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 March 1997.

Charts

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

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 the Report using the alphabetical order of the national languages.*

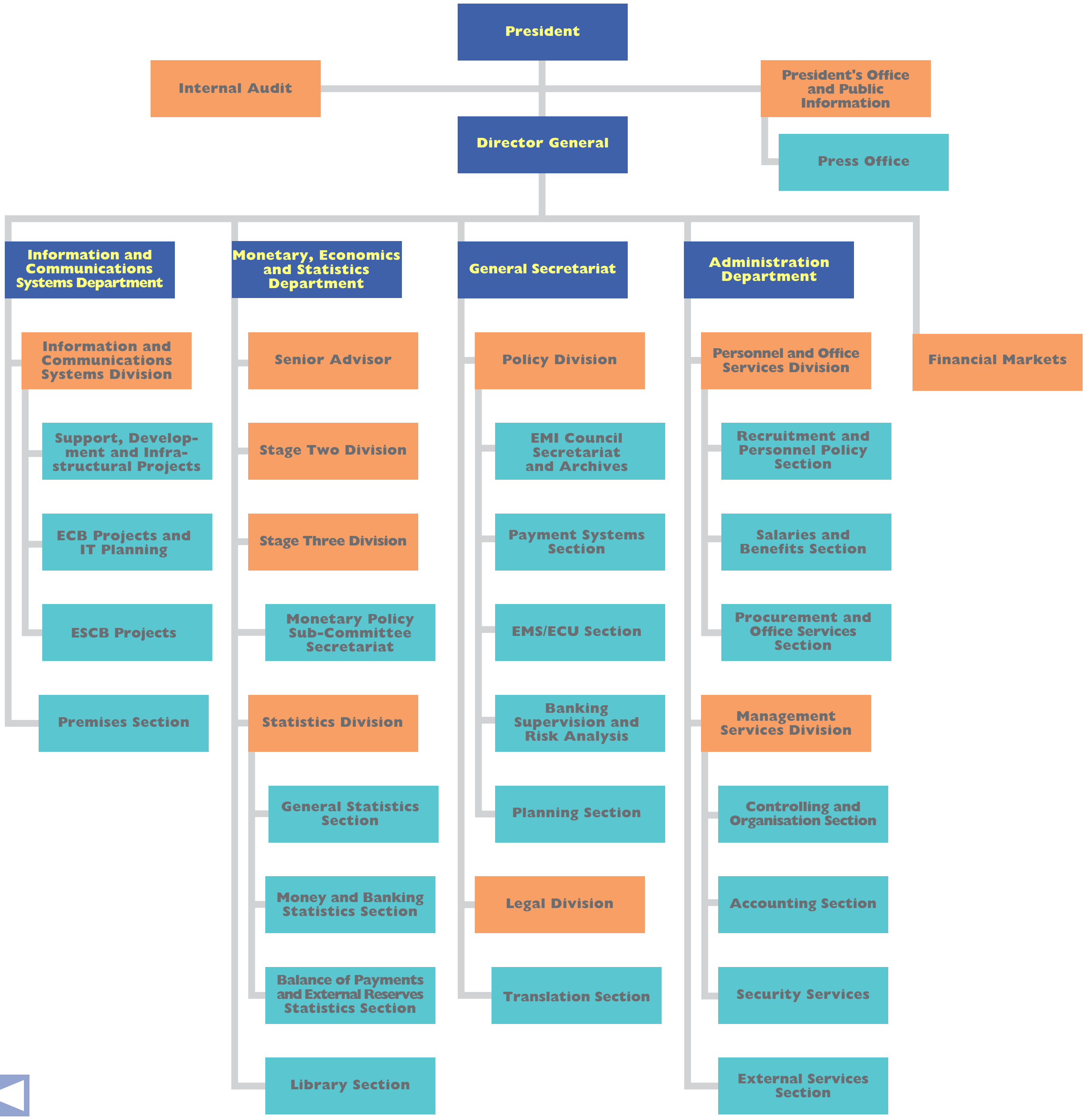
Back row (left to right): L. Papademos, P. Jaans, A. de Sousa, B. Andersen, S. Hämäläinen, W. Duisenberg, H. Tietmeyer, U. Bäckström, J.-C. Trichet, A. Verplaetse, K. Liebscher.

Front row: M. O'Connell, A. Fazio, A. Lamfalussy (President), L. Rojo (Vice-President), E. George.

Council of the EMI

A. Lamfalussy	*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*
M. O'Connell	*Central Bank of Ireland*
A. Fazio	*Banca d'Italia*
P. Jaans	*Institut Monétaire Luxembourgeois*
W. Duisenberg	*De Nederlandsche Bank*
K. Liebscher	*Oesterreichische Nationalbank*
A. de Sousa	*Banco de Portugal*
S. Hämäläinen	*Suomen Pankki*
U. Bäckström	*Sveriges Riksbank*
E. George	*Bank of England*

EUROPEAN MONETARY INSTITUTE



EMI Management

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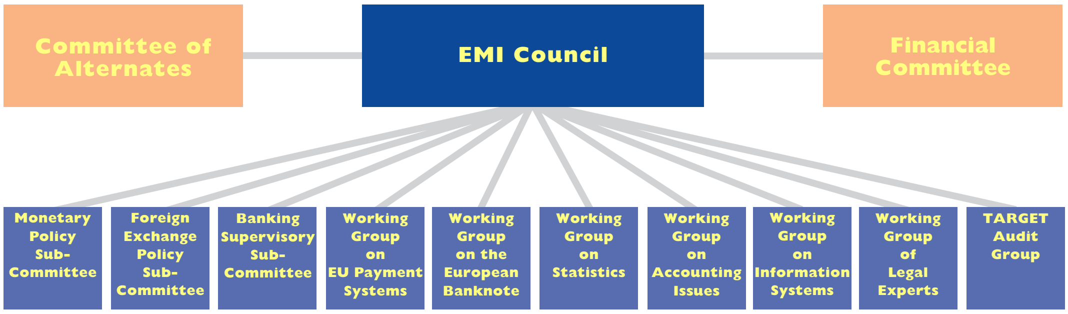
H. K. Scheller	*Secretary General,* *Head of General Secretariat*
G. J. Hogeweg	*Head of Monetary, Economics and* *Statistics Department*
P.-W. Schlüter	*Head of Administration Department*
J. Etherington	*Head of Information and Communications* *Systems Department*



Financial Committee

L. Rojo		*Banco de España*
P. Jaans	(until 31 August 1996)	*Institut Monétaire Luxembourgeois*
E. George	(as of 1 September 1996)	*Bank of England*
A. Fazio	(until 31 August 1996)	*Banca d'Italia*
J.-C. Trichet	(as of 1 September 1996)	*Banque de France*

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J.-J. Rey		*Monetary Policy Sub-Committee*
F. Saccomanni		*Foreign Exchange Policy Sub-Committee*
B. Quinn	(until 29 February 1996)	*Banking Supervisory Sub-Committee*
T. de Swaan	(as of 1 March 1996)	
W. Hartmann		*Working Group on EU Payment Systems*
A. Jarvis		*Working Group on Printing and Issuing a European Banknote*
K. Hanau		*Working Group on Statistics*
H. Heemskerk		*Working Group on Accounting Issues*
Y. Barroux		*Working Group on Information Systems*
J. Guill		*Working Group of Legal Experts*
M. Caparello	(as of 2 July 1996)	*TARGET Audit Group*

Foreword

The EMI's Annual Report for 1996 highlights, first, the monetary, economic and financial conditions in the Union, including the state of convergence; and second, the activities of the EMI, with particular focus on the progress made by the Institute in fulfilling its statutory obligation to undertake the necessary preparatory work for the start of Monetary Union.

