy and Finland. Despite the marked declines recorded in Spain and Finland, the unemployment rates in these two countries remained the highest in the EU.

The unemployment data from EUROSTAT to which reference is made in the paragraph above are calculated according to ILO recommendations. These data are more comparable than national data, but are not yet fully harmonised. In some cases, they differ markedly from the corresponding national definitions (see Table 4). In particular, on an annual basis the EUROSTAT estimates for 1997 are higher for Greece, Sweden and the United Kingdom and lower for Denmark, Germany, the Netherlands, Austria and Finland.

1.3 Achievements in macroeconomic convergence

In accordance with Article 109j (1) of the Treaty, at the end of March 1998 the EMI presented its report to the EU Council on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of Economic and Monetary Union. This Convergence Report included an examination of the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the convergence criteria, as set out in the Treaty. It therefore covered the performance of individual EU countries in terms of the degree of price stability, government debt and deficit positions, long-term interest rates and exchange rates. In early May 1998 the EU Council, meeting in the composition of Heads of State or Government, confirmed which Member States had fulfilled the necessary conditions for the adoption of the single currency. The outcome of this meeting is reported in Box 2. A summary of the examination of convergence by the EMI, which included developments in 1997, is provided in an annex, which contains selected parts of the Introduction and Summary of the Convergence Report. Data relating to the Maastricht Treaty convergence criteria (excluding the exchange rate criterion) are shown in Table 5.

Table 5

Economic indicators and the Maastricht Treaty convergence criteria

(excluding the exchange rate criterion)

		HICP inflation (a)	Long-term interest rate (b)	General government surplus (+) or deficit (-) (c)	General government gross debt (c)
Belgium	1996	1.8	6.5	-3.2	126.9
	1997 (d)	1.4	5.7	# -2.1	122.2
	1998 (e)	-	-	# -1.7	118.1
Denmark (f)	1996	2.1	7.2	# -0.7	70.6
	1997 (d)	1.9	6.2	# 0.7	65.1
	1998 (e)	-	-	# 1.1	# 59.5
Germany	1996	1.2	6.2	-3.4	60.4
	1997 (d)	1.4	5.6	# -2.7	61.3
	1998 (e)	-	-	# -2.5	61.2
Greece	1996	7.9	14.4	-7.5	111.6
	1997 (d)	5.2	9.8	-4.0	108.7
	1998 (e)	-	-	# -2.2	107.7
Spain	1996	3.6	8.7	-4.6	70.1
	1997 (d)	1.8	6.3	# -2.6	68.8
	1998 (e)	-	-	# -2.2	67.4
France	1996	2.1	6.3	-4.1	# 55.7
	1997 (d)	** 1.2	** 5.5	# -3.0	# 58.0
	1998 (e)	-	-	# -2.9	# 58.1
Ireland	1996	2.2	7.3	# -0.4	72.7
	1997 (d)	*** 1.2	*** 6.2	# 0.9	66.3
	1998 (e)	-	-	# 1.1	# 59.5
Italy	1996	4.0	9.4	-6.7	124.0
	1997 (d)	1.8	6.7	# -2.7	121.6
	1998 (e)	-	-	# -2.5	118.1
Luxembourg	1996	*** 1.2	*** 6.3	# 2.5	# 6.6
	1997 (d)	1.4	5.6	# 1.7	# 6.7
	1998 (e)	-	-	# 1.0	# 7.1
Netherlands	1996	1.4	6.2	# -2.3	77.2
	1997 (d)	1.8	5.5	# -1.4	72.1
	1998 (e)	-	-	# -1.6	70.0
Austria	1996	1.8	6.3	-4.0	69.5
	1997 (d)	* 1.1	* 5.6	# -2.5	66.1
	1998 (e)	-	-	# -2.3	64.7
Portugal	1996	2.9	8.6	-3.2	65.0
	1997 (d)	1.8	6.2	# -2.5	62.0
	1998 (e)	-	-	# -2.2	# 60.0
Finland	1996	** 1.1	** 7.1	-3.3	# 57.6
	1997 (d)	1.3	5.9	# -0.9	# 55.8
	1998 (e)	-	-	# 0.3	# 53.6
Sweden	1996	* 0.8	* 8.0	-3.5	76.7
	1997 (d)	1.9	6.5	# -0.8	76.6
	1998 (e)	-	-	# 0.5	74.1
United Kingdom	1996	2.5	7.9	-4.8	# 54.7
	1997 (d)	1.8	7.0	# -1.9	# 53.4
	1998 (e)	-	-	# -0.6	# 52.3

Source: European Commission.
*, **, *** = first, second and third best performer in terms of price stability.
= general government deficit not exceeding 3% of GDP; general government gross debt not exceeding 60% of GDP.

(a) Annual percentage changes.
(b) In percentages. The harmonised series for Greece starts in mid-1997. Before this, data were based on available best proxies; for the period from March to June 1997, yield data for long-term bonds with shorter maturities than the harmonised series were used; before that period, yields at issue for long-term bonds with shorter maturities than the harmonised series were used.
(c) As a percentage of GDP.
(d) Data for HICP inflation and long-term interest rate refer to the twelve-month period ending January 1998; European Commission (spring 1998 forecasts) for general government surplus or deficit and general government gross debt.
(e) European Commission projections (spring 1998 forecasts) for general government surplus or deficit and general government gross debt.
(f) General government gross debt figures are not adjusted for the assets held by the Danish Social Pension Fund against sectors outside general government, nor for government deposits at the central bank for the management of foreign exchange reserves. According to statements 5 and 6 relating to Council Regulation (EC) No. 3605/93 of 22 November 1993, the Council and the Commission agree that, for Denmark, these items shall be specified in the presentation of general government gross debt. They totalled 9.6% of GDP in 1996 and 8.0% of GDP in 1997. In addition, the data are not adjusted for the amounts outstanding in the government debt from the financing of public undertakings, which, according to statement 3 relating to the aforementioned Regulation, will be subject to a separate presentation for the Member States. In Denmark this item amounted to 5.2% of GDP in 1996 and 4.9% of GDP in 1997.

2 Monetary policies in Member States

This section describes the changes in monetary conditions in individual EU countries in 1997 and their monetary policy objectives for 1998. It reflects the task of the EMI in Stage Two of EMU, which is to strengthen co-operation between the national central banks and the co-ordination of the monetary policies of Member States with a view to ensuring price stability. In connection with these responsibilities, the appropriateness and compatibility of current monetary and foreign exchange policies were reviewed in regular discussions held at the EMI. In the context of this review, account is taken of the conduct of policies within the exchange rate mechanism (ERM), of which all EU countries other than Greece,[3] Sweden and the United Kingdom were members in 1997.

2.1 Further convergence of interest rates

The economic and financial environment in 1997 allowed for a continuation of the convergence of short and long-term interest rates and broadly stable exchange rates. The majority of EU countries (namely Belgium/Luxembourg, Denmark, Germany, France, the Netherlands, Austria, Finland and Sweden) broadly maintained low interest rates. This mirrored a situation of price stability against a background of narrowing - but generally still negative - output gaps, benign wage behaviour and the consolidation efforts of fiscal authorities. Official and key interest rates remained at low and closely aligned levels, although they were raised to a small extent in the autumn in response to inflation risks (see Chart 3 and the annex relating to the chronology of monetary measures). The concerted nature of these policy actions strengthened the cohesion among those countries with closely aligned interest rates.

Several other Member States (Spain, Italy, Portugal and initially also Greece) were able to continue the process of reducing interest rates in line with the degree of convergence of their overall economic fundamentals, particularly in respect of the achievement of price stability, with those of the countries referred to in the paragraph above. Short and long-term interest rates in these countries thus tended to follow a downward trend, progressively converging towards the lower level of the closely aligned countries (see Chart 4). Monetary policy in the two remaining EU countries (namely Ireland and the United Kingdom) was tightened, albeit to differing degrees, in response both to buoyant economic and monetary growth and to heightened inflation risks against a background of continued sound fundamentals. The widening of short-term interest rate differentials against Germany was accompanied by a further strong appreciation of the respective currencies vis-à-vis the Deutsche Mark. Later in the year, however, short-term interest rates in Ireland began to decline relative to Germany and the Irish pound moved closer to its central rates in the ERM grid.[4]

The convergence process was supported by the strong political commitment to EMU demonstrated at the regular meetings of the European Council and the corresponding reduction in market

[3] *Effective from 16 March 1998, the Greek drachma joined the exchange rate mechanism of the EMS at a central rate of GRD 357 to the ECU, which implied a depreciation of 14%. The Greek authorities thereby committed themselves to an economic and monetary policy which will be firmly geared to keeping inflation under control and on a downward trend.*

[4] *Effective from 16 March 1998, the bilateral central rates of the Irish pound against other ERM currencies were revalued by 3%, bringing them close to market rates.*

uncertainty. Of particular importance was the understanding, reached at the informal ECOFIN Council meeting in Mondorf-les-Bains in September 1997, that the bilateral exchange rates which will be used at the start of Stage Three in determining the irrevocable conversion rates for the euro would be pre-announced immediately after the selection of the countries which will adopt the single currency (see Box 2). Given the calm conditions on foreign exchange markets in Europe, an increasing number of market participants came to expect that the pre-announced bilateral exchange rates would be equal or very close to the bilateral central rates of the ERM. As a result, the market-led process of the convergence of exchange rates towards their ERM central rates and, as a corollary, the convergence of short-term interest rates gained further momentum.

2.2 Monetary policies in individual Member States

The Deutsche Bundesbank continued to maintain a low interest rate environment in 1997, reflecting the gradual return of broad money (M3) growth to a more satisfactory level and the subdued outlook for inflation in Germany. Over the summer, however, the appreciation of the US dollar and increases in administered prices caused an upturn in import, producer and consumer price inflation. With the aim of ensuring a further deceleration of the rate of monetary expansion and to counter the risks to price stability at an early stage, the Bundesbank decided on 9 October 1997 to adopt a somewhat less accommodating monetary stance. The securities repurchase rate - which had remained at 3.0% since August 1996 - was raised to 3.3%, while both the official discount rate and the lombard rate were kept unchanged at 2.5% and 4.5%, respectively (see Chart 3).

At the end of 1996 the Bundesbank extended the time horizon of its monetary target in terms of M3 from one year to two years in order to take account of possible uncertainties in financial markets in the period of transition to Stage Three. An annual rate of M3 growth of approximately 5% was targeted for both 1997 and 1998. As an additional point of reference for the shorter term, the target range for M3 growth in the fourth quarter of 1997 was set at 3.5-6.5%. In December 1997 the Bundesbank confirmed its two-year monetary target of around 5% per annum, but lowered the target corridor for 1998 to 3-6%. At the same time it acknowledged that in the second half of 1998 its monetary targeting strategy would have to take greater account of aspects covering the whole group of countries selected to participate in the euro area (see also Section 3).

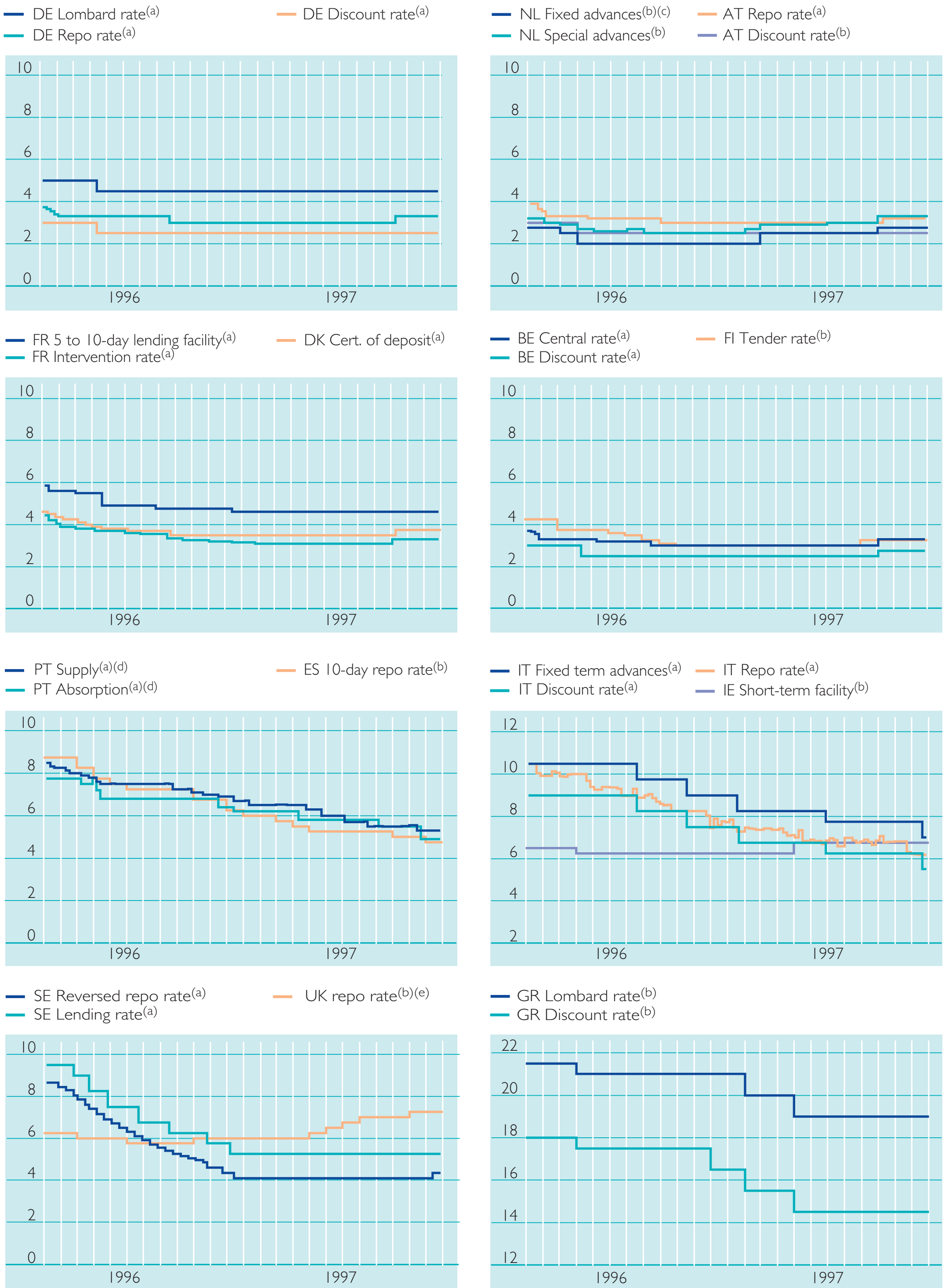
Whereas in 1996 the outturn of 8.1% for M3 growth in the last quarter exceeded the 4-7% target range, the pace of monetary expansion steadily decelerated in the course of 1997 so that, in the fourth quarter, M3 growth was 4.7%, i.e. just below the centre of the 3.5-6.5% target corridor (see Table 6 (a)). The deceleration of money growth was the result of a weakening in lending to both the private and the public sectors and a high net outflow of funds arising from transactions between domestic non-banks and non-residents. In 1997 domestic non-banks further reduced their cross-border deposits and ran down their portfolios of money market certificates. Reflecting this, the M3 aggregate extended by cross-border deposits, short-term bank bonds and investments in money market funds grew more slowly than M3 in 1997 (at a rate of 4.4% in the fourth quarter of 1997, compared with a rate of 4.7% for M3).

On 9 October 1997 official and/or key interest rates were also raised by 0.2-0.3 percentage point in parallel in Belgium/Luxembourg, Denmark, France, the Netherlands and Austria, whereby some central banks allowed for a small differential with equivalent German policy interest rates

Chart 3

Official and key interest rates

(in percentages)



Source: National data. (Rates indicated are the most relevant for monetary policy in each country.)
(a) End-of-week data, for Portugal beginning-of-week data.
(b) End-of-month data.
(c) Prior to 23 May 1997: Interest rate on advances.
(d) If the announcement of the regular rate of supply of liquidity is suspended, the interest rate corresponds to the rates on occasional operations.
(e) Prior to 3 March 1997: Minimum lending rate.

(see Chart 3). Suomen Pankki had already raised its tender rate by 0.25 percentage point in mid-September and Sveriges Riksbank increased its repo rate by the same magnitude in mid-December. The correspondence in the size, timing and direction of the monetary policy measures in these Member States reflected the close alignment of their short-term interest rates in an environment of stable exchange rates, similar medium-term inflation prospects and low long-term bond yields.

The Banque de France closed the small remaining gap with the German repurchase rate by raising its intervention rate by 0.2 percentage point to 3.3% in October. This measure aimed at preserving a high level of confidence in the French franc, which in the course of the year appreciated to its central rates against most other ERM currencies. From a domestic perspective, the slightly less accommodating stance also aimed at sustaining a non-inflationary recovery in the face of more dynamic

Table 6

Monetary policy targets and guidelines of Member States

(a) Monetary aggregates - targets and guidelines
(annual percentage changes)*

		1996		1997		1998
	Reference variable	Target/ guideline[a]	Outturn	Target/ guideline[a]	Outturn	Target/ guideline[a]
Germany	M3	4-7	8.1	3.5-6.5	4.7	3-6
Greece	M3	6-9	9.3	6-9	9.5	.
Spain	ALP	≤8	6.5	≤7	3.7	.
France	M3[b]	5	-3.2	5	2.0	5
Italy	M2	5	3.1	<5	9.7	~5
United Kingdom	M0	0-4	5.7	0-4	6.5	-
	M4	3-9	9.8	3-9	11.1	-

Source: National data.
* Fourth quarter-fourth quarter or December-December (United Kingdom: March-March).
(a) Medium-term objectives for Spain and France. Monitoring ranges for the United Kingdom were suspended 6 May 1997 and the Bank of England's Monetary Policy Committee subsequently decided not to reinstate them for the time being.
(b) M3 for 1996, also assessed by developments in the narrow and broader monetary aggregates thereafter (M1, M2, M3+P1).

(b) Formal inflation targets
(annual percentage changes)

		1996		1997		1998
	Target variable[a]	Target	Outturn	Target	Outturn	Target
Spain	CPI	3.5-4[b]	3.6	<3	2.0	2
Finland	CPIY	~2	0.2	~2	0.7	~2
Sweden	CPI	2 ± 1	0.8	2 ± 1	0.8	2 ± 1
United Kingdom	RPIX	1-4	2.9	≤2.5[c]	2.8	2.5

Source: National data.
(a) CPI = Consumer price index. CPIY = CPI excluding indirect taxes, subsidies and capital costs for owner-occupied housing, (mortgage interest payments and depreciation). RPIX = Retail price index excluding mortgage interest payments.
(b) Applies to the first quarter of 1996.
(c) Lower half of 1-4% range by spring 1997; 2.5% or less thereafter; target of 2.5% from June 1997 onwards.

money and credit developments than in 1996. Over the medium term the Banque de France has been seeking an expansion of the money supply by 5%; in December 1997 the monetary aggregates M1 and M2 recorded annual growth rates of 6.6% and 7.8%, respectively, compared with 0.8% and 3.6% in 1996. Whereas the contraction of M3 observed in 1996 continued in the first months of 1997, M3 began to recover from the spring onwards, underpinned by the pick-up in economic growth and an upturn in the demand for narrow money (see Table 6 (a)). The growth rate of gross total domestic debt, which is monitored as a prominent indicator of financing conditions, was 3.5% in December 1997, i.e. slightly higher than a year earlier.

The Belgian/Luxembourg franc again showed a high degree of stability vis-à-vis the Deutsche Mark, while Belgian short-term interest rates were maintained at slightly higher levels than those in Germany (see Chart 4). In Denmark inflationary pressures intensified during the year. As these were partly countered by fiscal tightening, the Danish krone nonetheless strengthened its position within the ERM and the positive three-month interest rate spread against the Deutsche Mark narrowed somewhat. During the year the Dutch guilder moved down to its central rate against the Deutsche Mark. De Nederlandsche Bank reacted by allowing short-term interest rates to rise from just below German levels to around par, which was seen as a welcome movement in view of the buoyancy of the Dutch economy. The exchange rate of the Austrian schilling remained very close to its central parity against the Deutsche Mark. Three-month interest rates in Austria were close to those in Germany, although in October the Oesterreichische Nationalbank set the repurchase rate at 3.2%, i.e. slightly below its German equivalent, in response to lower perceived domestic inflationary risks.

Although the average rate of underlying consumer price inflation in Finland stayed well below 2% in 1997, an upward trend was discernible in the course of the year, with inflationary pressures arising on account of continued strong growth performance and the strengthening of consumers' inflation expectations. Higher financial asset prices and housing prices were also viewed as a potential cause for concern. With a view to securing its objective of stabilising underlying inflation at (around) 2% (see Table 6 (b)), Suomen Pankki raised its tender rate from 3.0 to 3.25% in mid-September. During 1997 the Finnish markka was one of the stronger currencies within the ERM and three-month interest rates could generally be maintained at a level slightly below those in Germany.

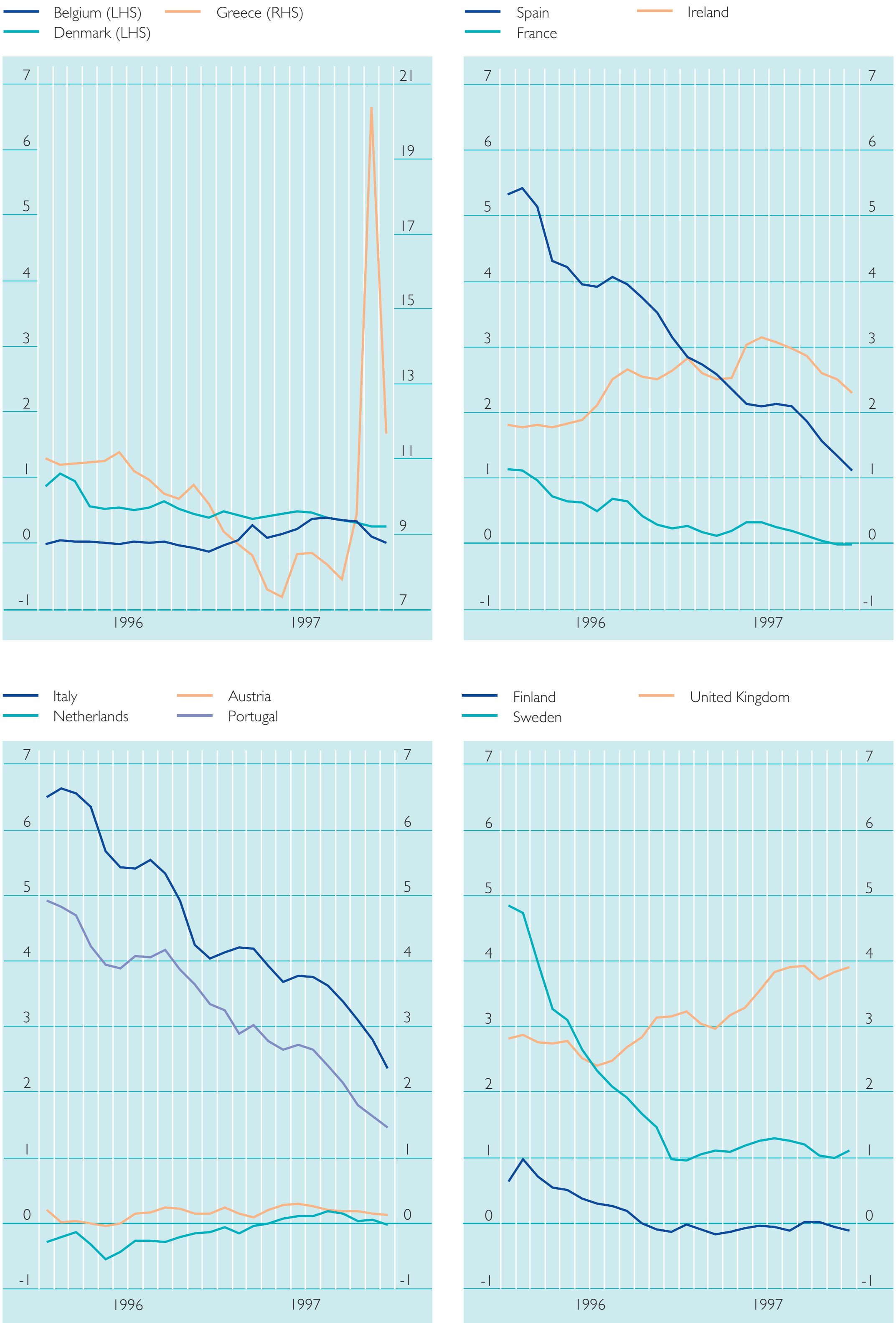
Sweden was also confronted with rising consumer price inflation during most of 1997, albeit from a very low level. Against the background of higher capacity utilisation and some concerns over wage settlements, Sveriges Riksbank took the precautionary step in December of increasing its securities repurchase rate from 4.1 to 4.35% in order to adhere to the 2% inflation target (with a margin of 1 percentage point on either side). On balance, the Swedish short-term interest rate spread over Germany was broadly stable at around 1.1 percentage points.

Conditions in several other EU countries supported a further reduction in interest rates. The Banco de España reduced its intervention rate in steps from 6.25% at the start of the year to 4.75% in December. This reflected the fact that consumer price inflation in Spain was declining rapidly to stabilise at an average rate of 2.0%, i.e. well in line with both the objective for 1997 of keeping it below 3% and the 2% target announced for 1998 (see Table 6 (b)). The stable position of the Spanish peseta within the ERM, the deceleration of the growth of broad monetary aggregates (see Table 6 (a)) and a supportive fiscal policy further assisted the downward trend in short-term interest rates, which by year-end had declined to 1.2 percentage points above those in Germany.