I see grounds for cautious optimism concerning macroeconomic developments, although the risks and challenges should not be underestimated. An economic recovery is under way and seems set to continue, accompanied by relatively low rates of inflation. For the most part, EU foreign exchange markets have been moderately calm. Long-term interest rates are low, while differentials have narrowed appreciably, to a large extent reflecting the influence of economic fundamentals, although this trend has been reversed somewhat in a number of cases recently. Against the overall background of subdued inflationary pressures, and given the tightening of the fiscal stance, monetary policy has justifiably been eased further, although counter-inflationary vigilance remains essential.

Unemployment trends, however, are extremely worrisome; in my view, the recent record of the Union in terms of job creation is dismal. Employment has barely risen in the Union as a whole since the cyclical trough in 1993 - and projections envisage little improvement. This points to the crucial need for continued labour cost moderation and enhanced labour market reforms, for it is evident that the recovery of output growth alone will be insufficient to remedy deep-seated structural patterns of unemployment.

The EMI's report entitled "Progress towards convergence 1996", published in November, concluded that the majority of Member States did not fulfil the necessary conditions for the adoption of a single currency. A further report will be prepared in early 1998 for Monetary Union to start on 1 January 1999. It is extremely important that the economies of the Member States making up the Monetary Union should be convergent and capable of remaining so.

Clearly, progress has been made in respect of the convergence of inflation and bond yields, and exchange rate stability has been broadly maintained. In a welcome development, Finland and Italy are now ERM members. However, on the fiscal side, the situation remains far from satisfactory in many countries. Despite efforts aimed at consolidation, which have contributed to a reduction in actual deficits, the latter still overshoot the reference values laid down in the Treaty in most countries. Debt ratios have continued to rise in the aggregate, despite favourable trends in some Member States. In my view, the composition of consolidation continues to rely excessively on high revenue ratios and less than is desirable on expenditure cuts. Furthermore, sustainable consolidation cannot be achieved by one-off and accounting measures.

Turning to the activities of the EMI, I note with pleasure that considerable further progress has been made in preparatory work. In particular, the EMI met its statutory obligation to specify by end-1996 the regulatory, organisational and logistical framework for the ESCB to perform its tasks in Stage Three. Among the areas in which work has advanced, I would highlight the following:

- the EMI contributed to proposals for EU regulations on the introduction of the euro;
- the operational aspects of monetary policy, including instruments and procedures, have now been specified in some detail, while the factors underlying the eventual choice of strategy by the ECB in the Monetary Union have been outlined; the EMI also submitted to the EU Council draft recommendations for regulations on statistics, minimum reserves and sanctions;
- ERM II - the foreign exchange relationship to be established between the Monetary Union and Member States which are not participants - has been clarified;
- concerning the TARGET payment system, the EMI has addressed issues such as the operating time and the organisational framework;
- the EMI released a statement of statistical requirements to enable the ESCB to carry out its functions in Stage Three.

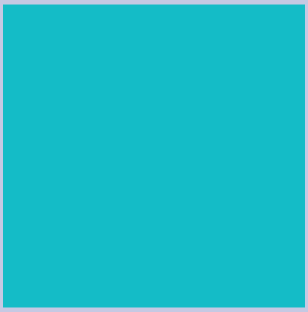
There are a large number of other areas in which work is being carried forward, including aspects of the foreign exchange reserve management of the ESCB; securities settlement systems; the preparation of euro banknotes; the harmonisation of accounting rules and standards for the ESCB and information and communications systems. Progress has also been made on certain legal and changeover-related items.

A great deal of work remains to be done in all of the areas mentioned above, notably the detailed specification of all the technical features of the various instruments and procedures, and more generally in respect of the implementation of the overall framework so that a single monetary policy can operate smoothly from the outset. This will undoubtedly reveal many further issues - but they can be overcome. The EMI is well on track to achieve its objective of ensuring that all the technical preparations are ready to allow Stage Three of EMU to start in 1999.

Frankfurt, 4th March 1997

Alexandre Lamfalussy

Alexandre Lamfalussy,
President



Executive summary

Executive summary

With this year's Annual Report, the European Monetary Institute (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 1996 and the activities of the EMI; it also presents the Institute's annual accounts. To a significant extent, the material presented in this year's Report draws on earlier, more extensive EMI publications, particularly the reports entitled "Progress towards convergence 1996" (November 1996) and "The single monetary policy in Stage Three - Specification of the operational framework" (January 1997). In addition, this Report is also considered as fulfilling the reporting obligations according to Article 7 of the EMI Statute, notwithstanding the intention of the Institute to publish further material later this year, particularly on the preparations of the procedures necessary for carrying out a single monetary policy in the third stage.

1 Economic, monetary and financial conditions in the European Union

Economic and financial background in 1996

Against the background of broadly favourable global economic developments, a moderate recovery of *GDP growth* got under way in the EU from the second quarter of 1996 onwards. In some countries growth may have been weaker in the fourth quarter, but this is not to be seen as a reversal of the underlying trend. The resumption of GDP growth in the course of the year was not, however, sufficient to offset the effects of the slowdown which began in late 1995 and continued into early 1996, so that growth for the year as a whole was markedly lower; real GDP growth in the EU is estimated to have been around 1.7% in 1996, compared with 2.5% in 1995. A key element of the weaker average performance of growth in 1996 was the subdued increase in fixed investment. In this respect, a durable pattern of growth, particularly one associated with an acceleration of investment across the Union, had not yet been clearly established by the end of 1996.

In parallel with moderate GDP growth, employment did not increase in most Member States. The *unemployment rate* for the EU as a whole fell slightly during mid-1996, but rose to just over 11% towards the end of the year. In the light of longer-term trends, it is clear that the bulk of EU unemployment is of a structural rather than of a cyclical nature; for several decades there has been a clear and unbroken trend rise in EU unemployment and a rather weak relationship between GDP growth, employment and unemployment. As a consequence, while some increase in employment can be expected as a result of GDP growth, in addition to continued wage moderation a reduction in structural rigidities in labour

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.*

(and product) markets is a sine qua non for the alleviation of the unemployment problem in the EU. In most countries labour market reforms still seem to be too marginal to significantly improve labour market trends. Even in countries where substantive measures have been undertaken, more time will be necessary for the effects of such reforms to be fully assessed.

Price developments have remained favourable. A crucial role has been played by an increased emphasis placed on medium-term-oriented monetary policies geared towards the achievement and maintenance of price stability. Moreover, the favourable price climate was supported by increased competition, both domestically as a result of privatisation and deregulation and internationally, partly related to European integration and, in some countries, to the effects of the opening-up of eastern Europe. As a result, inflation in the EU as a whole fell to an average of 2.6% in 1996. This compares favourably with the rate of 3.1% observed in 1995 and is also a major achievement in a historical context. Most Member States are currently enjoying inflation rates of close to or below 2%, and in others inflation rates are declining. In 1996 the reduction in inflation rates was also supported by slow growth in import prices and weaker domestic inflationary pressures, the latter linked to weak demand and low increases in unit labour costs in most Member States.

As regards *fiscal policies*, the stance in 1996 continued to be directed towards the need for consolidation, given persistently high general government deficit and debt ratios in most Member States. In the EU as a whole, fiscal deficits have continued to decline since their peak in 1993, but the average general government deficit-to-GDP ratio was still expected to stand well above 4% in 1996, thus remaining a matter of serious policy concern. The average debt ratio in the EU has increased steadily from below 60% in 1991 to well above 70% in 1996. Furthermore, whereas the momentum towards lower deficits continued in 1996, the composition of fiscal consolidation was a ground for concern from the perspective of the sustainability of developments in government expenditure and revenue. Whereas in 1994-95 some correction took place, which was reflected in falling deficit ratios mainly driven by expenditure restraint, in 1996 the momentum shifted away from cuts in expenditure and towards increases in revenues. Finally, also with a view to achieving durable consolidation, short-term or one-off measures, which are only effective in one year, which improve the current budgetary situation at the expense of future budgets, or which have mere presentational effects, cannot be regarded as contributing to sustainability.

Compared with *exchange rate developments* in previous years, relatively calm conditions prevailed within the Exchange Rate Mechanism (ERM). In particular, between the end of May and mid-October 1996, the bilateral exchange rates between the participating currencies remained within relatively narrow bands, and exchange rate volatility declined significantly compared with 1995. In addition, two further currencies joined the ERM in 1996: the Finnish markka with effect from 14 October and the Italian lira on 25 November. Developments in currencies not participating in the ERM followed a broadly common pattern of appreciation until the autumn of 1996; thereafter the pound sterling experienced stronger upward pressure while other currencies remained broadly stable. Overall, when measured in terms of real effective exchange rates, many EU currencies may be considered to have moved towards exchange rate levels that are more sustainable with respect to underlying competitive positions.

Against the backdrop of these trends, *long-term interest rates* declined over the course of 1996 in all Member States, with the exception of the United Kingdom, which was in a different cyclical position. Moreover, long-term interest rate differentials against countries with the lowest bond yields narrowed significantly. A combination of factors appears to account for this trend, including a significant reduction in expected inflation differentials within the EU, perceptions of progress towards fiscal consolidation, the relative stability of exchange rates and a decrease in political uncertainty in a number of countries. These factors were seen by the markets as improving the prospects for Economic and Monetary Union (EMU) - an element which may in turn have played an independent role in the narrowing of differentials, both directly and by further improving prospects for exchange rate stability.

Monetary policies in Member States

The economic and financial environment in 1996 allowed for a further steady but cautious easing of *monetary policies* via reductions in official and key interest rates in most EU countries. On balance, in the majority of Member States (namely Belgium/Luxembourg, Denmark, Germany, France, the Netherlands, Austria, Finland and Sweden) official and key interest rates declined to low and very similar levels. The convergence of short-term interest rates and inflation rates in 1996, in conjunction with the achievement of a high degree of exchange rate stability, suggests the emergence of a closely aligned stance of monetary policies among these EU countries. In most of the remaining EU countries economic and exchange rate conditions in 1996 gradually became more supportive of an easing of monetary policies. As a result, their short-term interest rate differentials against the Deutsche Mark narrowed considerably. This led to a progressive convergence of the more differentiated monetary policy stance which had been warranted for much of 1995 to counter rising inflationary pressures and/or renewed exchange rate turbulence in some EU countries. The exceptions were Ireland, which, later in the year, chose to adopt a more strict monetary stance, and the United Kingdom, which raised official interest rates in the second half of 1996.

Economic prospects and challenges for convergence

As regards *economic prospects for 1997*, the conjunctural outlook is more favourable, while the need for structural adjustment persists. GDP growth in the European Union is expected to pick up in 1997, whereas the situation in labour markets is forecast to remain highly unsatisfactory in most Member States. It is in this field that a wide range of institutional rigidities account for the weak performance, and it will be a major challenge for most Member States to tackle them in a decisive and sustained manner.

With regard to the *state of convergence*, in November 1996 a comprehensive report entitled "Progress towards convergence 1996" was released by the EMI. The material presented in this Report mainly provides a brief update of the examination related to 1996. Little new data have become available since then; in particular, no new Commission data for the outcome of fiscal policies in 1996 are yet available.

Prospects for sustained low inflation in the EU are rather favourable although upward risks still remain, as is evidenced by significant increases in unit labour costs in some countries. Against the background of fiscal positions in 1996, many governments have taken initiatives to strengthen their consolidation efforts with a view to the outcome in 1997. It is too early to judge the effect these measures will have on outturns in 1997 and beyond. However, in general, more and durable progress is needed in order to ensure sustainable fiscal positions. If present assumptions about the improved conjunctural outlook turn out to be well founded, the necessary continuation and strengthening of structural adjustments should be facilitated. At the same time, the temptation to relax adjustment efforts in the light of seemingly diminishing constraints must be avoided at all costs. In a broader context, the decisive achievement of government objectives can make a major contribution to the reduction of risks linked to the state of public finances. In particular, there is a link between sustainable fiscal adjustment and an improvement of growth perspectives over the medium term which justifies viewing consolidation efforts not only against the background of the requirements of the convergence criteria, but also as necessary in themselves. Further progress will also contribute to sustaining exchange rate stability and the convergence of bond yields, whereas setbacks in the consolidation of public finances or other factors that may reduce confidence in the EMU process may negatively affect financial markets.