Chart 4

Short-term interest rate differentials against Germany

(three-month interbank rates; in percentage points)



Source: National data.

Consumer price inflation in Italy continued its downward trend and stabilised at an average rate of 1.7% for the year as a whole. This result, which also reflected currency stability and progress in fiscal consolidation, was well in line with the Banca d'Italia's intention, as stated in May 1996, to secure a rate of inflation of less than 3% in 1997. For 1998 the central bank is seeking to keep inflation at 2%. Monetary growth clearly exceeded the central bank's reference ceiling of 5% (see Table 6 (a)); however, the broad monetary aggregate M2 was affected by major portfolio shifts in response to the low-inflation environment. The Banca d'Italia therefore made a cautious reduction in both the discount rate and the fixed term advances rate by a total of 2 percentage points to 5.5% and 7.0% respectively. At the end of 1997 the Italian three-month interest rate had fallen to a level of less than 2.4 percentage points above the equivalent rate in Germany (see Chart 4).

In Portugal the stable position of the Portuguese escudo within the ERM was underpinned by the rapid decline in inflation to just above 2% and firm progress in fiscal consolidation. The Banco de Portugal was thus able to lower its official interest rates in several steps, steering the repo rate down from 6.7% at the beginning of 1997 to 5.3% by the end of the year. Against this background, the three-month interest rate spread over Germany narrowed to just over 1.5 percentage points.

The Bank of Greece announced that it was aiming to reduce inflation further to 4.5% by the end of 1997 and to below 3% by the end of 1998. For this purpose, a broadly stable exchange rate of the Greek drachma against the ECU and a rate of M3 growth within a range of 6-9% were targeted. With an outcome for consumer price inflation of 4.7% in December 1997, the central bank virtually achieved its price objective. The favourable trend in inflation enabled a further reduction in official interest rates to be made in the first part of the year, as the rapid expansion of M3 could be explained by portfolio adjustments linked to fiscal changes and the abolition of remaining short-term capital controls. In the autumn, however, the drachma was affected by speculative pressures in the wake of the financial crisis in Asia (see Box 1). Although the countermeasures taken by the central bank were successful in stabilising the currency in 1997, three-month interest rates ended the year some 4 percentage points higher than before the outbreak of the turmoil.

In the remaining two countries economic conditions in 1997 necessitated a divergent approach. The exceptionally strong performance of the Irish economy, as reflected in buoyant money and credit growth, tightening labour market conditions and rising asset prices, continued unabated. The associated inflation risks prompted the Central Bank of Ireland to raise its short-term facility rate by 0.25 percentage point to 6.5% in early May. Although the Irish pound remained the strongest currency within the ERM, it lost ground vis-à-vis sterling. As a result, the effective exchange rate showed a tendency to depreciate, which further exacerbated inflation risks. However, Ireland did not participate in the general round of official interest rate increases in October. Towards the end of the year, ahead of the selection in May 1998 of the countries to participate in Stage Three of EMU, short-term interest rates in Ireland declined relative to those in Germany and the Irish pound moved closer to its ERM central rates.

1997 witnessed a major revision of the UK monetary policy framework. Immediately following the May general election, the new Government decided, inter alia, to grant operational independence for the setting of interest rates to the Bank of England while retaining responsibility for defining the inflation target.[5] Just in advance

[5] *In addition, the Government's monitoring ranges for the expansion of the monetary aggregates M0 and M4 were suspended in May 1997 and the Bank of England's Monetary Policy Committee subsequently decided not to reinstate them for the time being.*

of the announcement of this decision, the Chancellor of the Exchequer raised the securities repurchase rate by 0.25 percentage point to 6.25%. The newly established Monetary Policy Committee of the Bank of England subsequently increased the securities repurchase rate in four steps to 7.25% in November in order to keep the outlook for underlying (RPIX) inflation in line with the Government's objective of 2.5% (as restated in June). This significant monetary tightening was deemed necessary in the light of the current and prospective strength of domestic demand, notwithstanding the expected effects of tighter fiscal policy, the ending of windfalls from the demutualisation of mortgage lending institutions and the appreciation of sterling. The persistence of strong monetary developments also gave cause for concern about future inflation.

3 Economic prospects and challenges

This section describes the prospects for the EU and the world economy, considers the conduct of monetary policies in the period of transition to Stage Three of EMU and addresses the creation of the ESCB and the ECB. Box 2 outlines the characteristics of the future euro area, as defined by the outcome of the meetings of the EU Council on 2/3 May 1998, meeting in the composition of Heads of State or Government, to confirm which Member States fulfil the necessary conditions for the adoption of the single currency.

3.1 Economic outlook for 1998-99

Economic forecasts released by major international organisations in spring 1998 suggest that growth prospects for the EU in 1998 and 1999 are favourable, as domestic demand should strengthen further, offsetting to some extent an expected deterioration in the external environment due to, inter alia, the crisis in Asia.

Real GDP growth in the EU, which has been gaining momentum since the second quarter of 1997, is expected to strengthen further as domestic demand continues to accelerate in a number of EU countries. Consumer and business confidence indicators are pointing in the same direction. This partly reflects the impact of a low level of nominal interest rates, particularly at long maturities, prevailing in an environment of, by and large, subdued inflationary pressures, where external competitiveness has been maintained or improved despite currency depreciations in many Asian countries. This environment, combined with increased corporate profitability, particularly in the export-oriented industries, is expected to be conducive to investment growth. Private consumption is also projected to pick up further due to a rise in real wages and reduced uncertainty regarding employment prospects in 1998 and 1999. With a continued need for fiscal consolidation, the impact of government consumption and investment on domestic demand is likely to remain limited. Despite the projected improvement in labour market conditions, the rate of unemployment is expected to decline only modestly in 1998 and 1999. A sustained reduction in the rate of unemployment will depend crucially on the implementation of structural reforms to address labour and product market rigidities.

As regards the outlook for inflation, the continuation of stability-oriented monetary policies combined with wage moderation, with the latter partly reflecting the persistence of relatively high rates of unemployment, and still negative output gaps in certain countries are expected to limit inflationary pressures. In addition, the decline in oil prices, provided that it is by and large sustained, and the counter-inflationary impact of the Asian crisis - arising from a depreciation of certain Asian currencies and the moderation of global growth - should contribute to dampening inflationary pressures from the outside. Risks to the inflation outlook relate to, inter alia, the possibility of a faster than expected pick-up in aggregate demand in the EU and thus to a closing of output gaps, the development of wages, a further appreciation of the US dollar and, in the light of the latest OPEC agreement, a sustained reversal of the recent decline in oil prices.

The main uncertainty with regard to the above outlook stems from the external environment. World output and trade growth are expected to be weaker in 1998 and 1999 than in 1997 owing to a sharp decline in real GDP growth in parts of Asia, a modest slowdown in the US growth rate and a deterioration in the economic and financial situation in Japan. The extent of the weakness in the external environment arising from the turmoil in Asia will depend on the scope and timing of the adjustment of macroeconomic policies in the countries affected, and on the extent to which financial reforms are implemented. The possibility of further spillover effects cannot yet be ruled out. The contractionary impact of the Asian crisis on EU growth may be partly offset by two factors: first, the decline in long-term interest rates in the EU as well as in the United States - which is linked to, inter alia, investors' reassessment of the risk in emerging markets; and, second, the marked decline in commodity prices, which may contribute to a further rise in real incomes.

3.2 Monetary policies in the remainder of Stage Two

The primary objective of the monetary policies of the eleven countries selected to participate in the euro area in the remaining months of Stage Two is to ensure that the current environment of broad price stability is maintained for the euro area as a whole, thereby providing the ESCB with a favourable starting position.

As outlined in Section 2, the majority of countries selected to participate in the euro area have already achieved short-term interest rates which are closely aligned at a low level. The conditions in the first part of 1998 have allowed this common position to be firmly consolidated and the remaining members have been able to maintain the downward trend in their key interest rates. This suggests that a de facto common monetary policy stance is tending to emerge in the selected euro area countries, against a background of broadly stable prices and exchange rates. By the end of 1998 at the latest, those countries' short-term interest rates will have converged to a common level which will be consistent with the objective of maintaining price stability in the euro area.

This overall pattern of convergence in short-term interest rates is consistent with a situation on the eve of Stage Three in which market exchange rates between the countries selected to participate in the euro area are equal to the pre-announced bilateral exchange rates which will be used in determining the irrevocable conversion rates for the euro (see Annex). These pre-announced bilateral exchange rates are consistent with economic fundamentals and are compatible with sustainable convergence.

The institutional background to the above-mentioned development has, of course, changed. The confirmation on 2/3 May 1998 by the Heads of State or Government of the Member States which will adopt the single currency heralded the start of the final phase of the transition to Stage Three, which includes the establishment of the ESCB and the ECB and the liquidation of the EMI. During the remainder of Stage Two, the Governing Council and the Executive Board of the ECB will finalise the preparations needed for the conduct of the single monetary policy in the euro area as of 1 January 1999 (see Chapter 2). In the meantime, the participating national central banks will retain their national monetary powers. The institutional changes entailed in the establishment of the ESCB and the ECB provide a suitable framework within which the participating national central banks will be able to engage in close co-operation with a view to co-ordinating their national monetary policies in order to achieve the primary objective of maintaining price stability in the euro area. Furthermore, in accordance with Article 44 of the ESCB/ECB Statute, the ECB is to take over the tasks of the EMI which still need to be performed in Stage Three of EMU, given the existence of Member States with a derogation. The General Council of the ECB is to assume responsibility for relations with the national central banks of the non-euro area Member States.

Box 2

Characteristics of the euro area

On 2/3 May 1998, on the basis of the Council recommendation and following the European Parliament's Opinion, the Council - meeting in the composition of Heads of State or Government - unanimously decided that eleven Member States, namely, Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, The Netherlands, Austria, Portugal and Finland fulfil the necessary conditions for the adoption of the single currency on 1 January 1999. These countries will therefore participate in the third stage of Economic and Monetary Union.

The table below shows a range of indicators which highlight some of the key characteristics of the euro area. This table provides an initial comparison for the year 1997 (or the latest year for which data are available) between the euro area, the EU-15, the United States and Japan, thereby broadly describing the euro area's "starting position". However, the figures shown are estimates collected from various sources, and further elaborated aggregate data will become available during the course of 1998 or later, based on newly compiled statistics. Overall, the data highlight a significant change compared with the environment previously prevailing in individual EU countries. The introduction of the euro will create an area which will closely resemble the United States in terms of the magnitude of its domestic economy and its degree of openness.

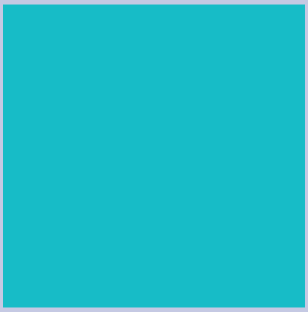
In terms of population, with around 290 million inhabitants, the euro area is somewhat larger than the United States and more than twice the size of Japan. In a global context, it is a "large domestic economy" which has a share of world GDP of almost 20%, thereby possessing a considerable purchasing power matched only by that of the United States. Intra euro area exports account for almost 17% of total world exports. Excluding these intra-area exports, the euro area still accounts for approximately 20% of world exports and thus in terms of its percentage of world exports is larger than either the United States or Japan. Patterns of production are broadly similar to those of the United States and Japan. However, the service sector is smaller than that of the United States, but larger than that of Japan, whose economy still features a relatively preponderant manufacturing sector. Figures for general government current receipts and expenditures show that the euro area has a larger public sector than either the United States or Japan, with close to 50% of GDP accounted for by government expenditures. The ratios of exports and imports to euro area-wide GDP, both standing somewhat above 10%, suggest that the degree of openness of the euro area is comparable to that of the United States and Japan (after adjusting for intra-area trade). This contrasts with the typical nature of individual EU countries, as "small or medium-sized economies" with an average ratio of exports or imports to GDP of around 25% (although there are sizable variations across the individual countries within the euro area). Figures for the value of debt securities, stock market capitalisation and bank assets show that the combined weight of financial markets in the euro area is substantial, although the relative weight of individual components differs. Compared with the United States and Japan, the weight of equity and debt securities markets is lower and the relative importance of banking is far greater.

Considering a number of recent macroeconomic variables, real GDP growth for the euro area as a whole was 2.5% in 1997. Reflecting different positions in the cycle, GDP growth in 1997 was markedly different from that in the United States and Japan. Inflation in the euro area, as measured by the harmonised index, was 1.6%, similar to the outturn for Japan, but below that for the United States. The unemployment rate was significantly above that of both the United States and Japan. Short and long-term nominal interest rates were lower in the fourth quarter of 1997 than they were in the United States. Average general government debt and deficit figures for the countries comprising the euro area show debt and deficit ratios of 75.2% and 2.5% respectively (with significant differences among Member States); on average, they were above those in the United States but below those in Japan (where the debt ratio is nearly 100%). Finally, the current account balance, as for the EU as a whole, was in surplus. This surplus was lower than in Japan and compares with a deficit in the United States.

Key characteristics of the euro area, 1997

		Euro area	EU-15	United States	Japan
Area [(a)]	*1,000 km²*	2,365.0	3,234.2	9,372.6	377.8
Population	*mn*	290.4	374.1	267.9	126.0
GDP (as % of world GDP) [(b)]	%	19.4	24.6	19.6	7.7
Nominal GDP	*ECU bn*	5,548.1	7,132.3	6,896.5	3,708.4
Sectors of production [(c)]					
Agriculture, fishing, forestry	*% of GDP*	2.4	2.4	1.7	2.1
Industry (incl. construction)	*% of GDP*	30.9	30.0	26.0	39.2
Services	*% of GDP*	66.7	67.6	72.3	58.7
General government					
Total current receipts	*% of GDP*	47.0	46.3	36.7	32.6
Total expenditures	*% of GDP*	49.6	48.7	37.0	36.0
Exports of goods [(d)]	*% of GDP*	12.3	9.2	8.1	8.8
Imports of goods [(d)]	*% of GDP*	11.0	8.6	10.6	6.9
Exports (as % of world exports) [(e)]	%	19.5	.	14.8	9.7
Debt securities [(f)]	*ECU bn*	5,347.1	6,632.5	8,450.4	4,071.9
	% of GDP	102.7	102.8	157.2	103.7
Stock market capitalisation [(g)]	*ECU bn*	1,620.7	2,889.4	5,244.0	2,804.4
	% of GDP	31.1	44.8	97.6	71.4
Bank assets [(h)]	*ECU bn*	10,082.5	12,479.7	4,211.0	6,217.3
	% of GDP	202.8	201.2	74.6	157.4
Real GDP growth	%	2.5	2.7	3.8	1.0
CPI inflation [(i)]	%	1.6	1.7	2.3	1.7
Unemployment rate (as % of labour force)	%	11.6	10.6	4.9	3.4
Short-term interest rate [(j)]	%	4.4	5.1	5.6	0.7
Long-term interest rate [(j)]	%	5.7	5.9	5.9	1.7
General government					
Surplus (+) or deficit (-)	*% of GDP*	-2.5	-2.4	-0.3	-3.4
Gross debt [(k)]	*% of GDP*	75.2	72.1	63.1	99.7
Current account balance	*% of GDP*	1.7	1.2	-1.9	2.2

Source: European Commission (spring 1998 forecasts), unless otherwise stated.
(a) Source: EUROSTAT.
(b) 1996; at current prices and purchasing power standard.
(c) 1993; at current prices. Source: OECD, Historical Statistics, 1960-1995.
(d) 1996. Source: EUROSTAT. Data for euro area exclude intra euro area trade; data for EU-15 exclude intra EU-15 trade.
(e) 1996; excluding intra euro area exports.
(f) 1995. Source: IMF, International Capital Markets, November 1997. Domestic and international debt securities by nationality of issuer. EMI calculation.
(g) 1995. Source: IMF, International Capital Markets, November 1997. EMI calculation.
(h) 1994. Source: IMF, International Capital Markets, November 1997. EMI calculation.
(i) Euro area and EU-15: annual average, HICP inflation.
(j) 1997 Q4. Source: National data. EMI calculation.
(k) End-year data. Source for United States and Japan: IMF, World Economic Outlook, April 1998.



Chapter II

Preparatory work for Stage Three

1 Monetary policy

1.1 Monetary policy strategy

In February 1997 the EMI published a report entitled "The single monetary policy in Stage Three - Elements of the monetary policy strategy of the ESCB". Having reviewed a number of alternative strategies, the report identified intermediate monetary targeting and direct inflation targeting as the basis for a potential strategy for Stage Three. While noting that it would be neither necessary nor useful, at that point, to select a specific strategy, the report listed a number of key elements which should be viewed as an indispensable part of any strategy: a clear definition of the final objective of price stability and of the specific targets against which the performance of the ESCB could be assessed; the availability of a broad set of indicator variables to help assess the risks to future price stability; a prominent role for monetary aggregates, provided that money demand in the euro area is sufficiently stable in the long run; and tools enabling forecasts for inflation and other euro area economic variables to be produced. In addition, the report noted that monetary policy in Stage Three would also require a comprehensive data set and analytical capacities, including econometric models, to assist in the formulation of policy.

Following publication of the above-mentioned report, work at the EMI in the field of strategy concentrated on the preparation of the infrastructure necessary to support monetary policy decision-making irrespective of the strategy to be chosen. Preparatory work was initiated on the definition of monetary aggregates for Stage Three, the preparation of organisational and methodological aspects of the ESCB's forecasting procedures and the development of indicators of fiscal stance at the euro area-wide level. EMI staff also carried out work on a number of other topics, such as the measurement of inflation and inflation expectations, the leading indicator properties of financial variables and studies of money and credit demand in the EU.

In the field of econometric modelling, a major project was launched which was concerned with the development of an ESCB multi-country macroeconomic model and involved collaboration between the EMI and NCBs. In the course of the year the specification of the model was agreed, the supporting database constructed and work commenced on the estimation of the model, which is due to become available as an operational tool in the second half of 1998. In addition, further work was carried out by EMI staff on the development of a euro area-wide macroeconomic model designed to summarise the broad contours of the average transmission mechanism of monetary policy in the euro area. This euro area-wide model has already been used for forecasting and simulation purposes in the context of Stage Two co-ordination exercises. Furthermore, a number of statistical tools to be used for forecasting purposes were developed and refined by EMI staff.

1.2 Implementation of the single monetary policy

Instruments and procedures

The conceptual phase of the preparatory work dealing with the instruments and procedures necessary for implementing the single monetary policy in Stage Three was concluded at the end of 1996, thus leading to the publication in January 1997 of an EMI report entitled "The single monetary policy in Stage Three - Specification of the operational framework" (the "Framework Report"). The first half of 1997 was devoted to defining the technical specifications for the ESCB's operational framework and this work led to the publication in September 1997 of an EMI report entitled "The single monetary policy in Stage Three - General documentation on ESCB monetary policy instruments and procedures". In the second half of the year the detailed specification of all the instruments and procedures, including the preparation of the relevant legal and technical infrastructure, progressed further and the setting-up of the ECB tools necessary for the implementation of the future monetary policy of the ESCB was begun. This work continued into early 1998. The second half of 1998 will be devoted to a thorough testing of the procedures and systems to be used in Stage Three.

The EMI Council has defined a set of monetary policy instruments that will be made available to the ESCB. It is envisaged that the ESCB will mainly use open market operations, but that it will also offer two standing facilities. In addition, preparations are being made to enable the ESCB to implement a minimum reserve system should the Governing Council of the ECB decide to do so.

As regards open market operations, these will normally be based on tender procedures. Only outright operations and the other types of operations used for fine-tuning purposes by the ESCB may be conducted through bilateral procedures. The procedures, time frame and calendar for ESCB tenders have been designed in such a way as to meet the requirements of money market participants to the greatest possible extent. For most open market operations, namely the main refinancing operations, the longer-term refinancing operations and, possibly, the issuance of debt certificates, the ESCB will use the so-called standard tenders. These tenders will be executed within 24 hours of their announcement. The time frame for standard tenders foresees that the ESCB will announce the tender results within approximately two hours of the deadline for the submission of bids by financial institutions. In fine-tuning operations either bilateral operations or so-called quick tenders will be executed. Quick tenders will be completed within around one hour of the announcement of the tender.

Despite the fact that bank holidays in the Member States differ, a calendar of regular ESCB tender operations will be established, which will ensure that all counterparties in the euro area will be able to participate in the main and longer-term refinancing operations conducted by the ESCB at all times.

The settlement of open market operations based on standard tenders will normally take place on the first business day following the trade date. In contrast, fine-tuning open market operations will normally be settled on the trade date itself, in order to make sure that these operations have an immediate liquidity impact. For outright transactions and foreign exchange swaps, the ESCB will apply settlement dates in line with market practice. While the ESCB will aim at settling the transactions related to its open market operations simultaneously in all Member States, the possibility cannot be ruled out that the precise timing of the settlement of open market operations during the course of the day will differ across the euro area at the start of Stage Three, owing to some operational constraints on national securities settlement systems.

With regard to the ESCB's two standing facilities, their use will largely be influenced by the ESCB's end-of-day procedures, which will be of particular importance for the operation of the money markets. The normal closing time for TARGET will be 6 p.m. ECB time. At that time, all the debit positions of counterparties will automatically be treated as a request for recourse to the marginal lending facility. NCBs will start their end-of-day procedures at 6.30 p.m. ECB time. This will also be the deadline for requests to access the ESCB's deposit facility. These end-of-day procedures have been devised so as to maximise the flexibility available to counterparties, while at the same time bearing in mind the need to perform the ESCB's monetary policy functions.

The EMI is currently carrying out the preparatory work necessary to enable the ESCB to impose minimum reserve requirements as from the start of Stage Three. A proposal for a draft EU Council Regulation on minimum reserves was published as an annex to the EMI's "Framework Report". During 1997 the EMI discussed this draft Regulation in the context of an informal discussion with the Monetary Committee. As a result, an amended text will be formally presented to the EU Council by the ECB shortly after its establishment, in accordance with Article 106 (6) of the Treaty. The minimum reserve system would include an averaging mechanism that would allow counterparties to smooth temporary liquidity shocks over the maintenance period, which is envisaged to have a time span of one month. With regard to the reserve base, the EMI has proposed that minimum reserves may be applied to the liability items on the balance sheets of institutions subject to reserve requirements. Some liabilities resulting from off-balance sheet items could also be included in the reserve base. The relevant liability items are reported for statistical purposes at the end of the calendar month preceding the start of the maintenance period. This does not imply that all these balance-sheet items would be subject to a positive reserve ratio, but merely that these would be the relevant and potential liability items if the Governing Council of the ECB were to decide in favour of a minimum reserve system.

Eligible counterparties and assets

Common eligibility criteria have been defined for the counterparties and the assets to be used in operations with the ESCB.

With regard to counterparties, if minimum reserves are applied, all institutions subject to minimum reserve requirements will be eligible to access open market operations and the two standing facilities. If no minimum reserves are applied, it is to be expected that the range of counterparties will broadly correspond to the range of credit institutions. Only for the purpose of fine-tuning operations will the ESCB deal with a more limited range of counterparties, for obvious reasons of efficiency. The ESCB's counterparties will need to satisfy certain prudential and operational requirements. In particular, counterparties will have to be financially sound institutions, subject to prudential supervision and able to participate in the relevant ESCB operations under the technical conditions set by the ESCB.

Eligible assets will be classified as either tier one or tier two assets. Tier one will consist of marketable debt instruments fulfilling uniform euro area-wide eligibility criteria. Tier two will consist of additional assets, marketable and non-marketable, which are of particular importance for national financial markets and banking systems and for which eligibility criteria will be established by NCBs, subject to the minimum eligibility criteria established by the ECB. All eligible assets will be subject to specific risk control measures. These risk control measures were defined during the course of 1997, taking into account market practices and reactions to initial proposals from the EMI. For tier one instruments, risk control measures will consist of initial margins, specific valuation haircuts differentiated according to the residual maturity and coupon structure of the debt instrument (implying that the value of the underlying asset will be calculated as the market value of the asset less a certain percentage (haircut)) and margin calls aimed at ensuring over time that the valuation of the underlying asset matches the amount of liquidity provided plus the value of the initial margin. Risk control measures for tier two assets complementing the initial margins will be proposed by those NCBs which have included such assets in their lists, and these measures will have to be approved by the ECB. The ESCB will aim to ensure consistency in the application of the risk control measures for tier two assets across the euro area.

Preparatory work for the implementation of monetary policy instruments

As monetary policy will be implemented on a decentralised basis, with the ECB carrying out bilateral fine-tuning operations only under exceptional circumstances, the main preparatory work for the introduction of the euro has been undertaken by the NCBs. This consists in their adapting the whole set of monetary policy instruments and procedures used at present. The EMI is in charge of monitoring the implementation of this work and co-ordinating the projects and developments.

In particular, the EMI is supervising the preparation by each NCB of its own set of legal requirements to be used in its relations with monetary policy counterparties. This documentation is being prepared on the basis of a common set of legal requirements that will help to ensure a level playing-field throughout the euro area.

An ESCB internal IT infrastructure is currently being prepared for the execution of both tender operations and bilateral transactions. The processing of tender operations will require several sequential steps involving intra-ESCB communication, while the processing of bilateral transactions will involve a real-time IT system connecting the ECB and the NCBs.