As the deadlines for moving to Stage Three approach, the essential requirement of achieving a high degree of sustainable convergence will have to be fulfilled. This is all the more important since agents are starting to look beyond the year 1999 and to form expectations about likely longer-term developments in the euro area. At stake is the macroeconomic environment in which the European Central Bank (ECB) will have to take its first steps in ensuring price stability.

These considerations make it all the more essential that monetary policies remain vigilant with a view to ensuring price stability. The stance adopted in the period ahead will be particularly important in that it will increasingly affect inflation in 1999 and thereafter, and hence price expectations for the euro area. As regards budgetary policies, it must be kept in mind that the necessary strict compliance with the fiscal criteria also implies ensuring the sustainability of government financial positions as a precondition for the adoption of the single currency. As agreed by the European Council in Dublin in December 1996, the maintenance of sound budgetary positions in Stage Three will take place within the framework of the Stability and Growth Pact. The paramount importance of sustainable budgetary positions also stems from the future burden which will arise from the interaction between interest payments on the accumulated debt stocks, high and persistent unemployment, and demographic trends. Finally, exchange rate stability remains an element in judging the degree of sustainable convergence both before and after 1999. As part of the future monetary and exchange rate policy co-operation between the euro area and non-participating EU countries, a new exchange rate mechanism (ERM II) will be established. Membership will be voluntary; nevertheless, EU Member States with a derogation can be expected to join the mechanism.

2 Preparatory work for Stage Three

In 1996 the EMI made further progress in preparing the ground for the European System of Central Banks (ESCB) to be able to perform its tasks from the start of Stage Three. This involved continuing preparatory work in the areas of monetary policy, foreign exchange policy, statistics, payment systems, issuing banknotes, accounting rules and standards, information systems, and also on legal issues. The EMI has also continued to monitor progress in the preparatory work for the introduction of the euro, following the adoption of the changeover scenario by the European Council in Madrid in December 1995.

Monetary policy

In publishing its report on 'The single monetary policy in Stage Three - Specification of the operational framework" in January 1997, the EMI provided the public and the counterparties of the national central banks (NCBs) with information of interest regarding the operational aspects of monetary policy. The EMI's preparatory work on the single monetary policy is progressing according to schedule and the conceptual phase has been concluded for all the main issues of relevance. The list of potential candidate strategies for monetary policy in Stage Three has been narrowed down to two: monetary targeting and direct inflation targeting. The EMI Council has also 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: a marginal lending facility and a deposit facility. In addition, preparations are being made for an infrastructure allowing the ECB to impose minimum reserve requirements if it wishes to do so. In order to secure a single monetary policy stance and a level playing-field for counterparties across the whole of the euro area, the EMI has worked out common eligibility criteria, both for the counterparties and for the assets to be used in their operations with the ESCB. No technical preparations are being undertaken at this stage for remote access to monetary policy operations.

In the course of 1997 the EMI intends to publish further material relating to the specification of the ESCB's operational framework for the conduct of the single monetary policy and to the fields of monetary policy strategy, monetary policy instruments and procedures, the TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) system and securities settlement systems.

Foreign exchange policy

In the area of foreign exchange policy, the broad lines of the future exchange rate relationships between the euro area and non-participating Member States were defined in 1996. The EMI's report on this issue was forwarded by the ECOFIN Council to the Dublin meeting of the European Council in December 1996, at which it was endorsed. The European Council invited the ECOFIN Council to prepare a draft Resolution for the European Council meeting to be held in Amsterdam in June 1997 setting out the fundamental elements of the new exchange rate mechanism (ERM II). The EMI has been invited to prepare, in parallel, a draft agreement between central banks for submission to the ECB and to the central banks of the Member States not forming part of the euro area. Preparatory work is also being conducted by the EMI and the NCBs to ensure that the ESCB will be in a position to avail itself of the two basic organisational arrangements - centralisation and decentralisation - for the conduct of its foreign exchange operations. Further preparation is under way to ensure that the ECB will be in a position to set the foreign reserve management policy and to monitor its implementation from the start of Stage Three.

Statistics

With regard to statistics, the EMI, where appropriate in consultation with the European Commission, has prepared a statement of statistical requirements for

Stage Three. These requirements were set out in a detailed document which the EMI released in July 1996 for the use of banking associations and others involved in statistical preparations, and were summarised for more general use in an explanatory booklet published at the same time. Since statistical preparations take a long time, Member States have been strongly encouraged to begin implementation promptly. The statistical information needed for the conduct of policy in Stage Three will be wide-ranging. While much of the statistical information is already available at the national level, the compilation of aggregates covering the euro area will raise questions of harmonisation and consolidation. The statistical requirements will have to be met by participating Member States in time for the start of Stage Three on 1 January 1999; some data, which should be as harmonised as possible, will be needed well in advance of the start of Stage Three.

Payment systems

In the field of payment systems, the EMI's "First progress report on the TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) project", which was released in August 1996, provided additional information on the organisational features of the system. To avoid impediments to the efficient conduct of the single monetary policy, a certain degree of harmonisation of the features of the national RTGS (Real-Time Gross Settlement) systems within the euro area will be ensured with respect to the provision of intraday liquidity, operating time and pricing policy. As part of the work to establish instruments and procedures for the single monetary policy and to ensure the smooth functioning of payment systems in Stage Three, the EMI assessed the adequacy of securities settlement systems and of their linkages with payment systems. The main conclusions are contained in the EMI's report entitled "EU securities settlement systems – Issues related to Stage Three of EMU", released in February 1997.

Preparation of euro banknotes

The EMI launched a euro banknote design competition in February 1996 which ran until mid-September. In December the EMI Council selected one of ten shortlisted design series, taking into account in particular the advice of an international jury comprising renowned experts in marketing, design and art history and the results of a public consultation exercise carried out in fourteen Member States. The President of the EMI informed the European Council at its December meeting in Dublin of the EMI Council's selection. The EMI is currently carrying out the work of developing the design sketches into the final designs. This includes working with the designer to facilitate the banknote production and to ensure that all requirements are met, for example the avoidance of national bias and the incorporation of security features. Thereafter, further preparations will be undertaken with respect to the production process, including the preparation of printing plates.

Accounting issues

In 1996 the EMI Council approved the accounting principles for the financial reporting of the ESCB. Application of these accounting principles will be mandatory for all items material to the operations of the ESCB, for all items of the ECB's financial statements, and for the calculation of monetary income. Nevertheless, NCBs might continue to draw up and publish their financial statements according to their own accounting rules. Work is under way to develop the necessary techniques so that individual NCBs and the ECB can adapt their accounting procedures and systems to comply with the chosen accounting principles, and the ESCB's reporting framework is to be elaborated upon. Work is also in progress on the development of an appropriate method for the determination of the income arising from the performance of the ESCB's monetary policy function.

Information and communications systems

In the field of information and communications systems, the EMI Council approved a technical solution for providing secure high-capacity teleconference services for the ESCB, and has been investigating the best way of extending the teleconference system beyond the ESCB, in particular to the non-EU central banks participating in the "Concertation Group". Agreement has also been reached on the main choices for the communications infrastructure linking the ECB with the NCBs, the specifications of which are being elaborated. The infrastructure is planned to be put in place towards the end of 1997 in order to allow testing to commence shortly thereafter. On the applications side, specification work reached a stage that should allow development of the necessary information systems support for the conduct of decentralised monetary policy open market operations, as well as to enable the monitoring of decentralised monetary policy interventions based on bilateral procedures and of foreign exchange interventions to be carried out from the start of Stage Three.

Banking supervision

Prudential supervision in Stage Three will remain a competence of the national authorities and the supervisory framework laid down at the EU level will not be altered. The preparatory work of the EMI in this field aims to identify the possible ways in which Article 105 (5) of the Treaty and Article 25 (1) of the ESCB/ECB Statute could be implemented as well as to make a preliminary assessment of how the ECB could define its position in respect of the provision under Article 105 (6) of the Treaty.

Legal issues

In the legal field, in June 1996 the EMI transmitted to the Commission elements for secondary legislation governing the introduction of the euro. Commission proposals for two EU Council Regulations were endorsed in principle by the European Council in December 1996. One Council Regulation deals, inter alia, with the one-to-one replacement of the ECU (European Currency Unit) by the euro, the continuity of contracts and technical rules for the conversion rates, including rounding. The second addresses matters such as the substitution of the euro for the currencies of the participating Member States, transitional provisions with respect to the national currency units and the issue of banknotes and coins. The EMI also formulated recommendations for secondary Community legislation relating to statistical information, minimum reserves and sanctions, and developed a list of features of central bank independence to help guide national legislators when adapting their respective NCB's statute. 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, needed to be adapted. Further adaptations of national legislation which may be required in preparation for Stage Three, particularly with regard to the integration of NCBs in the ESCB and legislation other than the statutes of NCBs, are under consideration and the EMI will refer to this issue in future reports.

Changeover to the euro

The EMI has continued to monitor progress in the preparatory work for the introduction of the euro, following the adoption of the changeover scenario by the European Council at its meeting in Madrid in December 1995. The EMI provides a forum for the exchange of information between central banks on four main topics: NCBs' internal preparatory work for the establishment of the ESCB; changeover preparations by financial market participants; euro-related activities performed by the public authorities; and the provision of information on the changeover to the general public. Taking into account the national specificities in financial markets and banking structures, the NCBs constitute the main channel of dialogue regarding the latter three areas between the monetary authorities and financial market participants. Furthermore, there is an ongoing exchange of views between the EMI, in co-operation with the NCBs, and the banking and financial community to assess the need for co-ordination at the EU level concerning the process of the changeover to the single currency.

3 Other tasks of the EMI

Central bank co-operation in the field of payment systems

The EMI has continued to facilitate co-operation between the EU central banks in three major areas of payment systems: remote access; standardisation; and electronic money. These issues are analysed in the EMI's report on "Developments in EU payment systems in 1996", also due to be released in April 1997.

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. In this respect, the most important reforms implemented in 1996 were the establishment of a system of binding intraday limits on the multilateral net position which a participant is allowed to incur at any moment during the clearing process and the revision of membership and exit criteria. The EBA (ECU Banking Association) has requested advice from external legal counsel to develop a legal structure which would provide the System with a sound and enforceable legal basis and which would also be suitable for Stage Three. The EBA also started discussions with the EMI on issues related to the settlement of the System via TARGET in Stage Three.

Co-operation in the field of banking supervision

Consultations among banking supervisory authorities focused on three topics. First, the issue of credit institutions' internal control systems was analysed in depth with the aim of identifying elements which could assist banking supervisors and other interested parties in assessing the features and effectiveness of these systems. Second, an analysis of the methods used by EU banking supervisors to detect, at an early stage, financially fragile credit institutions showed that there are no fundamental differences in the basic approach to early warning methods. Third, co-operation among the central credit registers currently existing in seven Member States continued with the main objective of opening up the registers on a cross-border basis in order to grant reporting institutions access to the data stored in them.

Administration of EMS mechanisms and Community loans

Since both Finland and Italy had already been participating in the swap mechanism on a voluntary basis, the Finnish markka's entry and the Italian lira's resumed participation in the ERM during the autumn had no impact on the EMI's ECU swap operations. In 1996 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 capital, interest, commission and expenses on outstanding loans.

Advisory functions

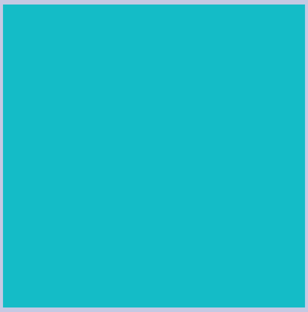
Article 109f (6) of the Treaty and Article 5.3 of the EMI Statute require that the EMI be consulted by the Council of the European Union or the responsible national authorities, as appropriate, on any proposed Community or national legislation within its field of competence. Sixteen requests for consultations were received in 1996. Six came from the Council of the European Union, three were received from the European Commission and seven originated from national authorities.

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

The EMI's regular monitoring procedure suggested that the Treaty requirements continued to be respected by the EU central banks. 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 in the course of 1996 and at the beginning of 1997.

Co-operation with other institutions

The EMI has continued to co-operate closely with other bodies of the European Union in a number of forms and at a number of levels. With regard to contacts with institutions outside the Community, the "concertation procedure" has remained a valuable forum for exchanging data among central bank foreign exchange experts. Working relationships have also been retained with the Bank for International Settlements, the IMF and the World Bank. The EMI has also established relationships with the central banks of the associated Central and Eastern European countries (CEECs) and other applicant countries.



Chapter I

Economic, monetary and financial conditions in the European Union

1 Economic and financial background in 1996

1.1 Major developments outside the EU

Favourable external climate

Global economic developments were broadly favourable in 1996. According to the latest data available from international organisations, real GDP in countries outside the EU is estimated to have expanded by just over 4%, compared with around 3½% in 1995. Inflationary pressures in industrialised countries remained subdued; a rise in oil prices was partly compensated by a slight decline in non-oil commodity prices. World import growth decelerated somewhat from the rate of 11% seen in 1995, but remained rather buoyant at 8% (see also Box 1).

In the United States GDP growth in 1996 was robust (see Chart 1), owing largely to buoyant private consumption, while unemployment reached a historical low of slightly above 5%. At the same time, CPI inflation remained at 3%. In Japan GDP growth was rapid in the first half of the year, but the pace of recovery slowed thereafter. CPI inflation in Japan was virtually zero, and there were no signs of inflationary pressures. Growth was also positive in most other industrialised countries outside the Union. An exception was Switzerland, where output declined as a consequence of the sharp appreciation of the Swiss franc.