In order to establish the lists of eligible assets proposed by the NCBs and eligible counterparties for ESCB monetary policy operations, the EMI is setting up systems which will compile all the relevant information, calculate the parameters of risk control measures and enable regular exchanges of information to be carried out within the ESCB. In addition, both the list of individual eligible assets, with the possible exception of certain categories of non-marketable assets, and that of institutions subject to reserve requirements will be made available to the public.

Another crucial project for the implementation of the single monetary policy is the setting-up of an effective system of liquidity management. It will require an integrated daily flow of information between the NCBs and the ECB, both with respect to liquidity forecasts and for the purpose of conducting decentralised monetary policy operations.

2 Foreign exchange policy

2.1 The ERM II

In the context of future foreign exchange policy co-operation between Member States participating in the euro area and other EU countries, work was conducted in 1997 at the level of both the ECOFIN Council and the EMI, in accordance with the broad lines defined in a report the EMI submitted on this issue to the Dublin meeting of the European Council in December 1996. The European Council meeting held in Amsterdam in June 1997 approved a Resolution relating to the new exchange rate mechanism to be introduced in Stage Three of EMU. In parallel, the EMI has finalised the draft agreement between the ECB and future non-euro area NCBs, which lays down the operating procedures for the ERM II; the draft agreement will be submitted to the ECB for endorsement following its establishment in early summer 1998. In the meantime the EMI has been continuing to work on the development of the technical infrastructure to enable the system to be operational as from 1 January 1999.

2.2 Foreign exchange intervention and the management of the ECB's foreign reserve assets

In 1997 implementation work on the conduct of potential foreign exchange intervention by the ECB focused on aspects related to the required operational framework and information systems support. The infrastructure currently being designed will make it possible for the ESCB to execute intervention, both within and outside the ERM II.

As regards the ECB's foreign reserve management, the information systems support needed by the ECB for its strategic decision-making processes is currently being developed, including the setting of the overall operational objectives in terms of currency risk, interest rate risk, credit risk and liquidity risk. This technical infrastructure will be used to convey the ECB's decisions to the NCBs, which could then be in charge of carrying out portfolio management operations in accordance with these instructions, pending a decision by the Governing Council of the ECB.

In accordance with Article 30.1 of the ESCB/ECB Statute, at the beginning of Stage Three NCBs will transfer foreign reserve assets up to an amount equivalent to €50 billion to the ECB. Work has been undertaken in order to facilitate the decision on the amount that will actually be transferred and on the modalities of the initial transfer of reserve assets. Likewise, work has been initiated to prepare complementary Community legislation which will enable the ECB, in accordance with Article 30.4 of the ESCB/ECB Statute, to make further calls on the NCBs' foreign reserve assets beyond the limit of €50 billion set in Article 30.1.

2.3 Guidelines for the NCBs' and Member States' operations with their foreign reserve assets

While foreign reserve assets in excess of those transferred to the ECB at the beginning of Stage Three will be held and managed by the NCBs, market transactions conducted with those assets will be monitored by the ECB with a view to ensuring consistency with the single monetary policy and the foreign exchange policy of the euro area. A similar monitoring framework will be put in place for transactions performed by euro area Member States involving the use of their foreign exchange working balances. A framework has been elaborated on this issue, encompassing not only central governments but also all public authorities within the euro area. Hence in accordance with Article 31 of the ESCB/ECB Statute, foreign exchange operations carried out by the NCBs with their remaining foreign reserve assets, the amount of which exceeds a threshold to be set by the ECB, will be subject to prior approval by the ECB. Similarly, market transactions effected by the Member States and changes in their foreign exchange working balances will be subject to a prior notification procedure if the amount in question exceeds a threshold to be set by the ECB. Through this procedure the ECB will be in a position to determine, if deemed necessary, the modalities of such transactions. In addition, ex post reporting requirements have been defined for both the euro area NCBs and the Member States. The EMI has finalised two draft proposals which will be submitted for approval to the ECB: one encompassing operations conducted by the NCBs and another covering transactions made by Member States. In addition, an arrangement to be established between the European Commission and the ECB has been prepared, which will enable the ECB to be kept informed, through notification and reporting procedures, of the Commission's foreign exchange operations.

2.4 The euro reference exchange rates

The EMI conducted work during 1997 aimed at preparing procedures for the computation and publication of the reference exchange rates for the euro. In March 1997 a meeting on changeover issues was held in Frankfurt between the EMI, the NCBs and EU-wide banking and financial associations. In this context, the EMI clarified its views on a number of aspects: (i) its preference for the "certain" quotation method (i.e. E1 = x amount of foreign currency) for defining euro exchange rates; (ii) the notion that a euro area-wide official fixing procedure involving the ECB and NCBs will not be required; and (iii) the need for the ESCB to compute and publish daily reference exchange rates for the euro. Further work on these issues is currently under way in order to establish the method to be used in determining the euro reference exchange rates and other procedural aspects linked to the dissemination of those rates.

2.5 The pre-announcement of the bilateral rates to be used in determining the irrevocable conversion rates for the euro

The Luxembourg European Council held in December 1997 stated in its conclusions that "the bilateral exchange rates which will be used to determine the conversion rates for the euro will be announced on 3 May 1998 for those Member States participating in the euro from the start". The Treaty requires that the formal adoption of the irrevocable conversion rates for the euro take place on 1 January 1999 upon a proposal by the Commission and after consulting the ECB. In addition, the fact that some of the ECU component currencies (the Danish krone, the Greek drachma and the pound sterling) will not be participating in the euro area from the start means that it is not possible to announce the irrevocable euro conversion rates for the participating currencies. However, it was possible to pre-announce the bilateral rates of the currencies participating in the euro area which will be used on 31 December 1998 to set the irrevocable conversion rates for the euro.

The Joint Communiqué[6] issued on 2 May 1998 by the Ministers and central bank governors of the EU Member States participating in the euro area, the European Commission and the EMI, as the forerunner

[6] *The official documentation is reproduced in an annex to this Annual Report.*

of the ECB, clarifies that these rates are the ERM bilateral central rates for the currencies of the euro area Member States. The method to be used on 31 December 1998 to set the irrevocable conversion rates for the euro will be the regular daily concertation procedure, which will take place at 11.30 a.m. on that day. According to this procedure and in the context of a teleconference, the NCBs of the Member States will provide one another with the exchange rate of their respective currency against the US dollar, once the NCBs have ascertained that the bilateral rates obtained by crossing the respective US dollar rates are equal to the pre-announced ERM bilateral central rates. The euro area NCBs stand ready to ensure this equality, if necessary through the use of appropriate market techniques. The next step will involve the final official ECU exchange rates against the EU currencies being set by multiplying (or dividing, depending on quotation conventions) the USD/ECU exchange rate by their respective US dollar exchange rate. The exchange rates of the official ECU vis-à-vis the currencies of the euro area Member States will be adopted by the Council as the irrevocable conversion rates for the euro on and with effect from 1 January 1999.

3 Statistics

3.1 Implementation of the statistical requirements for Stage Three

The Treaty requires the EMI to make the statistical preparations necessary to enable the ESCB to perform its functions in Stage Three.

A statement of these statistical requirements, the so-called implementation package, was released in July 1996, and soon afterwards NCBs started to discuss their implementation with national banking associations and other interested parties. The requirements were summarised in the EMI's Annual Report 1996 and are not repeated here except where necessary as background information to subsequent developments.

Much of 1997 was spent implementing these requirements and clarifying points of detail, where necessary. The EMI published provisional lists of institutions forming the Monetary Financial Institutions (MFI) sector, in addition to documents covering money and banking and balance of payments statistics in Member States. The EMI engaged in informal discussions concerning legal aspects of the statistical framework for Stage Three and defined the specifications for a substantial part of the necessary IT infrastructure.

Money and banking statistics

The EMI's publication entitled "European Money and Banking Statistical Methods" (April 1997) describes the statistical systems in Member States in the field of money and banking statistics as at the end of 1996. Meeting the requirements set out in the implementation package will imply changes in all Member States. Two EU-wide monitoring exercises during the course of 1997 recorded the progress made in implementing these changes. In general, the changes were being introduced without major difficulty. In some Member States the adoption of breakdowns by original maturity for certain items on banks' balance sheets and the agreed 15 working day deadline for the transmission of national data to the ECB were reported to have caused some initial difficulties.

The definition of Monetary Financial Institutions is set out in the implementation package. MFIs will report a monthly balance sheet and more detailed quarterly information, although smaller institutions are exempt from some of the reporting requirements. A provisional list of MFIs was published in September 1997. It mainly comprised credit institutions as defined in Community law, in addition to certain other financial institutions corresponding to the MFI definition, although not at that stage including money market funds. An addendum to the provisional list, comprising money market funds, was published in December 1997.

Following further testing and reviews, a final version of the list of MFIs was released in April 1998. Comprising some 11,000 institutions, it provides as homogeneous a population as possible for statistical purposes. It will facilitate the production of a comprehensive and consistent balance sheet of the money-creating sector in the single currency area and support other important statistical applications such as the ESA 95. It will also be used in connection with the selection of counterparties for the monetary policy operations of the ESCB.

In close collaboration with the NCBs, the EMI prepared guidelines for the compilation of money and banking statistics covering some forty issues. The EMI also clarified the reporting requirements to be met by NCBs, since they form part of the MFI sector and contribute to monetary statistics. In the areas of interest rates and securities issues statistics, more extensive use will be made of existing data sources for the time being.

The implementation package requires the first data compiled on the agreed new basis to be available for end-June 1998, and monthly thereafter, with back data on the closest possible approximation to it from September 1997 to be available by September 1998. With the help of the NCBs, the EMI is preparing estimates for earlier periods; for most Member States these cannot be exact because the harmonised balance sheet categories and geographical breakdowns of external positions necessary for the correct calculation of aggregates for the future single currency area are not available in the required detail for earlier periods.

Balance of payments statistics

EU Member States either adopted the provisions of the 5th edition of the IMF Balance of Payments Manual in the course of 1997 or intend to do so during 1998. The monthly key items for the balance of payments of the single currency area will conform as far as is practicable with the new IMF Manual. The more detailed data envisaged for a quarterly and an annual balance of payments (and for an annual statement of the international investment position (IIP)) will be compatible with the IMF's standard components. A large part of the necessary harmonisation of definitions will be accomplished in the process.

The implementation package contains few details concerning either the statistical treatment of derivatives in the balance of payments or the IIP. Both matters received close attention from the EMI in 1997. The requirements for the single currency area correspond to international standards as amended by international agreement. It will nevertheless take some time for uniformity and full consistency to be achieved in some areas, especially in the treatment of derivatives, the portfolio account in general and the valuation of outstanding stocks.

Derivatives and the portfolio account already present difficulties in some national balances of payments. Another difficulty which has been noted in monitoring exercises is timeliness: only nine Member States would currently be able to meet a six-week deadline for all monthly key items. Ireland and the United Kingdom do not have a full balance of payments on a monthly basis at present; both made considerable progress in preparing estimates in 1997.

Balance of payments estimates for 1998 covering key items for the future single currency area will be compiled from data without breaking counterparties down into residents of countries participating in the single currency area and residents of other countries, and so will take the form of an aggregation of net balances in each category of the national balances of payments. The first IIP for end-1998 will also be compiled on a net basis.

Financial accounts

The implementation package foresees a need for detailed information covering financial transactions and balance sheets for the single currency area to complement monetary analysis and policy research. The document suggests that it should be possible to compile, within the conceptual framework set out in the ESA 95, a fairly full, though not complete, account for the single currency area from monetary, balance of payments and capital market statistics, drawing also on national financial accounts as far as possible. These data should be compiled on a quarterly basis in order to be of real use to the ECB.

In 1997 the EMI established that it would indeed be possible to compile a quarterly set of financial accounts as described above and began work in order to design them.

Like the balance of payments, financial accounts also represent an area in which it is agreed that the Commission (EUROSTAT) and the EMI share responsibility at the European level. The approach to shared responsibility is summarised in Section 3.2 on organisation.

Other economic and financial statistics

The implementation package states that there is a need for government finance statistics, as they measure an important influence on monetary conditions; for statistics on prices and costs, since these relate directly to the ESCB's primary responsibility to maintain price stability; and for a wide range of economic statistics (relating to components of demand, output, the labour market, etc.), which provide the background for the conduct of monetary policy and foreign exchange operations.

All these statistics are the responsibility of the Commission (EUROSTAT) and the EMI is involved in their development in its capacity as a closely interested user. Much further work was done in 1997 to harmonise the treatment of government deficit and debt statistics in order to make the data comparable for the purpose of assessing convergence under Article 109j of the Treaty. In March 1997 the Commission published the first harmonised consumer price statistics covering the EU. These statistics, combined to form an aggregate covering the euro area, are likely to constitute the main measure of prices monitored by the ECB.

EU Member States have a legal commitment to implement the requirements of the ESA 95 starting in spring 1999. Although some Member States have derogations regarding certain parts of the ESA 95, this step will lead to increased harmonisation in national accounts statistics; preparatory work to this end proceeded in 1997. In addition, the EMI has strongly supported a Commission initiative to harmonise the frequency, timeliness and coverage of a wide range of conjunctural statistics to the extent deemed necessary. A short-term statistics Regulation has recently been enacted by the EU Council. This initiative will take some time to become fully effective, however, because the Regulation allows delays in implementation of up to five years. Meanwhile, arrangements are being made to speed up the availability of national data.

3.2 Organisation of statistical work at the European level

The EMI's Annual Reports for 1995 and 1996 noted the agreed division of responsibility between the Commission (EUROSTAT) and the EMI. This included shared responsibility for balance of payments statistics and financial accounts.

During 1997 further consideration was given to the sharing of responsibility in these areas. In the balance of payments, it has been suggested that the Commission (EUROSTAT) should compile data relating to most of the current account and the capital account (in the new terminology), while it is expected that the ECB will compile data relating to the financial account (in the new terminology) and the investment income part of the current account. Reflecting the Commission's knowledge in the area and its use of the data for certain policy purposes, both institutions will play a role in the compilation of direct investment statistics. A joint publication of data is envisaged. This arrangement relates to quarterly and annual balance of payments data; only the ECB is expected to be involved in the compilation of monthly key items.

In the area of financial accounts, the legal requirement laid down in the ESA 95 is for an annual frequency. The EMI, and prospectively the ECB, will take the lead in developing quarterly financial accounts relating to the single currency area following the approach described above and, together with the Commission (EUROSTAT), will monitor the implementation of the ESA 95 in the area of financial accounts.

The EMI and the future ECB will continue to co-operate closely with the Commission (EUROSTAT) on all statistical matters of common interest. The respective statistical responsibilities of the ECB and the Commission at the European level will need to be formally agreed following the establishment of the ECB.

3.3 Legal aspects

A draft EU Council Regulation concerning the collection of statistics by the ECB was published in the EMI's report entitled "The single monetary policy in Stage Three - Specification of the operational framework" in January 1997.

During 1997 the EMI discussed this draft Regulation informally within an ad hoc group of the Monetary Committee. Senior EU statistical committees also commented on it. The amended text will be formally presented to the EU Council by the ECB shortly after its establishment, in accordance with Article 106 (6) of the Treaty.

In order to give effect to this EU Council Regulation concerning the collection of statistics, the ECB will need to issue legal instruments in accordance with Article 34 of the Statute.

3.4 Information systems infrastructure

The design of a system for electronic data transmission within the ESCB was essentially completed by summer 1997. By the end of 1997 much of the implementation had already been completed, thus permitting the first test electronic transmissions to take place in January 1998. The system uses the GESMES-CB message format, which is generally applicable for the purpose of statistical data exchange in time-series format. It is likely to be widely used for the exchange of statistics between international organisations.

In 1997 the EMI also started to prepare its internal systems in order for them to be able to receive, process and store the large amounts of statistical data which the ECB will need to handle in Stage Three.

4 Payment systems

4.1 The TARGET system

In September 1997 the EMI released the "Second progress report on the TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) project".[7] The report provided further information on the progress made with regard to the organisational aspects and implementation of the system. It mainly addressed the following issues: 1) operating time; 2) pricing policies; 3) the provision of intraday liquidity to non-euro area NCBs; 4) the role of the ECB in TARGET; and 5) TARGET implementation.

With reference to the TARGET operating time, Christmas Day and New Year's Day will be the only two common holidays for TARGET, in addition to Saturdays and Sundays. On all other days the TARGET system will be open, although NCBs will be free to close their domestic systems on national holidays when the law or the respective banking community so require. Provided that at least two real-time gross settlement (RTGS) systems are open, the Interlinking system between those systems will also remain open. A calendar of TARGET operating days for 1999 (including a list of national RTGS closing days) will be published in August 1998. Moreover, it has been agreed that the normal TARGET operating hours will be from 7 a.m. to 6 p.m. ECB time, i.e. the time in the place where the ECB is located.

The precise level of the fee to be charged for cross-border TARGET transactions will be decided by the Governing Council of the ECB. The fee is expected to be close to the lower end of the previously indicated range of € 1.50 to 3.00. In addition, a price differentiation can be expected, which will be based on volume and will result in an average user cost of well below € 1.50 for participants making extensive use of TARGET.

As the follow-up to a decision taken by the EMI Council in December 1996,[8] three mechanisms are being prepared in order to prevent intraday credit, if provided by euro area NCBs to non-euro area NCBs, from spilling over into overnight credit.

The three mechanisms are as follows:

- mechanism 1: high penalty rates for spillovers (supplemented by non-pecuniary sanctions) and an early cut-off time for customer payments both in euro area and in non-euro area countries;[9]
- mechanism 2: limits (possibly set at zero) for intraday credit granted by euro area NCBs to non-euro area NCBs;
- mechanism 3: an earlier cut-off time for non-euro area TARGET participants (NCBs and credit institutions). In this case, the earlier cut-off time would not apply to the processing of payments by non-euro area NCBs, but rather to their use of intraday credit in euro.

The decision on these issues will be taken by the Governing Council of the ECB.

7 *An updated version of the technical annexes originally published in August 1996 (Interlinking specifications, a data dictionary and details of the minimum common performance features of RTGS systems within TARGET) and a further technical annex concerning end-of-day procedures were made available to interested parties.*

8 *See the EMI's report entitled "The single monetary policy in Stage Three - Specification of the operational framework", which was published in January 1997.*

9 *The early cut-off time for customer payments applies to all three mechanisms.*

The ECB will be connected to TARGET via its own payment mechanism (the ECB payment mechanism, or EPM), through which it will perform the following functions:

- maintain accounts on behalf of its institutional customers (excluding credit institutions);
- process payments for itself and its customers;
- provide settlement services to cross-border large-value net settlement systems.

Moreover, the ECB will provide end-of-day procedures and possibly other control measures for the TARGET system.

According to the schedule for TARGET testing and implementation, before being permitted to migrate (in late 1998) with their Interlinking/RTGS components towards TARGET production, the NCBs and the EMI/ECB have to complete the following three sets of tests: (i) static and dynamic tests, (ii) multilateral tests, and (iii) simulation tests. All NCBs had started static testing by April 1998. Fourteen RTGS systems have already completed the static tests, twelve the dynamic tests, and four have also completed the multilateral tests.

A brochure providing a general description of the TARGET system was published in May 1998.

4.2 Securities settlement systems

In 1997 preparatory work focused on two main aspects: the establishment of standards for the use of securities settlement systems (SSSs) in ESCB credit operations and the implementation of short-term solutions for the cross-border use of collateral.

Standards for using SSSs in ESCB credit operations

The EMI and the EU NCBs have analysed the settlement procedures for those assets which will be eligible for collateralising the monetary policy and payment systems operations of the ESCB. In particular, ESCB credit operations will have to be conducted according to procedures which: (i) prevent the NCBs from bearing inappropriate risk in conducting monetary policy operations; and (ii) ensure the same level of safety for all NCBs' operations settled throughout the European Union. Within this framework, the EMI has outlined nine basic standards against which the soundness of those SSSs to be used for the settlement of ESCB monetary policy and intraday credit operations will be assessed.

The standards and the underlying analysis are described in the EMI's report entitled "Standards for the use of Securities Settlement Systems in ESCB credit operations", which was released on 8 January 1998. These standards cover three main areas: legal issues, settlement and custody risks, and operational issues.

The first standard states that all SSSs and the links between them should have a sound legal basis, which will ensure that both the settlement of payments and the transfer of securities are final and that the rights of the ECB and the NCBs in respect of securities transferred or held within such systems for their account are adequately protected. The second standard aims to ensure that the cash leg of the settlement is conducted in central bank money. Standard 3 focuses on the security of collateral held in custody and states that SSSs should have adequate safeguards to protect NCBs against custodial risk, for instance when third-party depositories are used.

Standards 4 to 6 require that: (i) all SSSs be subject to regulation and/or control by a competent authority; (ii) participants be aware of the risks of and access conditions for using the systems; and (iii) proper risk management procedures be implemented in order to cope with the effects of the default of one or more participants.

Standard 7 concerns intraday settlement with finality, which must be possible from the start of Stage Three of EMU. As a first step, SSSs must ensure intraday finality for the settlement of ESCB credit operations. This could be achieved by means of various operational mechanisms, such as: 1) RTGS systems for securities transactions; 2) net securities settlement systems with several processing cycles during the day; 3) the pre-depositing of securities (including pre-pledging) on operational safe custody accounts held with an NCB; or 4) the free intraday delivery of securities. The choice between the four options will be left to the NCBs on the basis of the existing infrastructures at the domestic level. As a longer-term objective, it is envisaged that all SSSs will have to enable the ESCB to settle its credit operations by means of real-time delivery versus payment settlement facilities.

Standard 8 recommends operating hours and days consistent with those of the TARGET system.

Finally, Standard 9 requires the technical systems to have an adequate level of operational reliability and adequate backup facilities to be provided.

All the standards presented in the report must be met by SSSs by 1 January 1999, with the exception of the requirement for real-time delivery versus payment settlement facilities (Standard 7), which should be implemented by 1 January 2002.

On the basis of the results of the assessment, in September 1998 the ECB will publish a list of the SSSs to be used for ESCB credit operations.

Mechanisms for the cross-border use of collateral in Stage Three of EMU

In July 1997 the EMI Council decided to adopt the correspondent central banking model (CCBM) as an interim solution before the establishment of appropriate links between SSSs in order to facilitate the cross-border use of collateral in ESCB operations (monetary policy and intraday credit operations). With the CCBM, liquidity is provided by the home central bank, based on collateral held on securities accounts abroad.

The basic principle of the CCBM is that each NCB will act as a correspondent (for the delivery of securities) at the request of any other NCB. Each NCB will therefore need to open an account for the administration of securities for every other NCB. Thus, when an ESCB counterparty (in country A) wishes to obtain credit, it will approach its home NCB (NCB A), request the credit and offer collateral. In the event that the collateral is held in another country (country B), the counterparty will arrange for the collateral to be delivered (this step may involve a custodian) or otherwise transferred to a specified securities account with the NCB of country B (NCB B). NCB A will request that NCB B inform it upon delivery of the collateral and, once confirmation of the final, irrevocable delivery of the collateral has been received by NCB A, the latter will release the credit to the counterparty.

5 Preparation of euro banknotes

In the course of 1997 final designs were developed from the draft designs for the euro banknotes which were chosen by the EMI Council in December 1996 (see the EMI's Annual Report 1996, Chapter II, Section 5). Illustrations of the revised designs were published in July 1997. These form the basis for the origination work, in the context of which the designs are being transformed into printing plates in the first half of 1998. The selected draft designs were amended in order to meet a range of different requirements. First, the architectural features (gateways, windows and bridges) were reviewed so as to make sure that they would be representative of the relevant period, while at the same time not representing any specific structure. In addition, the design of the European map on the reverse side of the banknotes was checked and adjusted in order to give an appropriate representation of the European continent. Second, a range of security features, some intended for the benefit of the general public and others to be used for authentication purposes in banknote sorting and accepting machines, were integrated into the designs. Moreover, tests were conducted to ensure that it would be possible for the designs to be produced successfully, i.e. in particular with the same visual appearance, by the specific equipment of the different EU printing works. The technical specifications were finalised in accordance with the decision by the EMI Council that all the printing works which currently print banknotes issued by the central banks of the Member States participating in the euro area should be involved in the production of the euro banknotes.

In 1997, in order to identify potential problems at the earliest possible stage, all the techniques which will be used for euro banknote production were tested as part of a project to produce a test banknote. Ten printing works and eight paper mills participated in the production of a prototype euro banknote which included almost all the security features. The test banknote project revealed that all the participating printing works should be in a position to produce all the euro banknote denominations to an equal standard of quality and with an identical appearance. A zero-production run based on the latest, modified euro banknote designs will be conducted in autumn 1998 before mass production starts in early 1999.

The quantity of euro banknotes to be printed before the launch date of 1 January 2002 will be determined by two factors: first, the quantity of banknotes required to replace the stocks of national banknotes in circulation (launch stocks) in the participating countries and, second, the logistical stocks which will be necessary to ensure that the banknote changeover process operates smoothly. On the basis of current estimates, a total of more than 12 billion banknotes will be required for the EU Member States which will participate in the euro area from the start. Estimates will be updated annually.

The EMI is also undertaking preparatory work in respect of the legal protection to be given to the euro banknotes. The EMI Council has already agreed that, with regard to copyright protection, the © symbol should appear on the euro banknotes. Further aspects which are still under consideration in this connection are, inter alia, the need for harmonised rules regarding the reproduction of euro banknotes; euro area harmonised rules for the exchange of damaged banknotes; and ways in which to prevent and penalise the counterfeiting of euro banknotes.

With a view to increasing efficiency in combating counterfeiting, the EMI Council has agreed to set up a joint investigation centre and a database in which all technical data on counterfeit euro banknotes will be stored.