In the South-East Asian economies GDP growth continued to be rapid: at around 7½% it was only slightly lower than in 1995. In Central and Eastern European countries (CEECs) developments differed. While several countries continued to experience rapid growth rates (in particular Poland, the Czech Republic and the Slovak Republic), activity increased more modestly in others and declined in Bulgaria. Average growth in all CEECs is estimated to have been just below 4%. In contrast, the Commonwealth of Independent States (CIS) experienced a further decline in output of around 1%. Growth in countries in Latin America was over 3% and in Africa around 4½%.

Global bond markets adjust to changing expectations

Bond yield movements in major international markets largely reflected expectations about underlying economic developments. Yields on 10-year US bonds rose from 5.6% at the end of 1995 to a peak of 7.1% in July, due inter alia to a concern that inflationary tensions might shortly increase. The buoyant growth of US employment was particularly influential in this regard. However, this rise in yields turned out to be only temporary as it became evident that inflationary pressures in the United States remained subdued, and yields declined gradually to stand at 6.4% at year-end. In Japan both short-term and long-term interest rates remained at historically low levels during 1996. The 10-year bond yield rose from 2.9% at the end of 1995 to 3.4% at end-February as the recovery gathered pace. Thereafter, yields fluctuated around 3.3% until end-July and then declined gradually to 2.6% at year-end as the Japanese economic recovery faltered and interest rate expectations were revised downwards accordingly.

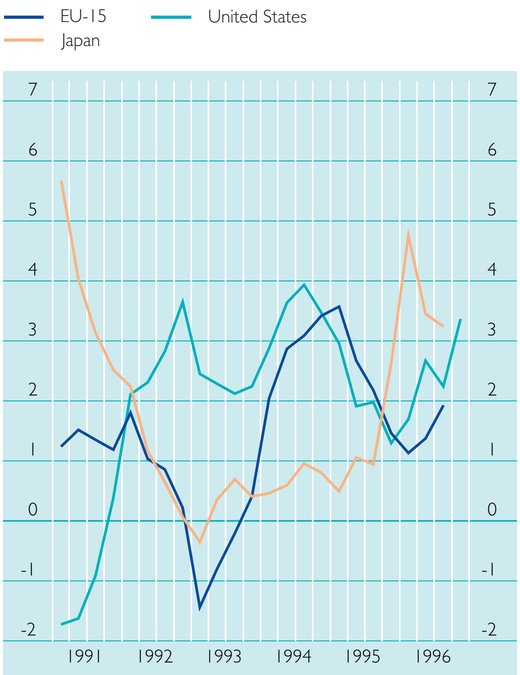
Relatively calm foreign exchange markets

During 1996 global exchange rate developments were characterised by a recovery of the US dollar, while the average day-to-day volatility of the US dollar/Deutsche Mark exchange rate was very low by historical standards. Against the

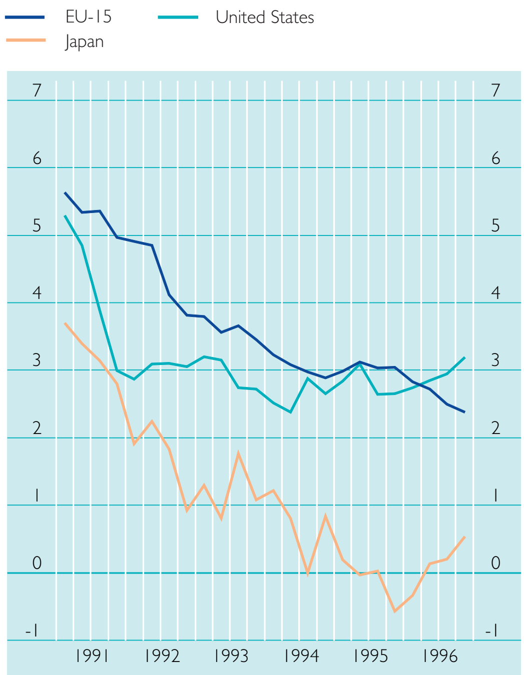
Chart 1

Main developments in major industrialised economies

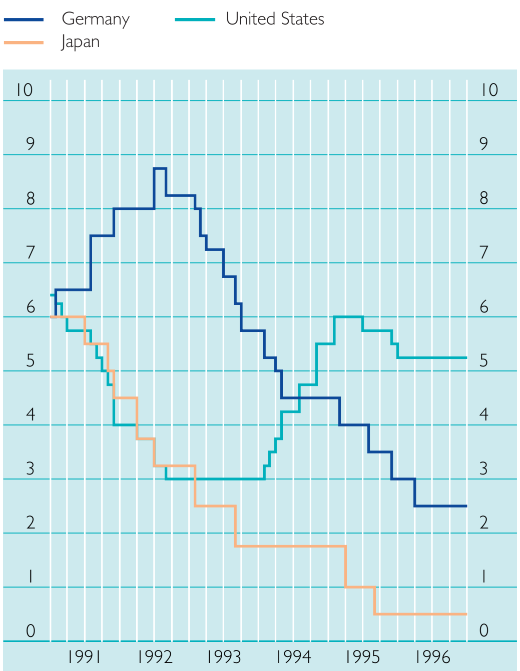
Output growth
(quarterly data; annual percentage changes)



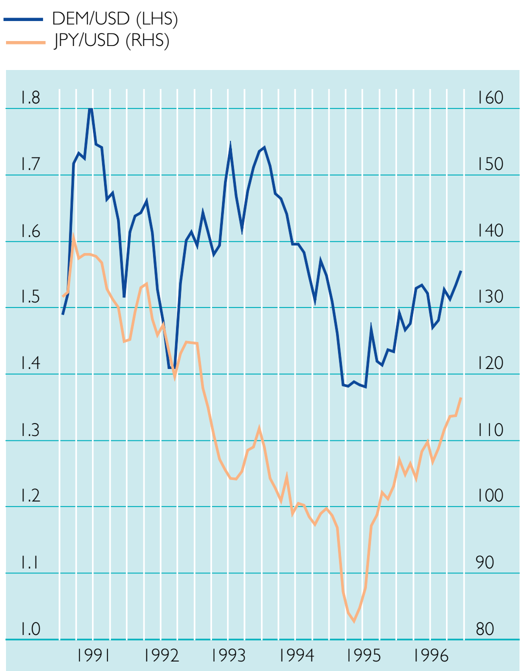
Inflation rates(a)
(quarterly data; annual percentage changes)



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



Exchange rates(c)
(end-month data)



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.

Deutsche Mark, the US dollar appreciated from DEM 1.43 in early January to a high of DEM 1.55 in late May, before falling at end-July to a level of around DEM 1.48 and recovering later in the year. At the end of 1996 the dollar stood at DEM 1.55, i.e. 8.4% above the end-1995 level. The US dollar also recovered vis-à-vis the Japanese yen, rising from JPY 105 at the beginning of the year to JPY 116 at year-end, 10.5% above the end-1995 level. An underlying reason for the dollar's appreciation was market expectations of a widening of positive short-term interest rate differentials vis-à-vis the Deutsche Mark and the Japanese yen.

Changes in nominal effective exchange rates of the three currencies were less pronounced than changes in their bilateral rates. During the year the nominal effective exchange rate of the US dollar against twenty-six trading partners appreciated by 4%, whereas that of the Japanese yen depreciated by 9% and that of the Deutsche Mark by 4%.

Box 1

Trends in the geographical allocation of EU exports of goods

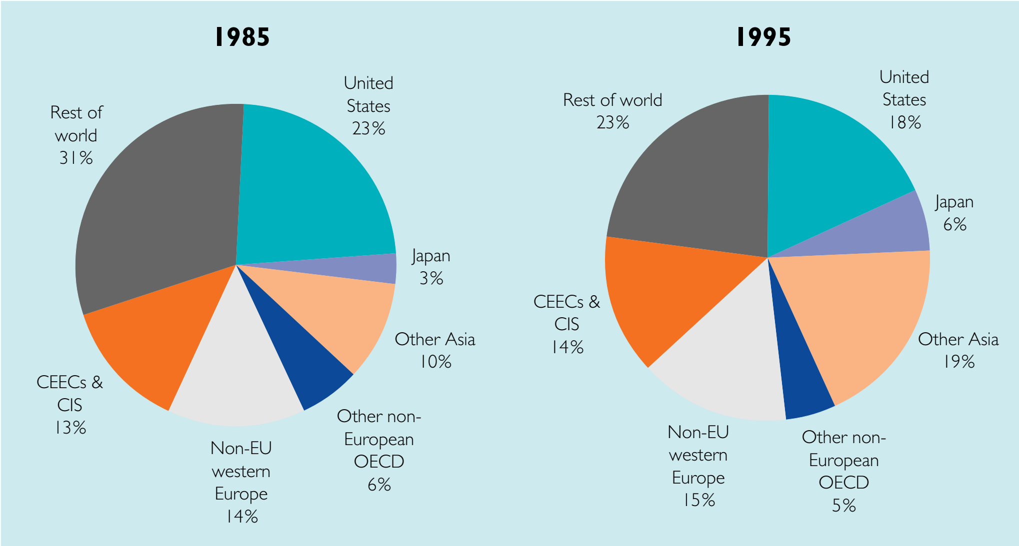
International trade is a key channel for the transmission of real economic impulses, and consequently its geographical distribution determines the benefit the EU may expect to gain from patterns of growth in the rest of the world. In this context, the chart below shows the geographical allocation of EU exports in value terms in 1985 and 1995 - the most recent date for which comprehensive figures are available. In general it should be noted that the geographical distribution of exports should be interpreted with caution as it may also change over time due to changes in real exchange rates.

According to the IMF Direction of Trade Statistics, total exports of goods of the fifteen Member States in 1995 are estimated to be valued at around USD 1,900 billion, representing 23% of EU-15 GDP. Extra-EU exports amounting to 38% of total EU exports or 9% of EU-15 GDP were distributed between the United States (18%); Japan (6%); other Asian countries (excluding Japan, including China) (19%); other non-European OECD countries (5%); non-EU western European countries (mainly Norway and Switzerland) (15%); Central and Eastern European countries (CEECs) and the Commonwealth of Independent States (CIS) (14%); and the "rest of the world" (23%) (see chart below).

Compared with 1985 the proportion of extra-EU exports directed to the United States, other non-European OECD countries and the "rest of the world" has declined. In contrast, the proportion of extra-EU exports to Japan and other Asian countries increased by 3 and 9 percentage points respectively. Over the period considered, both high real GDP growth and increased openness in other Asian countries have in themselves contributed to high world trade growth as well as to the increased importance of this area as a market for the EU. For example, its GDP is estimated to have grown by 109%, or almost 8% a year on average between 1985 and 1995, compared with a world-wide average of 40%, or just over 3% annually. The openness of other Asian countries also increased substantially, whereas elsewhere openness, on average, remained broadly unchanged.

Although the EU is a relatively closed area (i.e. extra-EU exports are a relatively small percentage of GDP), it nevertheless benefits in terms of exports from the growth of dynamic markets elsewhere in the world. In this respect, over the period 1985-95, the EU-15 total share in world trade (measured by the share of imports supplied by EU countries in total world imports, in value terms) declined slightly from 38% to 37%, whereas its *extra*-EU share declined from just under 16% in 1985 to around 14% in 1995, partly offset by an increase in the *intra*-EU trade share. The EU increased its share of Japanese imports (from 8% in 1985 to 14% in 1995), of imports by non-EU western European countries (from 40% to 70%) and of imports by the CEECs and CIS (from 36% to 51%). It maintained its share of imports by other Asian countries (15%) and of the "rest of the world" (around 42%), while its share of imports by the United States declined (from 22% to 18%) as did that by other non-European OECD countries (from 16% to 13%).

Geographical allocation of EU-15 exports of goods, 1985 and 1995



Source: IMF, Direction of Trade Statistics, December 1992 and December 1996.

1.2 Macroeconomic developments in the EU

Resumption of GDP growth during the year

Although the slowdown in the EU which began in late 1995 continued into early 1996, a moderate recovery got under way from the second quarter onwards. In some countries growth may have been weaker in the fourth quarter, but this is not to be seen as a reversal of the underlying trend. The resumption of growth in the course of the year was not, however, sufficient to offset the effects of the slowdown on average growth in 1996. Consequently, real GDP growth in the EU is estimated to have been around 1.7% in 1996 as a whole, i.e. markedly lower than its 1995 level of 2.5%. This general pattern of lower average growth in 1996 was reflected in most EU countries. Only Greece, the Netherlands and Portugal recorded higher growth in 1996 than in 1995. Although Ireland showed lower growth in 1996, at just above 7% the rate nevertheless remained well above that of the EU average (see Table 1).