The date for the launch of the euro banknotes and coins has been set at 1 January 2002 (see Section 10 on the changeover for more details). Preliminary discussions with European federations and associations on the optimal length and technical features of the period of dual circulation took place in all countries (except Denmark) as well as at the EMI. Finance Ministries, Mints, NCBs, representative consumer and retailer organisations and commercial banks were all involved in the discussions at the national level.

There is a broad preference for a fairly rapid cash changeover, i.e. shorter than the period of up to six months for which provision was made in the changeover scenario adopted by the European Council in Madrid in December 1995. The precise length of and conditions for the cash changeover within the overall time frame remain a matter for decision by the Member States. The ECB will continue to provide a forum for the exchange of views, in particular among NCBs, on how to prepare the logistics for the cash changeover at the national level. The storage of euro banknotes and coins prior to the launch date will be an essential element to be considered in this connection. Other important aspects relate to the physical exchange of national currency for the euro banknotes and coins, the preparation of automated teller machines (ATMs) and vending machines, and the distribution to the public of euro banknotes and coins via retailers.

The EMI also continued its preparatory work for the first three years of Stage Three, during which only national banknotes and coins will circulate. Article 52 of the ESCB/ECB Statute provides that: "Following the irrevocable fixing of exchange rates, the Governing Council shall take the necessary measures to ensure that banknotes denominated in currencies with irrevocably fixed exchange rates are exchanged by the national central banks at their respective par values." Against this background a basic agreement was reached on the mechanisms for exchanging and repatriating national banknotes between 1999 and 2002. This agreement commits a majority of the NCBs of the Member States participating in the euro area to implementing the following three measures between 1999 and 2002:

- first, with regard to wholesale transactions, the NCBs party to the agreement will ensure that in at least one of their central bank offices non-national euro area banknotes will be either exchanged for national banknotes or credited to an account; these banknotes will be repatriated to their NCB of issue;

- second, with regard to retail transactions, the exchange of non-national euro area banknotes for national banknotes at the counters of the relevant NCBs will be free of charge for the general public;

- third, with regard to the repatriation of national banknotes to their NCB of issue, NCBs will provide a free of charge service for their repatriation, unless they already levy a service charge on commercial banks for the depositing of national banknotes at their counters.

Commercial banks and bureaux de change, although not bound by Article 52 of the Statute, will be obliged to apply the fixed conversion rates when exchanging the national banknotes of the countries participating in the euro area in accordance with the Council Regulation on the introduction of the euro (which was adopted on 3 May 1998). Commercial banks and bureaux de change will also be obliged to display the level of any handling charge in a clear and transparent manner as highlighted in the Commission Recommendation concerning banking charges for conversion to the euro, dated 15 April 1998.

6 Accounting issues

The preparatory work on the accounting framework to be used for the ESCB was largely completed in 1997. This framework will form the basis for the internal and external reporting of the ESCB and serve to ensure that liquidity management and statistical requirements are met. The basic principles, which were approved by the EMI Council in 1996, were expanded through the development of specific techniques for the various assets and liabilities that will feature in the ESCB.

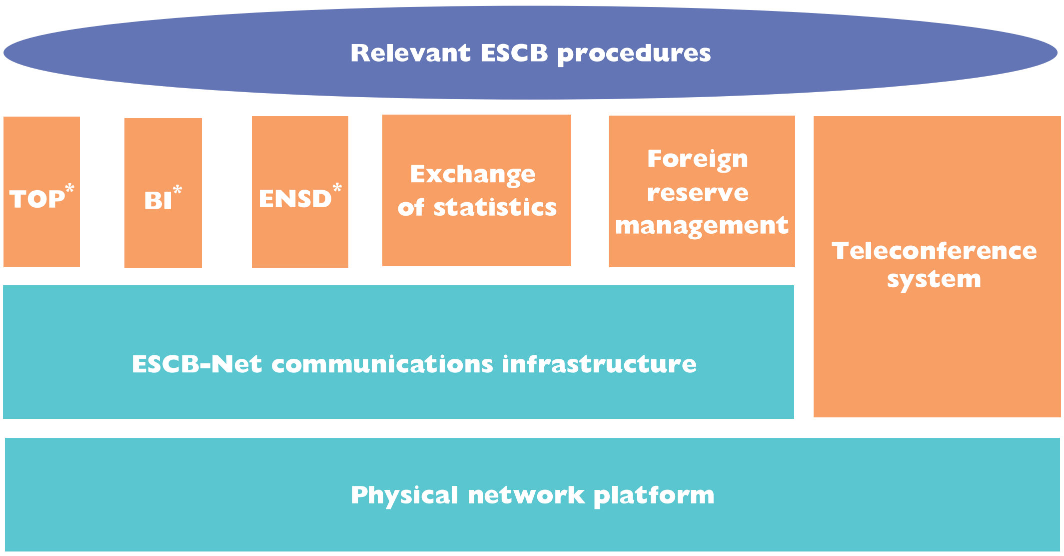
The transition to Stage Three was also examined and the necessary principles and techniques were developed. The main objective was to make a clear distinction between gains and losses (including unrealised ones) arising before the start of Stage Three from subsequent ESCB gains and losses. To this end an initial valuation of NCB (and ECB) assets and liabilities will be performed according to ESCB rules at the start of Stage Three. Any gains or losses arising from this exercise, together with any such items already on NCB accounts, will be treated according to national accounting arrangements in force at the end of Stage Two. Gains and losses arising from the irrevocable fixing of the bilateral exchange rates between the participating currencies will be treated as realised, as the related foreign exchange risk will cease to exist at the start of Stage Three; again, the treatment of these gains and losses will be subject to national rules.

Work is continuing on the method for allocating monetary income in order to prepare the decisions to be taken by the Governing Council of the ECB.

7 Information and communications systems

In 1997, in co-operation with the NCBs, the EMI was able to significantly step up its efforts to provide the information and communications systems support required for a number of operational and policy functions - to be conducted within the ESCB - which will involve the ECB and the NCBs.

Following the decision by the EMI Council in November 1996 on its technical design, the teleconference replacement project was successfully implemented in October 1997. The new teleconference system will enable several audio conferences to take place in parallel between the ECB and the NCBs. Five[10] non-EU central banks and the European Commission are also connected to the system. The teleconference system provides a secure means of communication, in particular for governors and monetary policy, foreign exchange market and payment systems experts to discuss urgent matters. In addition to the teleconference application itself, the implemented solution comprises an underlying physical infrastructure that will serve as the main network platform for the data transfers needed for the majority of ESCB-wide information systems applications:



* *The TOP system will be used to conduct monetary policy open market tender operations; the BI system will be used to monitor the ESCB's bilateral interventions; and the ENSD system will be used for the exchange of data for non-statistical purposes.*

In May 1997, following an EU-wide procurement tender process, the EMI Council approved the conclusion of a contract for the supply and maintenance of an ESCB-wide communications infrastructure. This will provide secure end-to-end file transfer and robust messaging services, using international and de facto industry standard protocols and applications. This infrastructure, known as the ESCB-Net, offers synchronous (real-time) and asynchronous communications services between all the ESCB institutions. With the exception of the Interlinking of the RTGS

[10] *Norges Bank, the Schweizerische Nationalbank, the Bank of Japan, the Bank of Canada and the Federal Reserve Bank of New York.*

systems which form the TARGET system, all projects in preparation for Stage Three of EMU and requiring new ESCB-wide exchanges of information will make use of the ESCB-Net. The ESCB-Net was fully implemented and tested by May 1998.

During the course of 1997 significant progress was made in the development of several ESCB-wide software applications. These applications will support the conduct of monetary policy operations, foreign exchange market interventions and the management of the ECB's foreign reserve assets. These include, in particular: (1) the TOP application, a system necessary for the ESCB to conduct decentralised monetary policy open market operations based on tender procedures; (2) the BI application, a system for the monitoring of decentralised monetary policy operations and bilateral foreign exchange interventions; (3) the ENSD application, a system providing information systems support for the exchange of data within the ESCB for non-statistical purposes; (4) the information systems support for the ESCB's statistical functions, providing the background data exchange necessary for the preparation of the ECB's policy decisions; and (5) the information systems support necessary for the decentralised management of the ESCB's foreign reserve assets. All these applications will be implemented by mid-1998. The second half of 1998 will be devoted to undertaking the testing of all the systems and procedures between the ECB and the NCBs, both automated and clerical, required to ensure the successful operation of the ESCB.

Furthermore, the EMI and the NCBs continued the preparatory work for the TARGET system. In order to minimise the risk of problems occurring at the start of live operation of the new payment system linking the domestic real-time gross settlement systems of the fifteen Member States and the ECB payment mechanism, an Interlinking test environment has been established. In the second half of 1997 static and dynamic tests were started which involved a number of NCBs and the EMI. Further tests will be conducted throughout 1998.

In order to guarantee and maintain an adequate and co-ordinated level of security of the information systems to be used by the ESCB, the EMI Council approved a framework for a security policy for the information systems of the ESCB. This framework establishes agreed responsibilities for all parties involved in the development, implementation and use of information systems. The information systems security policy defines common principles, roles and responsibilities related to the management and planning of the security of information and communications systems in co-operation between the EMI and the NCBs.

During the course of 1997 the EMI set up a large number of internal projects with the aim of selecting and implementing appropriate technology and systems to provide the information systems support necessary for the ECB to conduct its operations successfully. These projects range from improved office automation systems and internal administrative systems to new or improved statistical and decision support systems.

8 Banking supervision and financial stability

In Stage Three of EMU prudential supervision will remain a competence of the national authorities (either the NCB, or a non-central bank body or, in some cases, both together). In addition, the basic features of the prudential supervisory framework within the European Union - based on the harmonisation of the main national legislative provisions, the principle of "home country control" and cross-border co-operation among supervisors - will not be modified. Nevertheless, besides the advisory function of the ECB under Article 105 (4) of the Treaty (which is addressed in the last paragraph of this section), the Treaty and the ESCB/ECB Statute assign to the ESCB/ECB some functions related to the prudential supervision of credit institutions and the stability of the financial system which are explicitly referred to in the following:

- Article 105 (5) of the Treaty, which stipulates that the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system;

- Article 25 (1) of the ESCB/ECB Statute, which states that the ECB may offer advice to and be consulted by the Council, the Commission and national authorities on the scope and implementation of Community legislation relating to the prudential supervision of credit institutions and the stability of the financial system;

- Article 105 (6) of the Treaty, which envisages the possibility of assigning to the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions (with the exception of insurance undertakings).

In general terms, the inclusion of the above provisions in the Treaty and Statute was justified on three grounds. First, the ESCB, in the context of its macroeconomic activity, will oversee developments in financial markets and institutions and, therefore, will have at its disposal information which could be useful for the supervisory function. Second, the pursuit of the primary objective of the ESCB (price stability) will need to be supported by the stability of the banking and financial system, which is a major objective of supervisory authorities, along with the protection of depositors and investors. Third, there is a relationship between the measures taken for monetary policy purposes and those intended to promote the stability of the banking and financial systems. The EMI has analysed the possible implementation of these provisions with the assistance of the Banking Supervisory Sub-Committee.

Article 105 (5) of the Treaty, which applies only to those Member States adopting the euro, contemplates an obligation for the ESCB to contribute to the smooth conduct of policies pursued by the national authorities responsible for the prudential supervision of credit institutions and financial stability. Given the close links existing at the national level between the monetary policy and the prudential supervisory functions, as well as the assignment of responsibility for monetary policy to the ESCB, the main objective of the provision laid down in Article 105 (5) of the Treaty may be regarded as being to ensure effective interaction between the ESCB and the national supervisory authorities. The practical details of the way in which this relationship will be conducted will need to be defined in a pragmatic manner in the light of the specific needs emerging in Stage Three. At present, two main contributions on the part of the ESCB to national supervisory authorities can be identified.

First, the ESCB, and in particular the ECB, will play an active role in promoting co-operation among the EU national supervisory authorities, irrespective of the organisational model adopted in each country, as well as between the national authorities and the ESCB, with a view to achieving a common understanding on relevant supervisory policy issues. It is envisaged that such co-operation will rely on the assistance of a specific committee composed of representatives of NCBs and national supervisory authorities and that it will focus mainly on issues of a macro-prudential nature with a bearing on the stability of financial institutions and markets. Regardless of the fact that Article 105 (5) of the Treaty will apply only to those countries participating in the euro area, it is envisaged that co-operation will generally involve all EU supervisory authorities. This ESCB function is expected to supplement the framework for multilateral co-operation within the EU in the field of banking supervision and to interact smoothly with the co-operation pursued within the other banking supervisory forums (the Banking Advisory Committee and the Groupe de Contact at the EU level and the Basle Committee on Banking Supervision at the G-10 level).

Second, in the light of the relevant provisions of the BCCI Directive concerning the flow of information between NCBs and supervisory authorities, where appropriate, the ESCB will provide supervisory authorities with information on individual institutions and markets obtained as a result of its basic activities which could be helpful to the supervisory function. Conversely, banking supervisors will be prepared to provide the ESCB with supervisory information on individual institutions which could be of use to the ESCB in the performance of its basic tasks. A common understanding has been reached among banking supervisors on the basic features of the flow of information to the ECB and to NCBs in their capacity as monetary authorities. In general, although the ESCB should not need supervisory information for the purpose of its monetary and foreign exchange policy operations as a rule, banking supervisors will be prepared to consider requests from the ESCB in this area. In addition, in view of the possible systemic implications, banking supervisors will be prepared to inform the ESCB on a case-by-case basis should a banking crisis arise. Furthermore, banking supervisors will collaborate with NCBs and the ECB in order to detect non-compliance by any of the ESCB's counterparties with their obligations as laid down in the ESCB's rules on monetary policy instruments and procedures, although ultimate responsibility for ensuring compliance will remain with the competent NCB. With regard to the flow of information from banking supervisors to NCBs acting as the overseers of payment systems, a basic agreement had already been reached.

Article 25 (1) of the ESCB/ECB Statute - which applies to all EU countries - provides for a specific advisory function for the ECB in the field of Community legislation relating to the prudential supervision of credit institutions and the stability of the financial system. This function will be optional in nature and refers to the scope and implementation of Community legislation in the above-mentioned fields. This function may be regarded as an instrument by means of which the ECB would be able to contribute to the prudential supervision of credit institutions and financial stability at the Community and national levels. In this respect, the role played by the European Commission, with the assistance of the Banking Advisory Committee, in preparing new proposals for directives in the sphere of banking legislation is clearly acknowledged.

Article 105 (6) of the Treaty - which applies to all EU countries - covers the possibility of certain operational tasks in the field of prudential supervision being conferred upon the ECB. The right of initiative in this area lies with the Commission and the ECB is only involved in an advisory capacity. At this stage it is felt that it would be premature to envisage any transfer of supervisory powers from national authorities to the ECB.

Finally, Article 105 (4) of the Treaty (which applies to all EU countries with the exception of the United Kingdom) stipulates that the ECB must be consulted on draft Community and national legislative provisions falling within its fields of competence. The precise scope of this provision will be identified in the context of the Council Decision to be adopted by the EU Council, laying down the limits and conditions under which the ECB is to be consulted by the competent authorities on draft national legislation in accordance with the said article. According to the draft Council Decision proposed by the European Commission in February 1998, the ECB should be consulted on, inter alia, rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets.

9 Legal issues

9.1 Legal convergence

Member States are obliged, in accordance with Article 108 of the Treaty, to eliminate incompatibilities between their national legislation, on the one hand, and the Treaty and the ESCB/ECB Statute, on the other. In October 1997 the EMI published a report on "Legal Convergence in the Member States of the European Union as at August 1997" and in March 1998 it published its Convergence Report prepared as required under Article 109j (1) of the Treaty. Both reports distinguished between the statutes of NCBs and other legislation which needed to be adapted in the light of the relevant Treaty and ESCB/ECB Statute provisions. With regard to the statutes of NCBs, a distinction was made between adaptations in the area of central bank independence and other adaptations to ensure the necessary degree of integration of NCBs in the ESCB.

On the basis of features of central bank independence which had already been elaborated in previous reports on the independence of NCBs, in its October 1997 Report the EMI identified certain provisions in the statutes of NCBs which it considered to be incompatible with Treaty and ESCB/ECB Statute requirements on central bank independence and which, in its view, should therefore be adapted. Most of the provisions related to the institutional independence of an NCB (the prohibition of external influence, as laid down in Article 107 of the Treaty) and the personal independence of members of an NCB's decision-making bodies involved in the performance of ESCB-related tasks (security of tenure, as laid down in Article 14.2 of the ESCB/ECB Statute). Adaptations in the area of the independence of NCBs must come into effect at the latest at the date of the establishment of the ECB.

Furthermore, the EMI pointed out the need for the statutes of NCBs to be adapted in order to ensure the necessary degree of integration of NCBs in the ESCB, in accordance with Article 14.3 of the ESCB/ECB Statute. That Article states that NCBs will become an integral part of the ESCB and are required to comply with the ECB's guidelines and instructions.[11] This implies, in particular, that the statutes of NCBs should not contain any provisions which are not in line with the exclusive competence of the ECB in certain areas or which, if adhered to by an NCB, would prevent that NCB from complying with the rules adopted at the level of the ECB. Areas to which particular attention was paid were: statutory objectives, tasks, instruments, organisation and financial provisions (topics which correspond to the usual structure of the statutes of NCBs). Adaptations of the statutes of NCBs in this respect must come into effect at the start of Stage Three or, for Member States with a derogation or a special status, at the date on which they adopt the single currency.

In its October 1997 Report the EMI paid particular attention to completed or envisaged adaptations with extensive reference to its opinions on such adaptations which were delivered as part of consultation procedures under Article 109f (6) of the Treaty and Article 5.3 of the Statute of the EMI.

As far as the adaptation of legislation other than the statutes of NCBs was concerned, the EMI focused in particular on those laws with an impact on the performance by an NCB of its ESCB-related tasks and laws in

[11] *In conjunction with Article 43.1 of the Statute, Article 14.3 implies that fully participating NCBs will become an integral part of the ESCB and that they will have to comply with guidelines and instructions issued by the ECB.*

the monetary field, such as foreign exchange acts and coinage acts.

In its Convergence Report of March 1998, inter alia, the EMI assessed the compatibility of national legislation, including the statutes of NCBs, with Treaty and ESCB/ECB Statute requirements for Stage Three. An excerpt from the Introduction and summary part of the 1998 Convergence Report is incorporated as an Annex to this Report.

9.2 Secondary Community legislation

The EMI informally consulted the Monetary Committee on the following three draft ECB Recommendations for Council Regulations, which are to be adopted by the Governing Council of the ECB under Article 42 of the ESCB/ECB Statute: a draft ECB Recommendation for a Council Regulation (EC) concerning the collection of statistical information by the ECB (see Section 3.3), a draft ECB Recommendation for a Council Regulation (EC) concerning the application of minimum reserves by the ECB (see Section 1.2) and a draft ECB Recommendation for a Council Regulation (EC) concerning the power of the ECB to impose sanctions. The latter Recommendation specifies the limits and conditions under which the ECB will be entitled to impose fines or periodic penalty payments on undertakings as a result of their failure to comply with obligations laid down in its Regulations and Decisions.

In addition, the EMI contributed to the preparation of other secondary Community legislation relating to the transition from the EMI to the ECB in the following areas: the consultation of the ECB by national authorities on draft legislative provisions falling within the competence of the ECB; the statistical data to be used for the determination of the key for subscription of the capital of the ECB; the conditions and procedure for applying the tax for the benefit of the European Communities; and the categories of officials and other servants of the European Communities to whom the provisions of Article 12, the second paragraph of Article 13 and Article 14 of the Protocol on the Privileges and Immunities of the Communities apply (see also Chapter III, Section 5 below).

10 Changeover to the euro

During 1997 preparatory work for the changeover to the single currency gathered considerable speed. In all EU Member States with the exception of Denmark[12] ad hoc co-ordination bodies were created, detailed changeover scenarios outlined, co-ordination between institutions and interested parties organised, and an appropriate legal framework to complement the relevant Community legislation prepared. The EMI continued to keep track of developments as regards the changeover, in order to assess whether differing changeover preparations across Member States, owing to differences in the local organisational and infrastructural environments, might have implications for the single monetary policy to be conducted as from January 1999 onwards.

In the financial area, changeover preparations continue to be fuelled by a competitively driven process involving market operators and financial centres, both within and across countries. The EMI and the NCBs conducted a continuous dialogue with their respective banking communities and other financial market operators on issues concerning the introduction of the euro. The guiding principle applied by the monetary authorities is to leave responsibility for co-ordinated action in relation to the changeover primarily with the market operators themselves, while being prepared to lend assistance where necessary. The EMI and the NCBs have thus encouraged market operators to consider market-driven standardisation within Monetary Union.

In meetings between the EMI and representatives of EU-wide banking and financial associations the following issues, inter alia, have been considered:

- the replacement in contracts of *price references* that may lose their economic significance after the start of Monetary Union. The publication of national base rates by NCBs, at which central bank transactions are no longer effected, will cease from the start of Stage Three. National legislators may enact binding rules to replace obsolete base rates with new reference rates (preferably from among those to be published by the ESCB), should this be deemed appropriate;

- the replacement of *existing interbank rates* (e.g. BIBOR, FIBOR, HELIBOR, MIBOR, PIBOR, RIBOR, etc.) with new definitions of euro area-wide published indicator rates. While the publication of these local rates on a euro area-wide basis cannot be legally prohibited, the EMI and the NCBs have encouraged banking associations and money and foreign exchange markets operating in the future euro area to engage in the collective definition of euro area-wide indicators. In response to this policy message, in 1997 the Banking Federation of the European Union and the professional association of foreign exchange market dealers (known as ACI - The Financial Markets Association) announced its intention to compute and publish a euro area-wide indicator of interbank rates, which is to be known as the EURIBOR.[13]

The EMI also provided assistance in the establishment of common market standards in the euro area-wide money markets and foreign exchange markets. The EMI's publications on the operational framework for the single monetary policy provided

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[12] *In Denmark work has been carried out in order to prepare for the situation of Denmark as a Member State with a derogation.*

[13] *The British Bankers' Association has announced its plans to publish a euro LIBOR.*

interested market operators with information on the money market and foreign exchange market procedures to be followed by the ESCB. This information has become a natural focal point for the adaptation of national standards and the elaboration of new common standards at the European level.

Furthermore, the EMI offered further clarification to the markets concerning the following:

- the methods for quoting the euro on foreign exchange markets;
- the publication by the ECB of reference exchange rates;
- the calendar of business days for the conduct of monetary policy and the operation of TARGET.

In this connection the EU-wide banking and financial associations submitted to the EMI a "Joint statement on market conventions for the euro", which lists the market standards that will apply to trading and settlement on the euro money, bond and foreign exchange markets. The joint statement points out that the harmonisation of euro market conventions is desirable, as it would promote liquidity and transparency in the new markets and prevent confusion and disputes involving euro trading and settlement. The EMI Council welcomed and supported this initiative, observing that the implementation of such conventions would enhance the integration of, and ensure greater transparency in, the euro financial markets.

The EMI also assisted the EU-wide banking and financial associations in the establishment of an effective overnight rate for the euro area, known as the EONIA (euro overnight index average). Market participants noted that private calculation of an effective overnight rate would be problematic owing to the sensitivity of the information that would need to be supplied by individual banks for the computation of such a rate. Against this background, the EMI Council decided to prepare for the computation of such a rate by the ESCB. Accordingly, the ESCB will take on the computational aspects related to the reference rate, relying on the panel and methodology provided by the banking associations for the EURIBOR. Responsibility for publishing the reference rate will lie with the banking associations. Discussions are under way between the EMI and the relevant associations so as to arrive at a collectively agreed procedure.

The EMI recognised the need for a distinctive codified symbol for the single currency and expressed its support for the symbol E, proposed by the European Commission, as the logo for the euro. A symbol to identify the euro accords with the current use of abbreviations in written language. It also provides a distinctive sign for use in price lists and other documents including monetary values which may be of particular help during the transition phase. The EMI encourages the inclusion of the E symbol in the standard character sets which are widely used in the information technology industry.

A special section on changeover issues has been included as part of the information provided on the EMI's Web site (http://www.ecb.int). With a view to assisting all those involved in preparing for the changeover, the EMI has improved the distribution of relevant information. Apart from the documents on changeover issues approved by the EMI Council in 1997, the Web site also includes a bibliography and a list of more than 200 links to other Web pages which specifically offer information on the changeover to the single currency. The links are divided into eleven categories: central banks; EU institutions; national governments; associations of the banking and financial industry; credit institutions; stock exchanges, securities settlement systems and payment systems; associations of enterprises, commerce and services; business consultancy firms; information technology issues; newspapers, newsletters, magazines and bibliographies; and others. For each link, a summary is given of the information available on the relevant page. This information is updated on a regular basis and thus provides a convenient data source for all those involved in preparing for the changeover.

In response to mounting public demand for further confirmation of the details of the changeover to support preparatory work, the EMI Council and the EU Council decided on 4 November 1997, for banknotes and coins, that euro fiduciary money would be put into circulation in all participating countries as from 1 January 2002 onwards. This decision was taken after careful consideration of all possible options, including the possibility of having different introduction dates in the various participating countries. An extensive round of consultations took place, both at the national and at the EU-wide level, involving all interested parties.

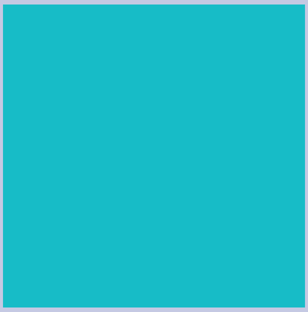
11 Public information

Since its establishment on 1 January 1994 the EMI has been working intensively to prepare the regulatory, organisational and logistical framework necessary for the ESCB to perform its tasks in Stage Three of EMU. As part of this process, the EMI has fulfilled its reporting obligations in accordance with Articles 7 and 11.3 of the EMI Statute by publishing reports on the state of the preparations for Stage Three of EMU, on its own activities and on monetary and financial conditions in the Community. In addition, in recognition of the needs of the financial community and of the general public, the EMI has over the past three years released a number of publications on its preparatory work with a view to both reporting on its activities and offering readers guidance in planning their own preparations. These publications have ranged from general information material on the EMI's role and functions and on the draft designs for the euro banknotes, to more technical reports dealing with monetary policy, statistics, payment systems and various aspects of the changeover to the single currency.

A list of all the documents published by the EMI since the beginning of 1997 appears at the end of this Report. A similar list has appeared in each of the EMI's previous Annual Reports.

In addition to producing its publications, in January 1998 the EMI established a presence on the Internet's World Wide Web in order to facilitate the EMI's provision of information to the general public. The EMI's Web site (http://www.ecb.int) provides access to the texts of recent speeches and reports published by the EMI, and includes a special section on changeover issues.

The EMI recognises that there is a need for the ESCB to ensure the transparency of its objectives and policies in Stage Three and to foster knowledge of its operations and tasks, thus enabling the financial community and the general public to both understand and support its policies. To this end, the EMI is developing an external communication policy - to be presented for consideration by the Governing Council of the ECB - on the most effective ways in which to disseminate information concerning the activities of the ESCB.



Chapter III

Other tasks of the EMI

1 Oversight of the ECU Clearing and Settlement System

The ECU Clearing and Settlement System falls under the oversight of the EMI by virtue of Article 109f (2), sixth indent, of the Treaty. The oversight of the ECU Clearing and Settlement System has the fundamental objective of seeking to ensure that the Euro Banking Association (EBA), which manages the system and which superseded the ECU Banking Association on 3 December 1997, takes the necessary measures to ensure that the system does not pose unacceptable risks either to participants in the system or to the ECU or domestic markets in the EU. Within this framework, the major line of action of the EMI is to ensure that adequate measures are taken to improve the system's compliance with the safety standards laid down in the 1990 G-10 Report on Interbank Netting Schemes (the so-called "Lamfalussy standards").

Moreover, during 1997 the EMI and the NCBs monitored the preparatory work conducted by the EBA on its Euro Clearing and Settlement System for Stage Three of EMU (EURO 1).

1.1 Activities of the ECU Clearing and Settlement System in 1997

In 1997 the number of transactions declined in comparison with 1996, while the value rose slightly. The monthly average number of daily transactions fell by over 6%, from 6,383 in 1996 to 5,982 in 1997. In comparison, the average daily turnover rose from ECU 46.0 billion in 1996 to ECU 46.9 billion in 1997.

The ECU Clearing and Settlement System (ECU 3) functioned quite smoothly during 1997, on average completing settlement earlier in the day than in 1996. Settlement delays occurred on only a handful of days, caused by either technical problems localised at only one or a few clearing banks or system incidents affecting the network used by the ECU Clearing and Settlement System. Two new software releases, which were implemented by S.W.I.F.T. in July and September 1997, have now brought the system back to the required service level, and no network incidents have been recorded since.

In 1997 some enhancements to the activation of the emergency liquidity facilities were introduced to ECU 3, i.e. the system providing for binding intraday limits. In addition, the clearing rules were amended to allow for the orderly completion of clearing should a clearing bank be unable to send its authenticated settlement message for purely technical reasons.

As part of their oversight functions the EMI and the NCBs studied a proposal put forward by the Exchange Clearing House Organisation (ECHO) - to net contracts denominated in ECU and to settle the relevant flows through the ECU Clearing and Settlement System - and no objection was raised to ECHO commencing operation in ECUs. In Stage Three ECHO is expected to settle its euro operations via TARGET.

1.2 Preparatory work for Stage Three of EMU

The EBA is in the process of defining the legal structure and the liquidity and loss-sharing arrangements for EURO 1. In addition, the EBA - in co-operation with the EMI and the NCBs - is finalising the settlement arrangements in accordance with an EMI Council decision. The latter states that the EBA will open a central settlement account at the ECB. It may also open other settlement accounts with those NCBs which agree to provide such accounts. To date, only the Banque de France has indicated its intention to open a local settlement account for the EBA (by June 1999).

Finally, an arrangement to secure the timely settlement of EURO 1 in the event of a participant failing to settle is being elaborated by the EBA. A cash collateral pool covering the largest net debit exposure possible in the system (E 1 billion) would serve this purpose. In accordance with an EMI Council decision, the ECB acts as the holder of the cash collateral pool for the EBA. In addition, liquidity and loss-sharing arrangements are being developed by the EBA to deal with multiple defaults.

Since EURO 1 will be based on the same technical infrastructure and intraday risk management features as the current ECU 3, the EMI - in co-operation with the NCBs - reviewed ECU 3 in order to assess its compliance with the Lamfalussy standards as a starting-point for an assessment of the compliance of EURO 1. Ongoing efforts being made by the EBA to improve ECU 3 with a view to meeting the Lamfalussy standards should therefore be seen as preparation for the introduction of a fully compliant EURO 1.

2 Electronic money

At present, electronic money is not a widespread phenomenon. However, the possibility that its development could be more pronounced in the long run cannot be ruled out. Since the publication of the "Report to the Council of the EMI on Prepaid Cards" in May 1994, not only has the number of multi-purpose prepaid card projects greatly increased, but the use of electronic money for payments via computer networks (so-called network money) has also started to develop.

In 1997 the EMI therefore carried out a further study on the impact on EU economies of the emergence of electronic money. It took particular account of new market developments and conducted a thorough analysis of their implications for monetary policy. The results of the study provided the basis for the "Opinion of the EMI Council on the issuance of electronic money" of 2 March 1998, which was transmitted to the Commission, the text of which is reproduced in Box 3 below.

Box 3

Opinion of the EMI Council on the issuance of electronic money[1]

1. At the present juncture, electronic money is not a widespread phenomenon. However, in the long run a more pronounced development of electronic money cannot be ruled out.

2. The issuance of electronic money is likely to have significant implications for monetary policy in the future. Therefore, EU central banks regard it as important to establish clear rules on the conditions under which electronic money can be issued.

3. In 1994 the EMI Council recommended that only credit institutions (according to national law) should be allowed to issue multi-purpose prepaid cards.[2] However, this recommendation was not implemented in all Member States. Against this background, the European Commission started in 1997 to work on a proposal for a European Parliament and Council Directive on the issuance of electronic money by non-credit institutions, in particular with the objective of granting the European passport to these institutions.

4. In the light of the developments over the past few years and further reflection on the matter, not least with respect to monetary policy effectiveness and considerations of level playing-field, and considering that funds collected for issuing electronic money are by nature redeemable, the EMI Council regards as essential that the following minimum requirements be fulfilled, regardless of the nature of the issuer of e-money:

   - the meaning of "electronic money" must be clearly defined and distinguished from "single-purpose" or "limited-purpose" prepaid cards;

   - issuers of electronic money must be subject to prudential supervision;

   - the issuance must be subject to solid and transparent legal arrangements, technical security, protection against criminal abuse, and statistics reporting;

   - a legal requirement must be imposed that electronic money is redeemable at par, implying that issuers must be in a position to convert electronic money into central bank money on request of the holder of the electronic money;[3]

- the possibility must exist for central banks to impose reserve requirements on all issuers of electronic money, in particular in order to be prepared for a substantial development of electronic money with a material impact on monetary policy.

- In addition, an insurance scheme for electronic money schemes could be envisaged as a way to protect the public.

5. Against this background, and in line with the 1994 recommendation of the EMI, the most straightforward solution would be to limit the issuance of electronic money to credit institutions, as this would avoid changing the existing institutional setting for monetary policy and banking business. More specifically, with a view to the transition to Monetary Union, the issuance of electronic money should be limited to "credit institutions as defined in Article 1 of the First Banking Co-ordination Directive" since Article 19.1 of the Statute of the ESCB, in its current wording, allows the ECB to impose reserve requirements only on these institutions in Stage Three of EMU.

6. At the same time, the EMI Council acknowledges that the definition of "credit institution" of the First Banking Co-ordination Directive requires an institution to "receive deposits or other repayable funds from the public and grant credit for its own account".[4] The EMI would see great merit in pursuing an amendment to the First Banking Co-ordination Directive's definition of "credit institution" to allow institutions which are not willing to enter into credit operations to issue electronic money. This would provide a level playing-field, in particular as it would ensure that all issuers of electronic money would be subject to an appropriate form of prudential supervision and fall under the range of institutions potentially subject to ECB reserve requirements.

7. Yet, as a transitional provision until the First Banking Co-ordination Directive is amended, the EMI Council would accept that those institutions already issuing electronic money, but which do not fall under the definition of credit institution in the First Banking Co-ordination Directive, could continue to provide domestic payment services provided they are subject to the regulations as defined in item 4 above, excluding, however, reserve requirements.[5]

8. Given the world-wide aspects of the issuance of electronic money, in particular network money, which carries the risk of delocation, the EMI stresses the need for international co-ordination in this field.

Notes:

1 *The opinion was adopted by a large majority of EMI Council members, with the exception of Denmark, Sweden, the United Kingdom and Luxembourg.*

2 *The EMI's 1994 "Report to the Council of the EMI on Prepaid cards" (p. 8) foresaw the possibility of allowing some non-fully fledged credit institutions to issue multi-purpose prepaid cards under specific conditions in exceptional circumstances (e.g. in the case of schemes already in operation before the policy conclusions of the report were drawn up).*

3 *The details of such a redeemability requirement have yet to be specified. (To avoid burdensome procedures, one may, for example, consider imposing a fee or a threshold on minimum amounts before redemption can be demanded by the holder of the electronic money instrument. In addition, logistical difficulties could possibly be overcome by allowing for redemption via bank deposits.)*

4 *The EMI Council also acknowledges the fact that national definitions of "credit institution" differ across Member States and that in some countries issuers of electronic money currently exist which do not fulfil the respective national definition of a credit institution.*

5 *As noted above, an exception was already foreseen in the EMI's 1994 report on prepaid cards. The exception was a permanent grandfathering clause for schemes which had already been established at that point in time. It would be necessary to examine whether such a permanent grandfathering clause could be maintained in a revised version of the First Banking Co-ordination Directive for such schemes, e.g. if their nature would make the application of the ensuing banking legislation less sensible.*

3 Co-operation in the field of banking supervision and financial stability

In accordance with Article 109f (2), fourth indent, of the Treaty, in 1997 the EMI held consultations on a number of issues falling within the competence of NCBs and affecting the stability of financial institutions and markets. The most important topics discussed were as follows.

3.1 Performance and stability of the EU banking systems in the medium and long term

A survey was conducted on a wide range of issues of potential relevance to the stability of the EU banking systems with a view to increasing the awareness of NCBs and banking supervisory authorities of both current trends in the EU banking systems and developments which are likely to occur in the medium and long term, both in general and in relation to the establishment of EMU. The main findings of the survey are summarised below.

Although some generalisation is inevitable, given that the situation may vary within and across countries, the main trends relating to the EU banking systems over the past few years can be identified as follows: (i) a decline in banks' profitability; (ii) a narrowing of interest rate margins; (iii) a rise in non-interest income; and (iv) a reduction in staff costs and the number of staff. Although profitability did indeed increase in 1995 and 1996 in a number of countries, this does not alter the basic trend given that it reflects to a large extent the favourable conditions prevailing in the capital markets. These trends can be regarded as the combined effect of several factors - financial liberalisation, disintermediation, internationalisation and technological change - all of which have emerged in recent years and which are expected to continue to shape the EU banking systems in the years to come.

Notwithstanding the difficulties associated with measuring banking capacity, there are a number of good reasons to assume that excess banking capacity exists in many EU countries, although it has been acknowledged that a reduction in this excess has taken place over the past few years. Information technology can be regarded as having been the main driving force behind recent changes in capacity in the EU banking systems, both at the retail and at the wholesale level. This factor is expected to continue to exert pressure leading to further reductions in excess banking capacity, especially in the retail sector, mainly through the development of both new distribution channels ("remote banking") and electronic money. This potential development can be expected to affect principally branch networks and staffing levels.

Over the past few years the phenomenon of banking disintermediation - which can be regarded as the movement of services and functions away from the banking system and towards other financial or non-financial intermediaries, economic agents or markets - has been very much in evidence. The EU banking systems, although still growing, have been losing their relative share of financial intermediation to institutional investors (investment funds, insurance companies and pension funds). Credit institutions have reacted by establishing their own financial services groups, either through direct equity participation in non-bank intermediaries or by means of agreements with them. Credit institutions have been able to play a major role in these financial groups, partly as a result of their central role in financial transaction services (money transmission, securities settlement and administration) and partly owing to their size and capital strength. The trend towards disintermediation is expected to continue in the future since institutional investors will continue to grow, mainly on account of demographic and social changes (such as the ageing of the population and the increasing number of wealthy individuals in the EU countries).

With regard to the degree of concentration, the survey showed that this varied from country to country and that the situation reflected both the size of national economies (with a tendency towards a higher level of concentration in the smaller countries and a lower level in the larger ones) and, possibly, different national strategies. It seems that the EU banking systems do not currently suffer from a lack of competition as a result of concentration and that such competition is particularly intense in international wholesale banking and syndicated lending. In the context of EU competition policy, it can be argued that disintermediation and the establishment of the Single Market and EMU may all be grounds for reconsidering the definition of relevant markets for the purpose of merger control. In particular, disintermediation may lead to a broader definition from a product perspective and the establishment of the Single Market and EMU may widen the geographical definition of the market. Looking to the future, it is anticipated that there may be room for large-scale cross-border mergers given the relatively low concentration at the EU level.

EMU is expected to reinforce trends already prevailing in the EU banking systems. EMU should increase competition and strengthen the need to restructure the EU banking systems, inter alia by means of a reduction in excess capacity. The ending of foreign exchange transactions between EMU currencies and of the related hedging activity will, of course, have a negative impact on the earnings of banks. In addition, EMU is expected to favour the development of deeper and more liquid securities markets, which in turn might trigger the further disintermediation of the banking systems. This process could be reinforced by the fact that institutional investors may benefit from the broader single currency area to which the existing currency matching rules will apply. In relation to EMU, credit institutions are also expected to reconsider and upgrade their strategies, procedures and technologies. A three-layer EU banking system is likely to emerge, in which: (i) the first layer would be composed of a large number of small, locally based institutions; (ii) the second layer would comprise EU regional players; and (iii) the third layer would consist of very large EU-wide banks which consider themselves to be global players. In general, the overall outlook in the medium term is that pressure on banks' profitability is likely to increase with the establishment of EMU. However, the actual impact of this pressure will vary from one credit institution to the next. Nonetheless, EMU is also expected to bring a number of advantages which could offset any negative effects overall. In particular, a more stable economic environment may stimulate bank lending and reduce the risk of defaults by having a positive impact on credit risk, although there will inevitably be regional variations in activity which could affect credit quality differentially. The TARGET system will make a significant contribution to the establishment of sound and efficient payment systems by reducing systemic and liquidity risks. Credit institutions should also benefit from deeper and more liquid capital markets as such a situation will reduce their risks and facilitate their risk management activities. In addition, it is likely that EMU will lead to further harmonisation of the legal and operational environment in which credit institutions operate.

The overall conclusion drawn from the survey findings is that the EU banking systems are already facing a period of major change in the form of increased competition, concentration and restructuring and that this process is expected to be further intensified by the establishment of EMU. Therefore, credit institutions are likely to face pressure to improve their profitability and will have to strengthen their respective competitive positions. For their part, supervisory authorities will have to step up their monitoring activities in order to be in a position to detect the weaker credit institutions and to ensure that they take steps to adapt to the increasing pressure. The findings of the survey have been made available to the international supervisory forums.

3.2 The use of macroeconomic data in the supervisory process

As a follow-up to the work on supervisory early warning systems carried out in 1996 (see the EMI's Annual Report 1996), an investigation was carried out on the possible use of macroeconomic data in the supervisory process and the links between macroeconomic developments and fragility in the banking systems both as a whole and at the level of individual institutions. The main objective of this exercise was to identify practical approaches which, through the use of macroeconomic data normally available to NCBs, could complement the analytical tools used by banking supervisors to monitor both the banking system and individual credit institutions. In more general terms, this initiative should be regarded as an attempt to continue improving the effectiveness of supervisory activities and the efficient use of resources, particularly given the costs involved in managing banking crises.

There are two ways in which macroeconomic data could be used in the supervisory process. The first is based on the conduct of so-called macro-prudential analysis, which focuses on the stability of the banking and financial systems as a whole. This form of analysis establishes relationships between macroeconomic variables (such as GDP, the indebtedness of households and enterprises, the structure of risks in the banking system, etc.) and aggregated data obtained from supervisory reporting. The conduct of this examination normally consists of an assessment of the current conditions in the banking system and its possible future development. Three main categories of macro-prudential analysis have been described, notably: (i) regular analysis to evaluate the conditions in the banking system on a systematic basis; (ii) development analysis to address structural aspects from a long-term perspective; and (iii) event analysis to study specific aspects which might have an impact on the stability of the banking system.

The second way in which macroeconomic data can be used in the supervisory process relates to the potential use of the findings of macro-prudential analysis in the process of detecting potentially fragile credit and financial institutions. In general terms, the systematic consideration by supervisors of the outcome of macro-prudential analysis should enable them to perform their monitoring activities more effectively. In particular, supervisors should enhance their ability: (i) to detect individual institutions which are under strain; (ii) to prioritise the various aspects of their monitoring activities; and (iii) to develop communication with the management of the institutions. Furthermore, it is clear that the findings of macro-prudential analysis might also be utilised in the context of the more sophisticated early warning systems adopted by some banking supervisors. The possibility of making direct use of macroeconomic data or variables in the supervisory early warning process will be further investigated.

Drawing on actual experience, which is for the time being confined to a limited number of countries, some organisational approaches have been explored to determine practical ways in which macro-prudential analysis could be conducted at the national level, with a view to promoting the more widespread performance of this activity. This work suggests that it would be useful to conduct macro-prudential analysis at the EU level. The findings of the analysis relating to the possible use of macroeconomic data in the supervisory process have been made available to the international supervisory forums.

3.3 Other issues

First, specific attention has been devoted to recent developments which have taken place in industry-wide practice for the provisioning for bad and doubtful loans. This was a follow-up to previous work conducted on the subject (see the EMI's Annual Report 1996) and focused on new approaches to provisioning which credit institutions have started to use and which are based on statistical methods. In particular, whereas traditional provisioning methods are based on an item-by-item evaluation and provisions are made on the basis of a reduction in the value of the assets when tangible signals are detected, the new methods use a statistical approach to estimate the expected credit losses and the corresponding loss provisions are posted as a liability (if the actual loss is greater than expected the difference is charged to the loss provision). The main impact of this approach is that it can smooth the effects of credit losses on credit institutions' profits over the economic cycle. The survey on the new approaches showed that, for the time being at least, they are not widely used by EU credit institutions. One reason for this is that EU accounting legislation requires that provisions be made by means of reducing the value of the assets on the basis of an item-by-item evaluation. Nonetheless, in some non-EU countries (Canada, Switzerland and the United States) the use of the new methodologies is or may become more common, not least because it is in some cases endorsed by the supervisory authorities. It is likely that the new approaches will be addressed within the relevant international supervisory forums in the context of discussions on prudential supervisory capital. The findings of the survey have been made available to the international supervisory forums.

Furthermore, the possible future development of the current EU prudential supervisory regime for credit institutions' liquidity and the possible impact of the establishment of EMU have been addressed. The prudential supervisory regime is based on the following two elements: (i) the prudential rules governing credit institutions' liquidity as laid down in the Member States are not harmonised; and (ii) responsibility for supervising the liquidity position of foreign branches set up in the EU remains with the host supervisor, in co-operation with the home supervisor, in accordance with Article 14 (2) of the Second Banking Co-ordination Directive. The current trend towards the centralised management of liquidity by credit institutions - which is expected to be reinforced by the introduction of the single currency - and the need to maintain a fully effective supervisory function have both been identified as possible factors which might necessitate the revision of the current regime and, in particular, a shift in responsibility for foreign branches' liquidity from the host to the home supervisor. The findings of this examination were brought to the attention of the European Commission, which is competent to assess, with the assistance of the Banking Advisory Committee, the need to amend current EU banking legislation. The issue will have to be reassessed in the light of experience gained following the introduction of the euro and the single monetary policy and their actual impact on the liquidity management of credit institutions.

Finally, in 1997 co-operation continued among the credit registers operating in seven EU countries (Belgium, Germany, Spain, France, Italy, Austria and Portugal) and managed by NCBs, the main purpose of which is to record information on the overall degree of indebtedness of borrowers with a view to assisting credit and financial institutions in managing their credit risk. The main objective of this co-operation remains the opening-up of the registers on a cross-border basis in order to grant access to the information stored in all the EU registers to reporting institutions established in the EU Member States. The achievement of this objective is deemed to be essential in order to maintain the effectiveness of the registers in an environment characterised by the further integration of the EU banking and financial markets, which is also expected to be reinforced by the establishment of EMU. At this stage, the opening-up of the registers is already possible in four cases, whereas there are still legal obstacles to the opening-up of the remaining three registers. The NCBs concerned remain committed to promoting the adoption of the legislative amendments and/or administrative measures necessary to lift these obstacles. Meanwhile, co-operation has focused on identifying the main features of the future exchange of information among the registers.

4 Administration of EMS mechanisms and Community loans

The EMI's operational tasks relate to the administration of the mechanisms of the European Monetary System (EMS) - the Very Short-Term Financing mechanism (VSTF), the Short-Term Monetary Support mechanism and 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.

4.1 EMS mechanisms

The EMI carries out operations associated with the creation, utilisation and remuneration of official ECUs. Official ECUs are issued to EU central banks against the contribution of 20% of their gross gold holdings and US dollar reserves through revolving swaps. Contributions are compulsory for the EU central banks participating in the ERM and voluntary for EU central banks not participating in the ERM. The swap operations are renewed every three months, which allows for the necessary adjustments to be made in order to: first, ensure that each EU 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 official ECU. The results of these operations are shown in the Annual Accounts towards the end of this Report.

Greece joined the ERM with effect from 16 March 1998, which entailed compulsory participation in the ECU swap mechanism from that date. Since the Bank of Greece had been participating in the mechanism on a voluntary basis since January 1986, ERM membership had no implications for the EMI's ECU swap operations.

The amount of official ECUs issued by the EMI under the latest three-month swap transaction, which took place on 12 January 1998, reached ECU 62.9 billion. Compared with January 1997, the stock of ECUs increased by ECU 2.7 billion. The increase was mainly due to: first, an appreciation of the US dollar against the ECU; and, second, an increase in the total volume of US dollar reserve contributions from the EU central banks participating in ECU swap operations with the EMI. The increase was partially offset by a fall in the gold price and a decrease in the total volume of gold contributions.

In addition to the creation of official ECUs, the EMI records in its books transfers of ECUs among the participating central banks and Other Holders. In 1997 no transfers took place between participating central banks. Transfers between participating central banks and Other Holders resulted in net ECU positions of ECU 63.5 million, unchanged from the situation in 1996. This balance reflects the acquisition of ECUs by the Swiss National Bank through swap operations with two EU central banks during the period under review. The ECU mobilisation mechanism has not been activated since 1986. No use was made of the VSTF in 1997, nor of the Short-Term Monetary Support mechanism. The latter has not been activated since 1974.

4.2 Community loans

In accordance with Article 109f (2) of the Treaty and Article 11 of Council Regulation (EEC) No. 1969/88 of 24 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 by 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 1997 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 the total of outstanding Community lending operations as at 31 December 1996 and 1997.

Table 7

Outstanding Community loans

(as at year-end in millions)

	Outstanding loans denominated in Deutsche Mark		Outstanding loans denominated in ECUs		Total outstanding loans expressed in ECUs	
	1996	1997	1996	1997	1996	1997
Greece	-	-	500	500	500	500
Italy	3,900	3,900	1,475	1,475	3,479	3,447
Total	3,900	3,900	1,975	1,975	3,979	3,947

Source: EMI.

5 Advisory functions

Article 109f (6) of the Treaty and Article 5.3 of the EMI Statute 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 22 November 1993. Article 1 of this Decision states that "Member States shall consult the EMI on any draft legislative provisions within its field of competence pursuant to Article 109f of the Treaty and in particular on:

- currency legislation, the status of the euro 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".

Fifty-two requests for the EMI's opinion were received in 1997 and the first quarter of 1998. Eleven requests concerned proposed Community legal acts and forty-one concerned national draft legislative provisions falling within the EMI's field of competence. The consultations concerning the adaptation of the statutes of NCBs to meet the requirements of the Treaty were particularly relevant. The table below summarises the consultation procedures in which the EMI delivered opinions in 1997 and the first quarter of 1998.

Table 8

Consultation procedures in 1997

No.	Originator	Subject
1	European Commission	Harmonised Index of Consumer Prices
2	Ireland	Investment intermediaries
3	Greece	Supervision of authorised foreign currency dealers
4	Belgium	Prevention of the use of the financial system for money laundering purposes
5	Belgium	Financial instruments and securities clearing systems
6	Finland	Netting in securities and foreign exchange transactions
7	Netherlands	Prudential supervision
8	Netherlands	Statute of De Nederlandsche Bank
9	EU Council	Excessive deficit procedure
10	Germany	Statute of the Deutsche Bundesbank
11	Netherlands	Abolition of the retroactive effect in payment systems and securities settlement systems
12	Netherlands	Legislation revoking the Act on the exchange rate of the guilder, as well as introducing EMU-related amendments in the Act of external financial relations and the Act of the supervision of security trade
13	EU Council	Denominations of and technical specifications for the euro coins
14	EU Council	Capital adequacy of investment firms and credit institutions
15	Greece	Statute of the Bank of Greece

16	Austria	Participation of Austria in the new IMF borrowing arrangement
17	Italy	Introduction of the euro
18	Portugal	Statute of the Banco de Portugal
19	EU Council	Short-term statistics
20	Ireland	Statute of the Central Bank of Ireland
21	Austria	Stock exchange
22	European Commission	Minimum standards for the quality of HICP weights
23	EU Council	Allocation of financial intermediation services indirectly measured within the European System of Integrated Economic Accounts (ESA)
24	Germany	Introduction of the euro
25	Spain	Statute of the Banco de España
26	Sweden	Statute of Sveriges Riksbank
27	United Kingdom	Statute of the Bank of England
28	United Kingdom	Definition of the Money Market Contract
29	Finland	Clearing and settlement of securities transfers
30	Austria	Statute of the Oesterreichische Nationalbank and related legislation
31	Italy	Statute of the Banca d'Italia and related legislation

Consultation procedures in the first quarter of 1998

No.	Originator	Subject
1	Austria	Introduction of the euro
2	Austria	Introduction of the euro
3	Italy	Codified law on finance
4	Belgium	Protective measures for deposits and financial instruments
5	Spain	Statute of the Banco de España
6	Finland	Statute of Suomen Pankki
7	Italy	Statute of the Banca d'Italia
8	Belgium	Introduction of the euro
9	France	Issuance and putting into circulation of money in the overseas territories of Mayotte and Saint Pierre and Miquelon, and protection of payment and securities settlement systems
10	Denmark	Margin collateral in connection with the clearing and settlement of securities transactions
11	Portugal	Introduction of the euro
12	France	Statute of the Banque de France
13	Italy	Statute of the Banca d'Italia
14	EU Council	Consultation of the ECB by national authorities on draft legislative provisions
15	EU Council	Statistical data to be used for the determination of the key for subscription of the capital of the ECB
16	EU Council	Conditions and procedure for applying the tax for the benefit of the European Communities
17	EU Council	Categories of officials and other servants of the European Communities to whom the provisions of Article 12, the second paragraph of Article 13 and Article 14 of the Protocol on the Privileges and Immunities of the Communities apply
18	Ireland	Introduction of the euro
19	Netherlands	Introduction of the euro
20	Ireland	Investor compensation schemes
21	Belgium	Statute of the National Bank of Belgium

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

6 Monitoring of compliance with the prohibition on monetary financing and on privileged access

In 1997 the EMI continued to monitor NCBs' fulfilment of their obligations under Articles 104 and 104a of the Treaty and Council Regulations (EC) Nos. 3603/93 and 3604/93.[14] The European Commission monitors Member States' compliance with these provisions.

In 1997 the EU NCBs continued to respect the Treaty requirements. Remaining imperfections which had appeared in the transition to the new arrangements, as well as technical problems which had occurred in the implementation of new regulations, were finally corrected at the beginning of 1997.

The EMI also monitors NCBs' secondary market purchases of public sector debt instruments. The acquisition of debt instruments of the public sector in the secondary market - which, according to Council Regulation (EC) No. 3603/93, must not be used to circumvent the objective of Article 104 - is in general in compliance with the Treaty.

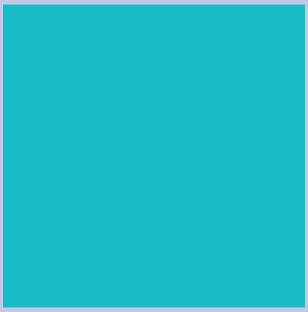
[14] *For further background information on the legal framework of this topic see the EMI's Annual Report 1994, Chapter III B.*

7 Co-operation with other institutions

The EMI has continued its close co-operation with other bodies of the European Union in a number of forms and at various levels. The President of the EU Council and a member of the European Commission have participated in meetings of the EMI Council, and the President of the EMI has attended meetings of the EU Council whenever matters relating to the objectives and tasks of the EMI have been discussed. This has included his attendance at informal ECOFIN Council meetings, where issues related to the irrevocable fixing of conversion rates, the organisation of the EU Council's dialogue with the ECB and the role of the ESCB in the implementation of Article 109 of the Treaty were discussed. In June 1997 the President appeared before the European Parliament to present the EMI's Annual Report 1996 to a plenary session and to answer questions related both to the monetary, economic and financial conditions in the Union and to the activities of the EMI, focusing in particular on the progress made by the EMI in fulfilling its statutory obligation to undertake the preparatory work necessary for Stage Three of EMU. The main challenges facing the EMI in the run-up to Stage Three of EMU and, in particular, the technical preparations necessary for the timely establishment of the ESCB were the key issues discussed when the President appeared before the Sub-Committee on Monetary Affairs of the European Parliament in October 1997. The same topics were on the agenda when the President held an exchange of views with members of the Economic and Social Committee of the European Communities in November.

At the working level, senior representatives of the EMI have regularly attended the meetings of the Monetary Committee as observers. Close working relationships have been maintained with the competent Directorates General of the European Commission, representatives of which also attend meetings of some EMI working groups. In the field of prudential supervision, an agreement was reached between the EMI and the European Commission in order to strengthen co-operation between the two institutions. According to this agreement, the EMI participates as an observer in the meetings of the Banking Advisory Committee, which assists the Commission in, inter alia, drawing up proposals for new Community banking legislation, while a representative of Directorate General XV takes part in the meetings of the EMI's Banking Supervisory Sub-Committee. In the field of statistics the EMI has further enhanced its procedures for co-operation with EUROSTAT (the European Commission's statistical office) and is represented by three members in the Committee on Monetary, Financial and Balance of Payments Statistics. Furthermore, the EMI has continued to co-operate with the national Mint Directors representing the institutions which will be responsible for producing the euro coins which will circulate alongside the euro banknotes as from 1 January 2002.

With regard to contacts with institutions outside the Community, the "concertation procedure" has remained a valuable forum for exchanging data among foreign exchange experts from central banks in the EU and those in Canada, Japan, Norway, Switzerland and the United States on exchange market developments, intervention and other official foreign exchange transactions. Consultations on matters of common interest between the EMI and the central banks of Norway, Iceland and Switzerland have taken place. Important links have also been retained with the Bank for International Settlements (BIS). The IMF has paid several visits to the EMI in the context of its regional surveillance activity and in order to exchange views on the future relationship between the ESCB and the IMF. The EMI also took part in meetings of the OECD Working Party No. 3. Furthermore, the EMI maintained its contact with the central banks of the associated Central and Eastern European countries (CEECs) and other applicant countries.



Annual Accounts of the EMI

Balance Sheet as at 31 December 1997

ECU

Assets

		1997	1996
I	**EMS-related assets**		
	Holdings of gold	26,228,410,973	*27,816,645,173*
	Holdings of US dollars	38,791,623,886	*31,710,534,867*
		65,020,034,859	*59,527,180,040*
II	**Other assets**		
(1)	Cash and bank sight accounts	24,164,570	*11,013,442*
(2)	Time deposits	597,499,982	*628,044,375*
(3)	Tangible assets	24,750,972	*7,815,279*
(4)	Other assets	2,345,761	*841,986*
		648,761,285	*647,715,082*
	Total assets (I and II)	**65,668,796,144**	*60,174,895,122*

Memorandum item:

	1997	1996
Forward claims in ECUs (from revolving quarterly swaps)	65,020,034,859	*59,527,180,040*

Liabilities

ECU

		1997	*1996*
I	**EMS-related liabilities**		
	ECUs issued to EU central banks	65,020,034,859	*59,527,180,040*
		65,020,034,859	*59,527,180,040*
II	**Other liabilities**		
(1)	Creditors and other liabilities	11,535,065	*4,200,209*
(2)	Provision for pensions and similar obligations	6,130,620	*3,742,631*
(3)	Other provisions	11,120,462	*7,074,292*
(4)	Contributions from EU central banks (pursuant to Article 16.2 of the Statute)	615,573,495	*615,573,495*
(5)	General reserve fund	17,124,455	*12,536,150*
(6)	Surplus/deficit for the year	(12,722,812)	*4,588,305*
		648,761,285	*647,715,082*
	Total liabilities (I and II)	**65,668,796,144**	*60,174,895,122*
	Memorandum item: Forward liabilities in gold and US dollars (from revolving quarterly swaps)	65,020,034,859	*59,527,180,040*

Profit and Loss Account for the year 1997

ECU

	1997	*1996*
Income		
Interest income	43,376,777	*44,532,696*
Total income	**43,376,777**	*44,532,696*
Expenses		
Staff costs	24,926,562	*18,157,530*
Other administrative expenses	28,613,295	*18,936,144*
Depreciation of tangible assets	3,012,512	*2,084,941*
Total expenses	**56,552,369**	*39,178,615*
Extraordinary income	916,447	*96,523*
Less: valuation loss	(463,667)	*(862,299)*
Surplus/deficit for the year	**(12,722,812)**	*4,588,305*
Allocation of deficit		
Offset against the general reserve fund	12,722,812	

Frankfurt am Main,
11 February 1998

EUROPEAN MONETARY INSTITUTE

W. Duisenberg
President

1. Accounting Policies

1.1 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.

1.2 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.

1.3 Notwithstanding the limited life of the EMI, the accounts have been prepared on a "going concern" basis. When the EMI goes into liquidation on the establishment of the ECB, all of its assets and liabilities will automatically pass to the latter, which will then liquidate the EMI in accordance with the provisions of Article 23 of the Statute of the EMI.

1.4 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 and financial fixed assets, are shown at year-end market value. Financial fixed assets are shown at acquisition cost less any provision for a permanent diminution in value. All other financial assets and liabilities are shown at nominal value.

1.5 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 economic lifetime of an asset, namely:

Equipment, furniture and plant in building	10 years
Computers, related hardware, software and vehicles	4 years

1.6 Apart from EMS-related assets and liabilities and financial fixed assets, foreign currency translation of balance sheet items into ECUs is based on the official rates published by the European Commission applying at 31 December 1997, or otherwise on closing market rates for that date. Foreign currency transactions reflected in the Profit and Loss Account are valued at the average of daily official rates for the year 1997. Translation of financial fixed assets denominated in foreign currencies is at the spot rates of exchange ruling on the dates of their acquisition.

1.7 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 are charged against profit.

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

2. Notes on the Balance Sheet

2.1 EMS-related assets and liabilities

These items relate to the three-month revolving swaps of official ECUs created in exchange for EU central banks' contributions to the EMI of 20% of their gold and US dollar reserves. These operations are described in Chapter III, Section 4, 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 by the EMI. 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.

2.2 Other assets

II (1) *Cash and bank sight accounts:* Working 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. Other cash balances were held on a one-day notice interest-bearing account in Deutsche Mark or were invested from time to time in Treasury bills of the Federal Republic of Germany. No such securities were held as at 31 December 1997.

II (2) *Time deposits:* As stated in the Annual Report for 1996, ECU 597.2 million of the resources contributed by the EU central banks pursuant to Article 16.2 of the Statute of the EMI was placed in time deposits in January 1995 at a fixed term of three years to generate the income deemed necessary to cover the EMI's administrative expenses. These deposits, which constituted a financial fixed asset of the EMI, matured on 30 December 1997. The proceeds were credited to a two-day notice interest-bearing account pending their reinvestment in the first week of January 1998.

II (3) *Tangible assets:* Net of cumulative depreciation of ECU 7.8 million these comprised, at year-end:

		in ECUs
	1997	*1996*
Special installations	2,065,988	*3,632,708*
Plant in building	7,225,869	*3,671*
Other equipment	2,184,088	*1,858,180*
Computers and software	12,976,562	*2,231,547*
Other	298,465	*89,173*
Total	24,750,972	*7,815,279*

"Special installations" comprises the costs of special additions and enhancements to the standard fittings and capital plant and equipment within the EMI's premises in the Eurotower building in Frankfurt am Main required to meet its particular operational needs. Following agreement of the final amounts due to the contractors from the EMI for the work carried out in respect of these special installations in 1994 and 1995, for which provisions had been made, the book value of this item was revised downwards by ECU 0.7 million. The corresponding provisions were released (see Note 3.3). There were significant increases in the asset value of plant in building and computers and software as the installation of ECB and ESCB systems started during the latter part of the year.

II (4) *Other assets:* This item principally includes 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.

2.3 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 payover to the European Communities, and accumulated pension contributions with interest thereon repayable to staff. Members of the 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 work carried out by end-1997 on several major infrastructural projects currently still in progress for the ECB and ESCB, the restoration of the EMI's premises at the end of its lease, office rental and service charge payments outstanding in respect of 1997, and the production of the Annual Report and the accounts for 1997.

II (4) *Contributions from EU central banks:* These represent the contributions made pursuant to Article 16.2 of the Statute by the EU central banks, as detailed below:

Central bank	ECU
Belgium	17,235,643
Denmark	10,464,542
Germany	138,808,404
Greece	12,311,159
Spain	54,476,907
France	104,644,800
Ireland	4,924,381
Italy	97,565,912
Luxembourg	923,360
Netherlands	26,161,252
Austria	14,162,957
Portugal	11,387,902
Finland	10,160,382
Sweden	17,857,642
United Kingdom	94,488,252
Total	615,573,495

II (5) *General reserve fund:* This represents accumulated undistributed profits from previous years, less any losses incurred. See also Note 3.5.

II (6) *Deficit for the year:* See Note 3.5.

3. Notes on the Profit and Loss Account

3.1 Income

Interest income: This item represents interest of ECU 42.3 million earned on the time deposits and of ECU 1.1 million from investment of cash balances (see Notes under "Other assets").

3.2 Expenses

Staff costs: This item relates to salaries and allowances (ECU 21.3 million), and to employer's contributions to pensions and health and accident insurance (ECU 3.6 million), in respect of staff employed by the EMI. Salaries and allowances of staff, including emoluments of holders of senior management positions, are modelled in essence on, and are comparable to, the remuneration scheme of the European Communities.

Numbers of staff (as at 31 December)	1997	*1996*
Permanent staff		
Senior management	7	*6*
Managerial	39	*36*
Professional	161	*90*
Support	127	*85*
Total	334	*217*
Staff on short-term contracts	13	*4*

The average number of permanent staff employed during 1997 was 281, compared with 202 for 1996. During 1997 135 permanent staff were recruited and 18 staff ceased to be employed.

Other administrative expenses: These cover all other current expenses, viz. rents, maintenance of premises and equipment, goods and equipment of a non-capital nature, professional fees, and other services and supplies, together with the expenses involved in the recruitment, relocation, installation and resettlement of staff.

3.3 Extraordinary income

This item represents extraordinary income arising mainly from the release of provisions made in previous years in respect of anticipated expenditure arising in those years that are no longer required.

3.4 Valuation loss

The depreciation of the Deutsche Mark against the ECU during 1997 resulted in an unrealised loss in the net value of assets held or denominated in Deutsche Mark. In the absence of a revaluation reserve, the full amount of this loss has been charged against profit.

3.5 Allocation of deficit

Pursuant to Article 17.6 of the Statute of the EMI, the deficit has been offset against the general reserve fund of the EMI.

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.

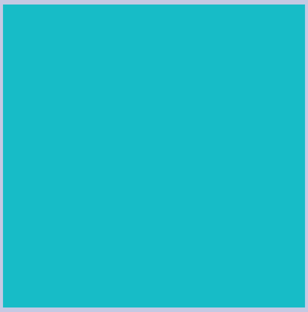
We conducted our audit in accordance with International Standards of Auditing. An audit includes examinations, on a test basis, of evidence relevant to the amounts and disclosures in the accounts. It also includes an assessment of the significant estimates and judgements made in the preparation of the 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 1 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 31 December 1997 and the results of its operations for the year then ended.

Frankfurt am Main, 12 February 1998

C&L DEUTSCHE REVISION
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

(Wagener)	(Kern)
Wirtschaftsprüfer	Wirtschaftsprüfer



Annexes

Excerpts from the Convergence Report (March 1998)

1 Convergence criteria

The criterion on price stability

Focusing on the performance of individual countries, over the twelve-month reference period ending January 1998 fourteen Member States (Belgium, Denmark, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, Finland, Sweden and the United Kingdom) had average HICP inflation rates of below the reference value. This reference value was calculated by using the unweighted arithmetic average of the rate of HICP inflation in the three countries with the lowest inflation rates, plus 1.5 percentage points. These three countries' inflation rates were 1.1% for Austria, 1.2% for France and 1.2% for Ireland, and, adding 1.5 percentage points to the average of 1.2%, the reference value is 2.7%. HICP inflation in Greece was 5.2%, considerably lower than in previous years, but still well above the reference value (see Table 5).

Looking back over the period from 1990 to 1997, the convergence of inflation rates can be explained by a variety of common factors. In the first place, as is indicated for each individual Member State, it reflects a number of important policy choices, most notably the orientation of monetary policy towards price stability and the increasing support received from other policy areas, such as fiscal policies and the development of wages and unit labour costs. In addition, in most Member States the macroeconomic environment, in particular during the period following the cyclical downturn of 1993, has contributed to the easing of upward pressure on prices. Finally, in many Member States broadly stable exchange rates and subdued import price developments have helped to dampen inflation. At the level of individual countries, it is apparent that a group of Member States recorded relatively similar inflation rates for most of the 1990s, while several others made particularly rapid progress in 1996-97. Among the latter, annual CPI inflation in Spain, Italy and Portugal fell from 4-5½% in 1995 to around 2% in 1997. These three Member States have had twelve-month average HICP inflation rates of below the reference value since mid-1997. In Greece, HICP inflation fell from 7.9% in 1996 to 5.4% in 1997, while remaining considerably above the reference value.

Looking ahead to the near future, in most countries recent trends and forecasts for inflation tend to indicate that there is little or no sign of immediate upward pressure on inflation. The risks for price stability are often associated with a narrowing of the output gap, a tightening of labour market conditions and increases in administered prices or indirect taxes; in several countries, for the most part those which are further ahead in the current cyclical upturn, the rate of inflation is generally forecast to rise to somewhat above 2% during the period 1998-99. This applies to Denmark, Spain, Ireland, the Netherlands, Portugal, Finland and the United Kingdom. These Member States need to exercise firm control over domestic price pressures with regard to, inter alia, wage and unit labour costs. Support is also required from fiscal policies, which need to react flexibly to the domestic price environment.

The criterion on the government budgetary position

With regard to the performance of individual Member States in 1997, three countries have recorded fiscal surpluses (Denmark, Ireland and Luxembourg) and eleven Member States have achieved or maintained deficits at or below the 3% reference value specified in the Treaty (Belgium, Germany, Spain, France, Italy, the Netherlands, Austria, Portugal, Finland, Sweden and the United Kingdom). Only Greece recorded a deficit of 4.0%, which is still above the reference value. For 1998, fiscal surpluses or further reductions in deficit ratios are projected by the Commission for nearly all Member States. The Greek deficit is expected to fall to 2.2% of GDP (see Table 5).

As regards government debt, in the three Member States with debt-to-GDP ratios of above 100%, debt has continued to decline in relation to GDP. In Belgium the debt ratio in 1997 was 122.2%, i.e. 13.0 percentage points lower than the peak in 1993; in Greece the debt ratio in 1997 stood at 108.7%, i.e. 2.9 percentage points below the latest peak in 1996; and in Italy the debt ratio was 121.6%, i.e. 3.3 percentage points below the peak of 1994. In the seven countries which in 1996 had debt ratios significantly above 60% but below 80% of GDP, debt ratios also declined. This was particularly the case in Denmark, Ireland and the Netherlands, where debt ratios in 1997 were 16.5, 30.0 and 9.1 percentage points respectively below their peak levels of 1993, and stood at 65.1%, 66.3% and 72.1% of GDP respectively; in Spain the debt ratio in 1997 declined by 1.3 percentage points from its peak level of 1996 to reach 68.8% of GDP; in Austria the corresponding reduction amounted to 3.4 percentage points, taking the debt ratio to 66.1% of GDP. In Portugal the debt ratio was 3.9 percentage points below its 1995 level, bringing the debt ratio to 62.0% of GDP. Finally, in Sweden the debt ratio was 2.4 percentage points below its peak level of 1994, reaching 76.6% of GDP in 1997. In Germany, which in 1996 had a debt ratio of just above the 60% reference value, the debt ratio continued its upward trend and in 1997 was 19.8 percentage points higher than in 1991, standing at 61.3% of GDP. In 1997 four countries continued to have debt ratios of below the 60% reference value (France, Luxembourg, Finland and the United Kingdom). In France the debt ratio continued its upward trend to reach 58.0% of GDP in 1997 (see Table 5).

For 1998 further reductions in debt-to-GDP ratios are projected by the Commission for all Member States which had debt ratios of above 60% in 1997. In the cases of Denmark, Ireland and Portugal, a reduction to a level at or below the reference value is forecast. As regards countries with debt ratios of 50-60% of GDP in 1997, Finland and the United Kingdom are anticipated to reduce their debt ratios further below 60%, whereas in France the debt ratio is expected to increase marginally.

Overall, progress in reducing fiscal deficit and debt ratios has generally accelerated. However, (...) in a number of Member States measures with a temporary effect have played a role in reducing deficits. On the basis of the evidence available to the EMI, the effects of such measures have been quantified at between 0.1 and 1 percentage point, with the level varying by country. To the extent that evidence is available, the magnitude of temporary measures in 1998 budgets has generally been reduced; in addition, as mentioned above, forecasts for 1998 suggest in most cases a further decline in deficit ratios. Reductions in debt ratios have benefited in part from a number of financial operations and transactions, such as privatisation, which are reflected in the so-called "stock-flow adjustment" item (...). Such transactions are expected to continue to play a role in several Member States.

Notwithstanding recent achievements, further substantial consolidation is warranted in most Member States in order to achieve lasting compliance with the fiscal criteria and the medium-term objective of having a budgetary position that is close to balance or in surplus, as required by the Stability and Growth Pact, effective from 1999 onwards. This applies in particular to Belgium, Germany, Greece, Spain, France, Italy, the Netherlands, Austria and Portugal, where deficits in 1998 are forecast to be between 1.6 and 2.9% of GDP. For most of these countries, these consolidation requirements also apply when comparing the fiscal deficit ratios as projected in the Convergence Programmes for 1999-2000 with the medium-term objective of the Stability and Growth Pact.

Taking a broader view on the sustainability of fiscal developments, the case for sustained consolidation over an extended period of time, requiring substantial fiscal surpluses, is particularly strong for those countries with debt ratios of above 100% (Belgium, Greece and Italy). This compares with significant overall deficits in 1997 and the years before. In countries with debt ratios of significantly above 60% but below 80% of GDP, keeping the deficit ratio at current levels would not bring down the debt ratio to below 60% within an appropriate period of time, which indicates the need for further, in some cases substantial, consolidation. Instead, realising the fiscal positions forecast for 1998 by the European Commission and maintaining a balanced budget from 1999 onwards would reduce the debt ratio to below 60% over appropriate periods (Spain, the Netherlands and Austria). Sweden could achieve the same result by realising the surplus position forecast for 1998 and maintaining it for several years thereafter. In Germany the debt ratio is forecast to be just above 60% of GDP in 1998, which could allow it to be reduced to below the reference value as early as 1999 if balanced budgets were achieved in that year. In Denmark, Ireland and Portugal current and forecast fiscal balances would allow the debt ratio to be reduced to a level equal to or just below 60% as early as 1998. Finally, in France, where the debt ratio is just below 60% of GDP, complying with the Stability and Growth Pact from 1999 onwards would also ensure that the debt ratio does not exceed the reference value.

It should be noted that in assessing budgetary positions of EU Member States, the impact on national budgets of transfers to and from the EC budget is not taken into account by the EMI.

The exchange rate criterion

During the two-year reference period from March 1996 to February 1998 ten currencies (the Belgian/Luxembourg franc, the Danish krone, the Deutsche Mark, the Spanish peseta, the French franc, the Irish pound, the Dutch guilder, the Austrian schilling and the Portuguese escudo) have been participating in the ERM for at least two years before this examination, as stated by the Treaty. The periods of membership for the Finnish markka and the Italian lira were shorter, as these currencies joined and rejoined the exchange rate mechanism in October 1996 and November 1996 respectively. Three currencies remained outside the ERM during the reference period referred to in this Report, namely the Greek drachma[15], the Swedish krona and the pound sterling.

Each of the ten ERM currencies mentioned above, with the exception of the Irish pound, has normally traded close to its unchanged central rates against other ERM currencies, and some currencies (the Belgian/Luxembourg franc, the Deutsche Mark, the Dutch guilder and the Austrian schilling) virtually moved as a bloc. On occasion, several currencies traded outside a range close to their central rates. However, the maximum deviation, on the basis of 10 business day moving averages, was limited to 3.5%, abstracting from the development of the Irish pound. In addition, the deviations were only temporary and mainly reflected transient movements of the Spanish peseta and the French franc (in early 1996), the Portuguese escudo (at end-1996/early 1997) as well as the Finnish

[15] *(...) the Greek drachma was incorporated in the exchange rate mechanism of the EMS, effective from 16 March 1998.*

markka (in early and mid-1997) vis-à-vis other ERM currencies. An examination of exchange rate volatility and short-term interest rate differentials suggests the persistence of relatively calm conditions throughout the reference period.

The Irish pound has normally traded significantly above its unchanged central rates against other ERM currencies; at the end of the reference period the Irish pound stood just over 3% above its central rates.[16] In parallel, the degree of exchange rate volatility vis-à-vis the Deutsche Mark increased until mid-1997 and short-term interest rate differentials against those EU countries with the lowest short-term interest rates widened over the same period. More recently, the former decreased and the latter narrowed somewhat while remaining relatively high.

In the case of the Italian lira, at the beginning of the reference period, before rejoining the ERM, it initially experienced a small and temporary setback in its previous strengthening trend, reaching a maximum downward deviation of 7.6% below its future central rate against one ERM currency in March 1996. Thereafter, it resumed its appreciation and tended towards its later central parities, moving for most of the time within a narrow range. In the case of the Finnish markka, also at the beginning of the reference period, before joining the ERM, it initially continued its weakening movement apparent over the previous few months - which had interrupted the longer-term upward movement since 1993 - reaching a maximum downward deviation of 6.5% below its future central rate against one ERM currency in April 1996. Thereafter, it appreciated and generally traded within a narrow range around its later central parities. Since joining and rejoining the ERM in October and November 1996 respectively, both the Finnish markka and the Italian lira have normally traded close to their unchanged central rates against other ERM currencies. As was the case for other ERM currencies, on occasion the Italian lira and the Finnish markka traded outside a range close to their central rates, but such deviations were limited and temporary. In both cases the relatively high degree of exchange rate volatility against the Deutsche Mark observed in earlier periods declined to low levels over the reference period and short-term interest rate differentials against those EU countries with the lowest short-term interest rates narrowed steadily in the case of the Italian lira and were insignificant in the case of the Finnish markka.

The three currencies remaining outside the ERM, namely the Greek drachma, the Swedish krona and the pound sterling, have normally traded above their March 1996 average bilateral exchange rates against other EU currencies. Short-term interest rate differentials against those EU countries with the lowest short-term interest rates remained wide in Greece, having narrowed until mid-1997 and widened significantly since November 1997, whereas they have narrowed significantly in Sweden. In the case of the pound sterling the short-term interest rate differential tended to widen.

The long-term interest rate criterion

Over the twelve-month reference period ending January 1998, fourteen Member States (Belgium, Denmark, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, Finland, Sweden and the United Kingdom) had average long-term interest rates of below the reference value. This reference value was calculated by using the unweighted arithmetic average of the long-term interest rates in the three countries with the lowest rates of HICP inflation, plus 2 percentage points. These three countries' long-term

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[16] *(...) the previous bilateral central rates of the Irish pound against other currencies of the exchange rate mechanism were revalued by 3%, effective from 16 March 1998.*

interest rates were 5.6% for Austria, 5.5% for France and 6.2% for Ireland, and, adding 2 percentage points to the average of 5.8%, the reference value is 7.8%. Representative long-term interest rates in Greece, which have been comparable with yields in other countries since June 1997, were 9.8% and thus stood well above the reference value (see Table 5).

Looking back over the period from 1990 to 1997, long-term interest rates were broadly similar in a number of countries when considered over the period as a whole. This applies to Belgium, Germany, France, Luxembourg, the Netherlands and Austria. In Denmark and Ireland long-term rates were also relatively close to those in the above-mentioned countries for most of the period. In Finland and Sweden the process of yield convergence accelerated from 1994-95 onwards and both countries have recorded limited differentials since around 1996. In Spain, Italy and Portugal, where yields were significantly higher for most of the 1990s, long-term interest rates declined steeply from 1995 onwards and moved below the reference value in either late 1996 or early 1997. A significant reduction was also seen in Greece. In the case of the United Kingdom, reflecting a different position in the cycle vis-à-vis continental European countries, a broad trend has been observed since the early 1990s of, first, convergence with, and later divergence from the long-term interest rates prevailing in the countries with the lowest bond yields, although long-term interest rate differentials have narrowed more recently.

The broad patterns observed in member countries are closely related to the developments in inflation rates (see above), which have facilitated a general reduction in long-term interest rates and a particularly marked decline in the case of the formerly high-yielding currencies. Other factors underlying this trend were the stability of exchange rates in most cases and the improvement in countries' fiscal positions, thereby reducing risk premia. These underlying developments were seen by the markets as improving the prospects for participation in Stage Three of EMU - an element which may in turn have played an independent role in accelerating the narrowing of yield differentials, both directly and by further improving the prospects for price and exchange rate stability.

2 Compatibility of national legislation with the Treaty

2.1 Introduction

Article 108 of the Treaty states that Member States shall ensure, at the latest at the date of the establishment of the ESCB, that their national legislation, including the statutes of their NCBs, is compatible with the Treaty and the Statute ("legal convergence"). This does not require the harmonisation of NCBs' statutes, but it implies that national legislation and statutes of NCBs need to be adjusted in order to make them compatible with the Treaty and the Statute. For the purpose of identifying those areas where the adaptation of national legislation is necessary, a distinction may be made between the independence of NCBs, the legal integration of NCBs in the ESCB and legislation other than statutes of NCBs.

Compatibility requires that the legislative process be completed, i.e. that the respective act has been adopted by the national legislator and that all further steps, for example promulgation, have been accomplished. This applies to all legislation under Article 108. However, the above distinction between different areas of legislation is important when it comes to determining the date on which legislation must enter into force. Many decisions which the Governing Council of the ECB and the NCBs will take between the date of the ESCB's establishment and the end of 1998 will predetermine the single monetary policy and its implementation within the euro area. Therefore, adaptations which relate to the independence of an NCB need to become effective at the latest at the date of the ESCB's establishment. Other statutory requirements relating to the legal integration of NCBs in the ESCB need only enter into force at the moment that the integration of an NCB in the ESCB becomes effective, i.e. the starting date of Stage Three or, in the case of a Member State with a derogation or a special status, the date on which it adopts the single currency. The entry into force of adaptations of legislation other than statutes of NCBs which are required to ensure compatibility with the Treaty and the Statute is dependent on the content of such legislation and therefore needs to be assessed on a case-by-case basis.

This Report provides, inter alia, an assessment on a country-by-country basis of the compatibility of national legislation with the Treaty and the Statute.

2.2 Independence of NCBs

Central bank independence is essential for the credibility of the move to Monetary Union and, thus, a prerequisite of Monetary Union. The institutional aspects of Monetary Union require monetary powers, currently held by Member States, to be exercised in a new system, the ESCB. This would not be acceptable if Member States could influence the decisions taken by the governing bodies of the ESCB.

The Statute contemplates an important role for governors of NCBs (via their membership of the Governing Council of the ECB) with regard to the formulation of monetary policy and for the NCBs with regard to the execution of the operations of the ESCB (see Article 12.1 of the Statute, last paragraph). Thus, it will be essential for the NCBs to be independent in the performance of their ESCB-related tasks vis-à-vis external bodies.

The principle of the independence of NCBs is expressly referred to in Article 107 of the Treaty and Article 14.2 of the Statute. Article 107 contains a prohibition on attempts to influence the ECB, NCBs or the members of their decision-making bodies, and Article 14.2 provides for security of tenure for such members.

The EMI has established a list of features of central bank independence, distinguishing between features of an institutional, personal and financial nature.[17]

As regards institutional independence, rights of third parties (e.g. government and parliament) to:

- give instructions to NCBs or their decision-making bodies;
- approve, suspend, annul or defer decisions of NCBs;
- censor an NCB's decisions on legal grounds;
- participate in the decision-making bodies of an NCB with a right to vote; or
- be consulted (ex ante) on an NCB's decisions

are incompatible with the Treaty and/or the Statute and, thus, require adaptation.

With respect to personal independence, statutes of NCBs should ensure that:

- governors of NCBs have a minimum term of office of five years;

[17] *There is also a criterion of functional independence, but as NCBs will in Stage Three be integrated in the ESCB, this is being dealt with in the framework of the legal integration of NCBs in the ESCB (see paragraph 2.3 below).*

- a governor of an NCB may not be dismissed for reasons other than those mentioned in Article 14.2 of the Statute (i.e. if he/she no longer fulfils the conditions required for the performance of his/her duties or if he/she has been guilty of serious misconduct);

- other members of the decision-making bodies of NCBs involved in the performance of ESCB-related tasks have the same security of tenure as governors;

- no conflicts of interest will arise between the duties of members of the decision-making bodies of NCBs vis-à-vis their respective NCB (and, additionally, of governors vis-à-vis the ECB) and other functions which members of the decision-making bodies involved in the performance of ESCB-related tasks may perform and which may jeopardise their personal independence.

Financial independence requires that NCBs can avail themselves of the appropriate means to fulfil their mandate. Statutory constraints in this field must be accompanied by a safeguard clause to ensure that ESCB-related tasks can be properly fulfilled.

2.3 The legal integration of NCBs in the ESCB

The full participation of NCBs in the ESCB necessitates measures in addition to those designed to ensure independence. In particular, such measures may be necessary to enable NCBs to execute tasks as members of the ESCB and in accordance with decisions taken by the ECB. The main areas of attention are those where statutory provisions may form an obstacle to an NCB complying with the requirements of the ESCB or to a governor fulfilling his/her duties as a member of the Governing Council of the ECB, or where statutory provisions do not respect the prerogatives of the ECB. Thus the EMI's assessment of the compatibility of the statutes of NCBs with the Treaty and the Statute focuses on the following areas: statutory objectives, tasks, instruments, organisation, financial provisions and miscellaneous issues.

2.4 Legislation other than the statutes of NCBs

The obligation of legal convergence under Article 108 of the Treaty, which is incorporated in a chapter entitled "Monetary Policy", applies to those areas of legislation which are affected by the transition from Stage Two to Stage Three. The EMI's assessment of the compatibility of national legislation with the Treaty and the Statute focuses in this respect on laws with an impact on an NCB's performance of ESCB-related tasks and laws in the monetary field. Relevant legislation requiring adaptation is in particular found in the following areas: banknotes, coins, foreign reserve management, exchange rate policy and confidentiality.

2.5 Compatibility of national legislation with the Treaty and the Statute

All Member States except Denmark, whose legislation does not require adaptation, have introduced, or are in an advanced process of introducing, changes in the statutes of their NCBs, following the criteria laid down in the EMI's Reports and in the EMI's opinions. The United Kingdom, which is exempt from the obligations under Article 108 of the Treaty, is in the process of introducing a new statute of its NCB which, while providing a greater level of operational central bank independence, is not expressly intended to achieve the legal convergence as required by the EMI for full compliance with the Treaty and the Statute. Throughout the European Union legislators, with the above exceptions, have undertaken a legislative process intended to prepare NCBs for Stage Three of EMU.

Joint Communiqué on the determination of the irrevocable conversion rates for the euro, dated 2 May 1998

In accordance with Article 109l (4) of the Treaty, the irrevocable conversion rates for the euro will be adopted by the Council, upon a proposal from the Commission and after consultation of the European Central Bank (ECB), on the first day of Stage Three, i.e. on 1 January 1999.

With a view to guiding markets in the run-up to Stage Three, the Ministers of the Member States adopting the euro as their single currency, the Governors of the Central Banks of these Member States, the European Commission and the European Monetary Institute (EMI) have agreed on the method for determining the irrevocable conversion rates for the euro at the starting date of Stage Three.

The current ERM bilateral central rates of the currencies of the Member States which, on the first day of Stage Three, will adopt the euro as their single currency, will be used in determining the irrevocable conversion rates for the euro. These rates are consistent with economic fundamentals and are compatible with sustainable convergence among the Member States which will participate in the euro area. The central banks of the Member States adopting the euro as their single currency will ensure through appropriate market techniques that on 31 December 1998 the market exchange rates, recorded according to the regular concertation procedure used for calculating the daily exchange rates of the official ECU, are equal to the ERM bilateral central rates as set forth in the attached parity grid.

The procedure agreed upon by all parties to this Joint Communiqué will ensure that the adoption of the irrevocable conversion rates for the euro will by itself, as required by Article 109l (4) of the Treaty, not modify the external value of the ECU, which will be replaced on a 1:1 basis by the euro. The attached annex provides detailed information on this procedure. The final official ECU exchange rates calculated accordingly and released on 31 December 1998 will be proposed by the Commission for adoption by the Council on the first day of Stage Three, i.e. on 1 January 1999, as the irrevocable conversion rates for the euro for the participating currencies.

In compliance with the legal framework for the use of the euro, once the irrevocable conversion rate for the euro for each participating currency has been adopted, it will be the only rate which will be used for conversion either way between the euro and the national currency unit and also for conversions between national currency units.

Table 9

ERM bilateral central rates to be used in determining the irrevocable conversion rates for the euro

	DEM 100 =	BEF/LUF 100 =	ESP 100 =	FRF 100 =	IEP 1 =	ITL 1000 =	NLG 100 =	ATS 100 =	PTE 100 =	FIM 100=
GERMANY: DEM	-									
BELGIUM/ LUXEMBOURG: BEF/LUF	2062.55									
SPAIN: ESP	8507.22	412.462								
FRANCE: FRF	335.386	16.2608	3.94237							
IRELAND: IEP	40.2676	1.95232	0.473335	12.0063						
ITALY: ITL	99000.2	4799.90	1163.72	29518.3	2458.56					
NETHERLANDS: NLG	112.674	5.46285	1.32445	33.5953	2.79812	1.13812				
AUSTRIA: ATS	703.552	34.1108	8.27006	209.774	17.4719	7.10657	624.415			
PORTUGAL: PTE	10250.5	496.984	120.492	3056.34	254.560	103.541	9097.53	1456.97		
FINLAND: FIM	304.001	14.7391	3.57345	90.6420	7.54951	3.07071	269.806	43.2094	2.96571	-

1 Why can only bilateral rates be announced?

Article 109l (4) of the Treaty provides that the rates at which the euro will be substituted for the currencies participating in the euro area will be adopted at the start of Stage Three of the Economic and Monetary Union, i.e. on 1 January 1999. The adoption of the irrevocable conversion rates for the euro shall by itself not modify the external value of the official ECU. Likewise, Article 2 of the Council Regulation of 17 June 1997 on certain provisions relating to the introduction of the euro stipulates that every reference in a legal instrument to the official ECU shall be replaced by a reference to the euro at a rate of one euro to one ECU. Therefore, the irrevocable conversion rates for the euro have to be identical to the value of the official ECU expressed in units of the participating currencies on 31 December 1998.

Since the ECU is a currency basket, which includes the Danish krone, the Greek drachma and the pound sterling,[18] it is not possible to announce before the end of 1998 the irrevocable conversion rates at which the euro shall be substituted for the participating currencies. However, it is possible to announce the bilateral rates of the currencies participating in the euro area which will be used on 31 December 1998 in computing the exchange rates of the official ECU and thus in computing the irrevocable euro conversion rates for these currencies.

2 Bilateral rates which will be used in determining the irrevocable conversion rates for the euro

For currencies participating in the euro area, the current ERM bilateral central rates will be used in calculating the final official ECU exchange rates which will be adopted by the Council as the irrevocable conversion rates for the euro on the first day of Stage Three, i.e. on 1 January 1999. The table attached to the Joint Communiqué contains those rates. In order to avoid minor arithmetical inconsistencies stemming from inverse calculations, it only includes one bilateral rate for each pair of currencies, which will be relevant for the procedure to be followed on 31 December 1998, as described below.

3 Calculation of the exchange rates of the official ECU on 31 December 1998

To calculate the exchange rates of the official ECU on 31 December 1998, the regular daily concertation procedure will be used. According to this procedure, the central banks of the Member States communicate the representative exchange rate of their respective currency against the US dollar.

Three steps can be identified.

Step 1: Determination of the EU currencies' concertation exchange rates against the US dollar

At 11.30 a.m. (CET), the EU central banks, including those with currencies which are not components of the ECU basket, provide

[18] *ECU basket currencies of Member States not participating in the euro area.*

to each other in the context of a teleconference, the US dollar exchange rate for their respective currencies. These exchange rates are recorded as discrete values lying within the market bid-ask spreads. While, as a rule, the discrete values are equal to the mid-points of the bid-ask spreads, the EU central banks, as is allowed by the current concertation procedure, will take into account the need to ascertain exchange rates expressed with six significant digits, like for the pre-announced rates. The bilateral rates between the euro area participating currencies obtained by crossing[19] the respective US dollar rates recorded by the EU central banks will be equal to the pre-announced ERM bilateral central rates, up to the sixth significant digit. The EU central banks participating in the euro area stand ready to ensure this equality, if necessary, through the use of appropriate market techniques.

Step 2: Calculation of the exchange rate of the official ECU against the US dollar

The rates as recorded by the EU central banks are thereafter communicated by the National Bank of Belgium to the Commission, which uses them to calculate the exchange rates of the official ECU. The USD/ECU exchange rate (expressed as 1ECU = xUSD) is obtained by summing up the US dollar equivalents of national currency amounts that compose the ECU.

Step 3: Calculation of the exchange rates of the official ECU against the EU currencies participating in the euro area.

The official ECU exchange rates against the EU currencies are calculated by multiplying the USD/ECU exchange rate by their respective US dollar exchange rates. This calculation is performed for all EU currencies, not only the ones which are components of the ECU basket.

These ECU exchange rates are rounded to the sixth significant digit. Exactly the same method of calculation, including the rounding convention, will be used in determining the irrevocable conversion rates for the euro for the euro area currencies.

For illustrative purposes, the calculation of the official ECU exchange rates vis-à-vis all EU currencies on 31 December 1997 is shown below.

In compliance with the legal framework for the use of the euro, once the irrevocable conversion rate for the euro for each participating currency has been adopted, it will be the only rate which will be used for conversion either way between the euro and the national currency unit and also for conversions between national currency units. Owing to rounding, the implicit bilateral rates which could be derived from the euro conversion rates may not always correspond, up to the last (sixth) significant figure, to the pre-announced ERM bilateral central rates referred to in this Joint Communiqué.

[19] *For example, FRF/DEM = FRF/USD : DEM/USD.*

	Step 1		Step 2	Step 3
	Amount of national currency units in the ECU basket (a)	USD exchange rate on 31 December 1997 (b)	Equivalent in dollars of national currency amount (c) = (a):(b)	ECU exchange rates (d) = (USD/ECU)*(b)
DEM	0.6242	1.7998	0.3487541	1.97632
BEF	3.301	36.92	0.0894095	40.7675
LUF	0.130	36.92	0.0035211	40.7675
NLG	0.2198	2.0172	0.1089629	2.22742
DKK	0.1976	6.8175	0.0289842	7.52797
GRD	1.440	282.59	0.0050957	312.039
ITL	151.8	1758.75	0.0863113	1942.03
ESP	6.885	151.59	0.0454186	167.388
PTE	1.393	183.06	0.0076095	202.137
FRF	1.332	5.9881	0.2224412	6.61214
GBP	0.08784	1.6561	0.1454718 @	0.666755
IEP	0.008552	1.4304	0.0122328 @	0.771961
			USD/ECU 1.1042128*	
FIM		*5.4222*		*5.98726*
ATS		*12.59*		*13.9020*
SEK		*7.9082*		*8.73234*

@ The dollar exchange rate for the GBP and IEP is the number of dollars per currency unit rather than the number of currency units per dollar. Column (c) is therefore calculated for each of these two currencies by multiplying the value in column (a) by that in column (b); and column (d) by dividing the dollar equivalent of the ECU (i.e. USD/ECU) by the rate in column (b).

* There is a difference of one unit (i.e. 1.104212**8** instead of 1.104212**7**) in the last significant figure because the dollar equivalents of national currency amounts are shown after rounding to the 7th decimal place, whereas an unrestricted number of digits is used for computation purposes.

Glossary

Association of South-East Asian Nations (ASEAN): an international organisation established in 1967 which comprises Indonesia, Malaysia, the Philippines, Singapore, Thailand, since 1984 Brunei, since 1995 Vietnam and since 1997 Myanmar and Laos. Among the main aims of ASEAN are the promotion of economic and social development in member countries and economic co-operation and trade between members of ASEAN.

Bilateral central rate: the official exchange rate between any pair of **ERM** member currencies, around which the **ERM fluctuation margins** are defined.

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

Central and Eastern European countries (CEECs): Community terminology used to refer to those countries of central and eastern Europe with which the European Community has concluded association treaties. These associated CEECs currently comprise Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia. In spring 1998 the Community launched the examination of the "acquis communautaire" with all CEECs while the accession negotiations have been opened only for the Czech Republic, Estonia, Hungary, Poland and Slovenia (and Cyprus).

Central securities depository (CSD): an entity which holds securities and which enables securities transactions to be processed by book entry. Physical securities may be immobilised by the depository or securities may be dematerialised (i.e. so that they exist only as electronic records). In addition to safekeeping, a central securities depository may incorporate comparison, clearing and settlement functions.

Collateral: assets pledged as a guarantee for the repayment of the short-term liquidity loans which credit institutions receive from the central banks, as well as assets received by central banks from credit institutions as part of repurchase operations.

Concertation procedure: framework within which central bank foreign exchange experts (from each EU Member State, Canada, Japan, Norway, Switzerland and the United States) participating in the Concertation Group exchange information about market developments. The framework provides for regular daily telephone sessions and periodic meetings of central bank experts.

Convergence criteria: criteria established in Article 109j (1) of the **Treaty** (and developed further in Protocol No. 6). They relate both to economic performance with respect to price stability, government financial positions, exchange rates and long-term interest rates, as well as to the compatibility of national legislation, including the statutes of NCBs, with the Treaty and the ESCB/ECB Statute. The reports produced under Article 109j (1) by the **European Commission** and the EMI examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of these criteria as well as the above compatibility.

Convergence programmes: medium-term government plans and assumptions regarding the development of key economic variables towards the achievement of the **reference values** indicated in the **Treaty**. Regarding budgetary positions, measures to consolidate fiscal balances as well as underlying economic scenarios are highlighted. Convergence programmes normally cover the next three to four years, but are regularly updated during that time. They are examined by the **European Commission** and the **Monetary Committee**. Their reports serve as the basis for an assessment by the **ECOFIN** Council. After the start of Stage Three of **Economic and Monetary Union**, Member States with a derogation will continue to submit convergence programmes, while countries which are members of the **euro area** will have annual stability programmes, in accordance with the Stability and Growth Pact.

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 but are also known as agency relationships in some domestic contexts. A loro account is the term used by a correspondent to describe an account held on behalf of a foreign bank; the foreign bank would in turn regard this account as its nostro account.

Correspondent central banking model (CCBM): a facility for the cross-border use of collateral in ESCB credit operations. In the CCBM, national central banks would maintain securities accounts with each other. As a result, NCBs would be able to act as local custodians for each other.

Council (of the European Union): is made up of representatives of the governments of the Member States, normally the Ministers responsible for the matters under consideration (therefore often referred to as the *Council of Ministers*). The Council meeting in the composition of the Ministers of Finance and Economy is often referred to as the *ECOFIN Council*. In addition, the Council may meet in the composition of the Heads of State or of Government. See also **European Council**.

Debt ratio: the subject of one of the fiscal **convergence criteria** laid down in **Treaty** Article 104c (2). It is defined as "*the ratio of government debt to gross domestic product at current market prices*", where government debt is defined in Protocol No. 5 (on the **excessive deficit procedure**) as "*total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government*".

Deficit ratio: the subject of one of the fiscal **convergence criteria** named in **Treaty** Article 104c (2). Defined as "*the ratio of the planned or actual government deficit to gross domestic product*" at current market prices, where the government deficit is defined in Protocol No. 5 (on the **excessive deficit procedure**) as "*net borrowing of the general government*".

Delivery versus payment system (or DVP, delivery against payment): a mechanism in a **securities settlement system** that ensures that the final transfer of one asset occurs if and only if the final transfer of (an)other asset(s) occurs. Assets could include securities or other financial instruments.

EBA (ECU Banking Association, known as the Euro Banking Association since December 1997): interbank organisation created in 1985 with the support of European institutions with the task of achieving three objectives: to promote the use of the **ECU** in financial and commercial transactions; to manage and develop the ECU Clearing and Settlement System and to be a representative body and discussion forum for all matters related to the use of the ECU. Now developing a successor Euro Clearing and Settlement System to operate in Stage Three of **EMU**.

ECB (European Central Bank): the ECB will have legal personality. It will ensure that the tasks conferred upon the **ESCB** are implemented either by its own activities pursuant to its Statute or through the national central banks.

ECB Executive Board: the decision-making body of the **ECB** which will implement monetary policy in accordance with the guidelines and decisions laid down by the **ECB Governing Council**. It will be composed of the President, the Vice-President and two to four other members, appointed from among persons of recognised standing and professional experience in monetary and banking matters by common accord of the governments of the Member States of the **euro area** at the level of the Heads of State or of Government, on a recommendation from the **Council** after it has consulted the **European Parliament** and the ECB Governing Council.

ECB General Council: in addition to the **ECB Governing Council** and the **ECB Executive Board**, the ECB's third decision-making body. Composed of the ECB's President, Vice-President and the governors of all EU national central banks. It will perform the tasks deriving from the situation in which not all EU Member States participate in the **euro area** right from the start.

ECB Governing Council: composed of the members of the **ECB Executive Board** and the governors of the national central banks of the countries participating in the **euro area**; it will be the supreme decision-making body of the **ECB** which will adopt the guidelines and take the decisions necessary to ensure the performance of the tasks entrusted to the **ESCB** under the **Treaty** and the ESCB Statute.

ECOFIN: see **Council (of the European Union).**

Economic and Monetary Union (EMU): the **Treaty** describes the process of achieving economic and monetary union in the EU in three stages. *Stage One* of EMU started in July 1990 and ended on 31 December 1993: it was mainly characterised by the dismantling of all internal barriers to the free movement of capital within the EU. *Stage Two* of EMU began on 1 January 1994. It provided, inter alia, for the establishment of the European Monetary Institute, the prohibition of monetary financing of and privileged access to financial institutions for the public sector and the avoidance of excessive deficits. *Stage Three* will start on 1 January 1999, in accordance with the decision pursuant to Article 109j (4), with the transfer of monetary competence to the **ESCB** and the creation of the **euro**.

ECU (European Currency Unit): in its present definition (Council Regulation No. 3320/94 of 20 December 1994), the ECU is a basket made up of the sum of fixed amounts of twelve out of the fifteen currencies of the Member States. Article 109g of the **Treaty** states that this composition shall not be changed until the start of Stage Three. The value of the ECU is calculated as a weighted average of the value of its component currencies. As official ECU, it serves, inter alia, as the numeraire of the **ERM** and as a reserve asset for central banks. Official ECUs are created by the EMI through three-month swap operations against one-fifth of the US dollar and gold assets held by the fifteen EU central banks. Private ECUs are ECU-denominated financial instruments (e.g. bank deposits or securities) which are based on contracts which, as a rule, make reference to the official ECU. The "theoretical" value of the private ECU is defined on the basis of the value of the individual components of the ECU basket. However, the use of the private ECU is different from that of the official ECU and in practice the market value of the private ECU may diverge from its "theoretical" basket value. The replacement of the private ECU by the **euro** at the rate of one to one is laid down in Article 2 of the Council Regulation on some provisions relating to the introduction of the euro (see (EC) No. 1103/97 of June 1997).

EEA (European Economic Area) countries: the EU Member States and Iceland, Liechtenstein and Norway.

Effective (nominal/real) exchange rates: in their *nominal* version, effective exchange rates consist of a weighted average of various bilateral exchange rates. *Real* effective exchange rates are nominal effective exchange rates deflated by a weighted average of foreign prices or costs relative to domestic ones. They are thus measures of a country's price and cost competitiveness. The choice of currencies and weights reflects the economic issue being analysed. The most commonly used measures of effective exchange rates employ trade weights.

Electronic money (e-money): an electronic store of monetary value on a technical device that is used for making payments to undertakings other than the issuing institution without necessarily involving bank accounts in the transaction, but as a prepaid bearer instrument.

EMS (European Monetary System): established in 1979 in accordance with the Resolution of the **European Council** on the establishment of the EMS and related matters of 5 December 1978. The Agreement of 13 March 1979 between the central banks of the Member States of the European Economic Community lays down the operating procedures for the EMS. The objective is to create closer monetary policy co-operation between Community countries leading to a zone of monetary stability in Europe. The main components of the EMS are: the **ECU**; the exchange rate and intervention mechanism (**ERM**); and various credit mechanisms.

EMU: see **Economic and Monetary Union**.

ERM (Exchange Rate Mechanism): the exchange rate and intervention mechanism of the **EMS** defines the exchange rate of participating currencies in terms of a central rate vis-à-vis the **ECU**. These central rates are used to establish a grid of bilateral exchange rates between participating currencies. Exchange rates are allowed to fluctuate around **bilateral central rates** within the **ERM fluctuation margins**. These margins have been set at ±15% since 2 August 1993. Pursuant to a bilateral agreement between Germany and the Netherlands, fluctuation margins between the Deutsche Mark and the Dutch guilder are maintained at ±2.25%. Adjustments of central rates are subject to mutual agreement between all countries participating in the ERM (see also **realignment**).

ERM II: successor exchange rate arrangement to the present **ERM**, which will provide the framework for exchange rate policy co-operation between the **euro area** and Member States not participating in the euro area from the start of Stage Three. Membership will be voluntary; nevertheless, EU Member States with a derogation can be expected to join the mechanism. The basic principles and operational features were agreed at the Dublin **European Council** on 13 and 14 December 1996. A European Council Resolution on the establishment of an exchange rate mechanism in the third stage of **EMU** was adopted at the Amsterdam summit on 16 and 17 June 1997, and a draft agreement between the **ECB** and non-euro area NCBs has been finalised for adoption by the ECB after its establishment.

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

ESCB (European System of Central Banks): the ESCB is composed of the **ECB** and the national central banks of the Member States. Its primary objective is to maintain price stability. Its basic tasks are to define and implement the monetary policy of the **euro area**, to hold and manage the official reserves of the participating Member States and conduct foreign exchange operations and to promote the smooth operation of payment systems in the euro area. The ESCB also contributes to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.

euro: the name of the European currency adopted by the **European Council** at its meeting in Madrid on 15 and 16 December 1995 and used instead of the generic term "**ECU**" used by the **Treaty** to refer to the European Currency Unit.

euro area: area covering those Member States which have adopted the **euro** as the single currency in accordance with the **Treaty** and in which a single monetary policy will be conducted under the responsibility of the decision-making bodies of the **ECB** (**ECB Governing Council**; **ECB General Council**; **ECB Executive Board**).

European Commission: institution of the European Community which ensures the application of the provisions of the **Treaty**, takes initiatives for Community policies, proposes Community legislation and exercises powers in specific areas. In the economic policy area, the Commission recommends broad guidelines for the economic policies in the Community and reports to the **Council** on economic developments and policies. It monitors public finances and initiates the procedure on excessive deficits. It consists of twenty members and includes two nationals from Germany, Spain, France, Italy and the United Kingdom, and one from each of the other Member States. *EUROSTAT* is the Directorate General of the Commission responsible for the production of Community statistics through the collection and systematic processing of data, produced mainly by the national authorities within the framework of comprehensive five-yearly Community statistical programmes.

European Council: provides the European Union with the necessary impetus for its development and defines the general political guidelines thereof. It brings together the Heads of State or of Government of the Member States and the President of the **European Commission**. See also **Council**.

European Parliament: consists of 626 representatives of the citizens of the Member States. It is a part of the legislative process, though with different prerogatives according to the procedures through which EU law is to be enacted. In the framework of **EMU**, the Parliament has mainly consultative powers. However, the **Treaty** establishes certain procedures for democratic accountability of the **ECB** to the Parliament (presentation of the annual report, general debate on the monetary policy, hearings to the competent parliamentary committees).

Fiduciary money: refers to banknotes and coins. These means of payment are termed "fiduciary" because their value is based on the confidence and trust of the holder in the issuer of the currency.

Fixed rate tender: a tender procedure where the interest rate is specified in advance by the central bank and participating counterparties bid the amount of money they want to transact at the fixed interest rate. See also **variable rate tender**.

Foreign exchange swap: simultaneous spot and forward transactions of one currency against another. The **ESCB** will execute open market monetary policy operations in the form of foreign exchange swaps where the NCBs (or the **ECB**) buy (or sell) **euro** spot against a foreign currency and at the same time sell (or buy) it back forward. This instrument will also be used in the management of the ESCB's foreign reserves.

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.

Harmonised Index of Consumer Prices (HICP): Protocol No. 6 on the **convergence criteria** referred to in Article 109j (1) of the **Treaty** establishing the European Community requires price convergence to be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions. Although current consumer price statistics in the Member States are largely based on similar principles, there are considerable differences of detail and these affect the comparability of the national results. In order to fulfil the Treaty requirement the **European Commission** (EUROSTAT), in close liaison with the National Statistical Institutes and the EMI, has carried out conceptual work on the harmonisation of consumer price statistics. The Harmonised Index of Consumer Prices is the outcome of these efforts.

Harmonised long-term interest rates: Protocol No. 6 on the **convergence criteria** referred to in Article 109j (1) of the **Treaty** establishing the European Community requires interest rate convergence to be measured by means of interest rates on long-term government bonds or comparable government securities, taking into account differences in national definitions. In order to fulfil the Treaty requirement the EMI has carried out conceptual work on the harmonisation of long-term interest rate statistics and regularly collects the data from national central banks, on behalf of the **European Commission** (EUROSTAT). Fully harmonised data are used in this report.

Interbank funds transfer system (IFTS): a **funds transfer system** in which most (or all) participants are credit institutions.

Implementation package: in July 1996 the EMI Council approved the "Statistical requirements for Stage Three of Monetary Union" (the "Implementation package"). This publicly available working document sets out in detail the statistics which will be required by the **ECB** in defining and conducting the single monetary policy. While dealing principally with money and banking and balance of payments statistics, it also covers other financial statistics, price and cost and government finance statistics, and background economic statistics.

Interlinking mechanism: one of the components of the architecture of the **TARGET system**. The term Interlinking is used to designate the infrastructures and the procedures which link domestic **RTGS systems** in order to process cross-border payments within TARGET.

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

Intra-marginal intervention: intervention carried out by a central bank to influence the exchange rate of its currency within its **ERM fluctuation margins**.

Large-value payments: payments, generally of very large amounts, which are mainly exchanged between banks or between participants in the financial markets and usually require urgent and timely settlement.

Links between securities settlement systems: the procedure between two securities settlement systems for the cross-border transfer of securities through a book-entry process (without physical transfer).

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

Monetary Committee: a consultative Community body, composed of two members appointed by each Member State in their personal capacity (normally one from the government and one from the central bank) and two representatives appointed by the **European Commission**. It was created in 1958 on the basis of Article 105 of the EEC **Treaty**. In order to promote co-ordination of the policies of Member States to the full extent needed for the functioning of the internal market, Article 109c of the Treaty lists a set of areas where the Monetary Committee contributes to the preparation of the work of the **Council**. At the start of Stage Three (**Economic and Monetary Union**) the Monetary Committee will be dissolved and an **Economic and Financial Committee** will be created instead.

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

Multi-purpose prepaid card: a prepaid card which can be used at the outlets of several service providers for a wide range of purposes, which has the potential to be used on a national or international scale but may sometimes be restricted to a certain area. Also known as an electronic purse.

Net settlement system (NSS): a **funds transfer system,** the settlement operations of which are completed on a bilateral or multilateral net basis.

Quick tender: a tender procedure to be used by the **ESCB** for fine-tuning operations when it is deemed desirable to have a rapid impact on the liquidity situation in the market. Quick tenders are executed within a time frame of one hour and are restricted to a limited set of counterparties.

Realignment: change in the **ECU** central rate and **bilateral central rates** of one or several currencies participating in the **ERM**.

Re-denomination of securities: the *denomination* of a security is the currency in which the par value of the security is expressed (in most cases, the face value of a certificate). Re-denomination refers to a procedure through which the original denomination of a security, issued in national currency, is changed into the **euro** at the irrevocably fixed conversion rate.

Reference period: time intervals specified in Article 104c (2a) of the **Treaty** and in Protocol No. 6 on the **convergence criteria** for examining progress towards convergence.

Reference value: Protocol No. 5 of the **Treaty** on the excessive deficit procedure sets explicit reference values for the deficit ratio (3% of GDP) and the debt ratio (60% of GDP), whereas Protocol No. 6 on the **convergence criteria** specifies the methodology for the computation of the reference values relevant for the examination of price and long-term interest rate convergence.

Remote access to an **IFTS:** the facility for a credit institution established in one country ("home country") to become a direct participant in an **interbank funds transfer system** (**IFTS**) established in another country ("host country") and, for that purpose, to have a settlement account in its own name with the central bank in the host country, if necessary, without having established a branch in the host country.

Reverse transaction: an operation whereby the central bank buys or sells assets under a repurchase agreement or conducts credit operations against **collateral**.

RTGS (real-time gross settlement) system: a settlement system in which processing and settlement take place on an order-by-order basis (without netting) in real time (continuously). See also **TARGET system**.

Scriptural money: all money in book-entry form and therefore not circulating in the form of banknotes and coins.

Second Banking Co-ordination Directive: adopted on 15 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).

Securities settlement system: a system which permits the transfer of securities either free of payment or against payment.

Settlement agent: an institution that manages the settlement process (e.g. the determination of settlement positions, monitoring the exchange of payments, etc.) for transfer systems or other arrangements that require settlement.

Settlement risk: general term used to designate the risk that settlement in a transfer system will not take place as expected. This risk may comprise both credit and liquidity risk.

Standard tender: a tender procedure to be used by the **ESCB** in its regular open market operations or for the issuance of debt certificates. Standard tenders are carried out within a time frame of 24 hours. All counterparties fulfilling the general eligibility criteria are entitled to submit bids in standard tenders.

TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) system: a payment system consisting of one real-time gross settlement (**RTGS**) system in each of the Member States participating in the **euro area** at the start of Stage Three of **Economic and Monetary Union**. The national RTGS systems will be interconnected through the **Interlinking mechanism** so as to allow same-day cross-border transfers throughout the euro area. RTGS systems of non-euro area Member States may also be connected to TARGET, provided that they are able to process **euro**.

Treaty: refers to the Treaty establishing the European Community. The Treaty was signed in Rome on 25 March 1957 and entered into force on 1 January 1958. It established the *European Economic Community (EEC)* and was often referred to as the "Treaty of Rome". The Treaty on European Union was signed in Maastricht (therefore often referred to as the "Maastricht Treaty") on 7 February 1992 and entered into force on 1 November 1993. It amended the EEC Treaty, which is now referred to as the Treaty establishing the *European Community*. The Treaty on European Union will be amended by the "Amsterdam Treaty", which was signed in Amsterdam on 2 October 1997 and is in the process of being ratified.

Variable rate tender: a tender procedure whereby the counterparties bid both the amount of money they want to transact with the central bank and the interest rate at which they want to enter into the transaction. See also **fixed rate tender**.

VSTF (Very Short-Term Financing): an **EMS** credit facility between central banks for financing interventions in **ERM** currencies.

Chronology of monetary measures taken in the EU in 1997[20]

2 January The *Oesterreichische Nationalbank* starts conducting the regular weekly tender with a 14-day instead of a 7-day maturity and also introduces some changes in the structure of the refinancing lines.

13 January The *Banco de Portugal* lowers its repo rate by 0.2 percentage point to 6.5%.

16 January The *Banco de España* reduces its official 10-day repurchase rate by 0.25 percentage point to 6.0%.

21 January The *Banca d'Italia* reduces its discount and fixed term advances (or lombard) rates by 0.75 percentage point to 6.75% and 8.25% respectively.

30 January The *Banque de France* lowers its intervention rate by 0.05 percentage point to 3.1%.

12 February The *Bank of Greece* starts conducting regular weekly tender operations in the form of interest rate tenders (American auction) or volume tenders for the collection of deposits from credit institutions and for sales/purchases of securities with a repurchase/resale agreement, both with a 14-day maturity. The first variable rate tender results in a weighted average allotment rate of 12.14%.

13 February The *Banque de France* announces that it will exempt from minimum reserve requirements all liabilities vis-à-vis non-banks which are related to securities repurchase transactions with a maturity of up to one year.

14 February The *Bank of Greece* lowers its discount and lombard rates by 1 percentage point to 15.5% and 20.0% respectively, and the overnight intervention rate by 0.5 percentage point to 11.9%.

19 February The *Bank of Greece's* weekly tender for 14-day deposits results in a lowering of the weighted average allotment rate by 0.19 percentage point to 11.95%.

27 February *De Nederlandsche Bank* raises the rate on special advances by 0.2 percentage point to 2.7%.

3 March The *Bank of England* introduces new daily intervention operations in order to set official interest rates and to supply liquidity to the clearing banks. These operations are extended to include gilt repo operations and other types of eligible debt instruments, as well as a broader range of counterparties, by including banks (other than discount houses) and securities firms.

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[20] *Dates of announcement of monetary measures.*

10 March *De Nederlandsche Bank* raises the rate on advances by 0.5 percentage point to 2.5% and the rate on special advances by 0.2 percentage point to 2.9%.

14 March The *Banco de España* reduces its 10-day repurchase rate by 0.25 percentage point to 5.75%.

28 March The *Bank of Greece* introduces an (overnight) deposit facility. Deposits up to a global ceiling of GRD 300 billion are remunerated at a rate of 11.9%, the remainder at 9.9%. The global ceiling is allocated among credit institutions on the basis of domestic market shares.

2 April The *Bank of Greece* conducts the weekly tender for 14-day deposits at a fixed rate of 11.9%, which implies a reduction of 0.05 percentage point.

11 April The *Banco de Portugal* reduces its repo rate by 0.2 percentage point to 6.3%, its liquidity absorption rate by 0.4 percentage point to 5.8% and its overnight credit facility rate by 0.5 percentage point to 7.8%.

15 April The *Banco de España* lowers its 10-day repurchase rate by 0.25 percentage point to 5.5%.

28 April The *Banco de España* starts accepting pledging as a complement to its repo operations. Eligible assets for pledging are Banco de España certificates, public and private fixed income assets and non-bank shares.

1 May *Danmarks Nationalbank* abolishes the limits (which were introduced in 1992) on the remuneration of the current account deposits that monetary policy counterparties maintain with the central bank.
The *Central Bank of Ireland* raises its short-term lending facility rate by 0.5 percentage point to 6.75%.

6 May The *Bank of England* announces an increase in the repo rate by 0.25 percentage point to 6.25%. The Chancellor of the Exchequer announces that the Bank of England has been granted operational responsibility for setting interest rates. Operational decisions will be made by a new Monetary Policy Committee comprising the Governor, two Deputy Governors and six other members.

9 May The *Banco de Portugal* reduces its repo rate by 0.3 percentage point to 6.0%, its liquidity absorption rate by 0.1 percentage point to 5.7% and its overnight credit facility rate by 0.1 percentage point to 7.7%.

12 May The *Bank of Greece* lowers its discount, lombard and overdraft rates by 1 percentage point to 14.5%, 19.0% and 24.0% respectively.

16 May The *Banco de España* lowers its 10-day repurchase rate by 0.25 percentage point to 5.25%.

23 May	*De Nederlandsche Bank* changes its monetary policy instruments: the averaging facility is transferred from the advance facility to the compulsory but remunerated cash reserve at the central bank, the volume of which is set in advance for a period of four or five weeks; the maximum borrowing per bank under the advance facility changes from average amounts over three months to fixed amounts with maturities of at least one month and at most three months; the name of the advance facility is changed to fixed advance facility, while the rate remains unchanged at 2.5%; a marginal lending facility is introduced, the rate of which is set at 4.5%; and the rate on special advances remains unchanged at 2.9%.
6 June	The *Bank of England* raises the repo rate by 0.25 percentage point to 6.5%.
27 June	The *Banca d'Italia* reduces its discount and fixed term advances (or lombard) rates by 0.5 percentage point to 6.25% and 7.75% respectively. Furthermore, the remuneration of required reserves is lowered from 5.5 to 4.5%.
10 July	The *Bank of England* raises the repo rate by 0.25 percentage point to 6.75%.
11 July	*De Nederlandsche Bank* raises the rate on special advances by 0.1 percentage point to 3.0%. The *Banco de Portugal* reduces its repo rate, its liquidity absorption rate and its overnight credit facility rate by 0.3 percentage point to 5.7%, 5.4% and 7.4% respectively.
21 July	The *Banco de Portugal* starts to accept private debt instruments as collateral in its open market operations, provided that these meet certain criteria.
24 July	The *Bank of Greece* lowers both its deposit facility rates (basic and floor rates) by 0.3 percentage point to 11.6% and 9.6% respectively.
7 August	The *Bank of England* raises its repo rate by 0.25 percentage point to 7.0%.
14 August	The *Bank of Greece* reduces its deposit facility rate (basic rate) by 0.3 percentage point to 11.3% with effect from 18 August.
18 August	The *Banco de Portugal* reduces its repo rate, its liquidity absorption rate and its overnight credit facility rate by 0.2 percentage point to 5.5%, 5.2% and 7.2% respectively.
15 September	*Suomen Pankki* increases its tender rate by 0.25 percentage point to 3.25%.

3 October	The *Banco de España* lowers its 10-day repurchase rate by 0.25 percentage point to 5.0%.
7 October	The *Bank of Greece* reduces its deposit facility rate (basic rate) by 0.4 percentage point to 10.9%.
9 October	The *Banque Nationale de Belgique* raises its central rate and its rate on ordinary end-of-day advances by 0.3 percentage point to 3.3% and 4.55% respectively, whereas the discount rate is raised by 0.25 percentage point to 2.75%. *Danmarks Nationalbank* raises its 14-day certificates of deposit rate and its discount rate by 0.25 percentage point to 3.75% and 3.5% respectively. The *Deutsche Bundesbank* announces that the next two securities repurchase agreements (on 15 and 22 October) will be offered at a fixed rate of 3.3% (an increase of 0.3 percentage point). The *Banque de France* raises its intervention rate by 0.2 percentage point to 3.3%. *De Nederlandsche Bank* raises the rate on special advances by 0.3 percentage point to 3.3% and the rate on fixed advances by 0.25 percentage point to 2.75%. The *Oesterreichische Nationalbank* announces an increase in its repo rate of 0.2 percentage point to 3.2%.
24 October	The *Central Bank of Ireland* announces that it will introduce averaging provisions into its reserve requirements. In order to maximise the use of these averaging provisions, it will conduct weekly repo operations by tender with a fixed or variable rate and a two-week duration, beginning on 20 November.
31 October	The *Bank of Greece* introduces a daily surcharge of 0.4% to apply - in addition to the annual overdraft facility rate of 24% - to further increments in the debit balances on banks' current accounts with the central bank.
3 November	*Suomen Pankki* reduces the maturity of its money market tenders from one month to two weeks. The normal settlement day for these tenders will be the banking day following the trade day. The maturity of the liquidity credit is reduced from seven days to one day. The limits on the amount of liquidity advanced under the marginal lending facility are abolished.
6 November	The *Bank of England* raises its repo rate by 0.25 percentage point to 7.25%.
18 November	The *Banco de Portugal* reduces its repo rate by 0.2 percentage point to 5.3%, and its liquidity absorption rate and its overnight credit facility rate by 0.3 percentage point to 4.9% and 6.9% respectively.

20 November The *Central Bank of Ireland* starts conducting weekly tender operations with a two-week maturity. The first repo operation is conducted at a fixed rate of 6.19%.

11 December *Sveriges Riksbank* raises its repo rate by 0.25 percentage point to 4.35%, with effect from 16 December.

15 December The *Banco de España* lowers its 10-day repurchase rate by 0.25 percentage point to 4.75%.

18 December The *Deutsche Bundesbank* sets the target range for M3 growth in 1998 at 3-6%, compared with 3.5-6.5% in 1997.

23 December The *Banca d'Italia* lowers its discount and fixed term advances (or lombard) rates by 0.75 percentage point to 5.5% and 7.0% respectively.

29 December The *Bank of Greece* reduces from 0.4 to 0.2% the daily surcharge to apply - in addition to the annual overdraft facility rate of 24% - to further increments in the debit balances on banks' current accounts with the central bank.

Other EMI publications[21]

"The single monetary policy in Stage Three - Specification of the operational framework", January 1997.

"Payment systems in the European Union - Addendum incorporating 1995 figures" ("Blue Book" addendum), January 1997.

"The single monetary policy in Stage Three - Elements of the monetary policy strategy of the ESCB", February 1997.

"EU securities settlement systems - Issues related to Stage Three of EMU", February 1997.

"Differences between national changeover scenarios and the potential need for harmonised action: Common policy messages", March 1997.

"Developments in EU payment systems in 1996", March 1997.[22]

"Recent developments in the use of the private ECU: statistical survey", April 1997.[23]

"European money and banking statistical methods 1996", April 1997.

"Annual Report 1996", April 1997.

"Common market standards for money market and foreign exchange transactions: Updated policy messages", July 1997.

"Selection and further development of the euro banknote designs", July 1997.

"The single monetary policy in Stage Three: General documentation on ESCB monetary policy instruments and procedures", September 1997.

"The European Monetary Institute", September 1997.

"Sponsoring by the ESCB of an overnight reference interest rate in Stage Three of EMU", September 1997.

"Second progress report on the TARGET project", September 1997.

"Provisional list of Monetary Financial Institutions as at December 1996", September 1997.

"Legal convergence in the Member States of the European Union - As at August 1997", October 1997.

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[21] *Since the beginning of 1997.*

[22] *A report relating to developments in 1995 was released in March 1996.*

[23] *The first edition of this annual review was published in February 1991.*

"Addendum to the provisional list of Monetary Financial Institutions. Money market funds as at December 1996", December 1997.

"European Union Balance of Payments (Capital and Financial Account) Statistical Methods", January 1998.

"Payment systems in the European Union - Addendum incorporating 1996 figures" ("Blue Book" addendum), January 1998.

"Standards for the use of Securities Settlement Systems in ESCB credit operations", January 1998.

"Final List of Monetary Financial Institutions", March 1998.

"Convergence Report - Report required by Article 109j of the Treaty establishing the European Community", March 1998.

"List of Monetary Financial Institutions - As at December 1997", April 1998.

"Money and Banking Statistics Sector Manual - Guidance for the statistical classification of customers", April 1998.

"Money and Banking Statistics Compilation Guide - Guidance provided to NCBs for the compilation of money and banking statistics for submission to the ECB", April 1998.[24]

"TARGET information brochure", May 1998

EMI's Web site: In January 1998 the EMI established a presence on the Internet's World Wide Web in order to facilitate the EMI's provision of information to the general public. The EMI's Web site (http://www.ecb.int) provides access to the texts of recent speeches and reports published by the EMI.

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[24] *Addressed to NCBs; available for information to other interested parties.*