The factors underlying the recovery included a reversal of previous developments which had dampened activity in the second half of 1995. In particular, the process of inventory adjustment was gradually completed in most countries, economic expansion in

Table 1

Recent developments in real GDP growth

(percentage changes)

	Annual rates[a]								Quarterly rates[b]				
	1994	1995	1996[c]	1995	1996				1995	1996			
				Q4	Q1	Q2	Q3	Q4	Q4	Q1	Q2	Q3	Q4
Belgium	2.3	1.9	1.4	0.7	0.6	1.8	1.9	.	0.5	0.4	0.9	0.1	.
Denmark	4.2	2.7	2.2	1.5	1.0	2.3	2.7	.	-0.2	0.7	1.1	1.0	.
Germany	2.9	1.9	1.4	1.0	0.2	1.2	2.4	1.8	0.1	-0.4	1.5	0.8	-0.2
Greece	1.5	2.0	2.6	-	-	-	-	-	-	-	-	-	-
Spain	2.1	2.8	2.2	2.2	2.0	2.0	2.2	.	0.4	0.6	0.6	0.6	.
France	2.8	2.2	1.3	0.4	1.1	0.8	1.4	.	-0.5	1.2	-0.2	0.9	.
Ireland	6.5	10.3	7.3	-	-	-	-	-	-	-	-	-	-
Italy	2.1	3.0	0.8	2.3	1.2	0.7	0.7	.	0.1	0.5	-0.4	0.6	.
Luxembourg	3.4	3.7	2.4	.	.	.	.	.	.	.	.	.	.
Netherlands	3.4	2.1	2.8	1.7	1.4	3.1	3.0	.	0.6	0.1	1.6	0.6	.
Austria	3.0	1.8	0.9	0.3	.	.	.	.	-0.4	.	.	.	.
Portugal	0.7	2.3	3.1	-	-	-	-	-	-	-	-	-	-
Finland	4.5	4.5	3.2	2.4	1.3	1.6	3.8	.	0.1	0.8	0.8	2.1	.
Sweden	3.3	3.6	1.2	2.2	1.7	0.7	1.4	.	-0.0	-0.4	0.5	0.7	.
United Kingdom	4.0	2.6	2.3	1.9	2.1	2.3	2.4	2.6	0.5	0.6	0.6	0.7	0.8
EU-15	2.9	2.5	1.7	1.5	1.1	1.4	1.9	.	0.1	0.4	0.6	0.7	.

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.

North America accelerated and exchange rates within the EU reverted smoothly towards the patterns prevailing prior to the turbulence of 1995. Moreover, inflationary prospects allowed an easing of monetary conditions and bond yields declined further. Reflecting these developments, industrial confidence started to recover in most Member States after having fallen sharply during 1995 and early 1996. On the other hand, improvements in consumer confidence were more limited and were restricted to a smaller number of EU countries.

Private consumption relatively resilient, investment growth more subdued

Slower growth in 1996 for the EU as a whole almost entirely reflected a more subdued growth rate of domestic demand than in 1995, especially in the case of fixed investment (see Table 2). The contribution of net exports remained small. Nevertheless, during the course of the year, domestic demand growth and net exports gradually improved in most EU countries. The main exception was Italy, where the expectation of further fiscal consolidation and the appreciation of the lira continued to dampen consumption and net exports respectively.

Low growth of real household disposable income, the effects on consumer confidence of the persistence of high, and in a number of countries rising, unemployment, as well as the uncertainties with respect to the scope and speed of fiscal consolidation, appear to have been among the main factors restraining the growth of private consumption. Nevertheless, over the year as a whole, private consumption strengthened modestly across the Union to reach an average growth rate of around 1.9%, similar to the increase in 1995. Consumption grew at rates well above the EU average in Denmark, Greece, France, Ireland, the Netherlands, Portugal, Finland and the United Kingdom.

Government consumption increased in 1996 by around 1.2% in the Union as a whole, a rate close to that observed in 1995; this subdued growth rate reflected the efforts of fiscal authorities to restrain spending in the light of the need for fiscal consolidation (see Section 1.4). Growth was negative in Italy and Sweden, while in Germany and Finland general government consumption rose by almost 3%.

A key element in the weaker average performance of growth in 1996 was the

Table 2

Composition of growth in the EU in 1996*
(annual percentage change)

	Real GDP	Domestic demand	Consumption: Private	Consumption: General government	Fixed invest-ment	Stock changes[a]	Trade: Exports	Trade: Imports
Belgium	1.4	1.4	1.3	1.2	2.4	-0.1	4.4	4.6
Denmark	2.2	2.2	2.8	2.0	6.9	-0.9	1.8	1.8
Germany	1.4	0.7	1.4	2.8	-0.7	0.5	4.6	2.0
Greece	2.6	3.6	2.2	1.7	9.9	1.7	2.2	6.4
Spain	2.2	1.8	2.0	1.0	1.0	0.3	8.5	6.9
France	1.3	0.9	2.3	1.5	-0.6	-0.8	3.6	2.2
Ireland	7.3	6.3	6.0	2.0	9.0	0.6	11.3	10.8
Italy	0.8	0.2	0.7	-0.8	1.7	-0.3	0.5	-2.7
Luxembourg	2.4	4.4	2.1	2.0	5.9	0.5	2.1	3.3
Netherlands	2.8	2.3	2.3	1.3	3.5	0.0	4.4	4.3
Austria	0.9	0.7	0.8	0.0	1.0	1.3	3.3	2.4
Portugal	3.1	3.0	2.7	0.7	6.7	-0.2	7.7	6.5
Finland	3.2	3.5	3.5	2.9	5.3	0.0	3.8	4.9
Sweden	1.2	0.5	1.5	-2.0	7.4	-1.1	5.2	3.4
United Kingdom	2.3	2.6	2.9	1.1	4.2	-0.2	6.0	7.1
EU-15[b]	1.7	1.3	1.9	1.2	1.7	-0.1	4.3	3.0
Memo item:								
EU-15[b] (1995)	2.5	2.2	1.8	1.0	3.6	0.5	7.5	6.8

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.

subdued increase in fixed investment, which amounted to only 1.7% for the EU as a whole, despite widespread and sizable reductions in long-term interest rates. In this respect, a durable pattern of growth, particularly one associated with an acceleration of investment across the Union, had not yet been clearly established by the end of 1996. However, there was also considerable variation across Member States; investment rose more strongly than in 1995 in Greece, Luxembourg, Portugal and the United Kingdom. In these countries more favourable expectations of growth and relatively high capacity utilisation rates were important underlying factors. In other EU countries investment rose more slowly than in the previous year; it actually declined in Germany and France. In France this appeared to be largely related to subdued growth expectations, while in Germany the end of the housing boom and uncertainties related to the fiscal and structural adjustment process seem to have played a role.

Export growth of EU countries in 1996 was 4.3% on average and on a year-on-year basis, considerably lower than in 1995. This reflected weaker growth in demand from major trading partners within the Union, offsetting the favourable impact of external demand (see also Section 1.1 above). The rise in imports amounted, on average, to around 3.0%. European Commission figures suggest that the EU current account balance, which was already in surplus in 1995, increased slightly in 1996 (see Table 3).

Table 3

Trade and current account balances in the EU*

(as a percentage of GDP)

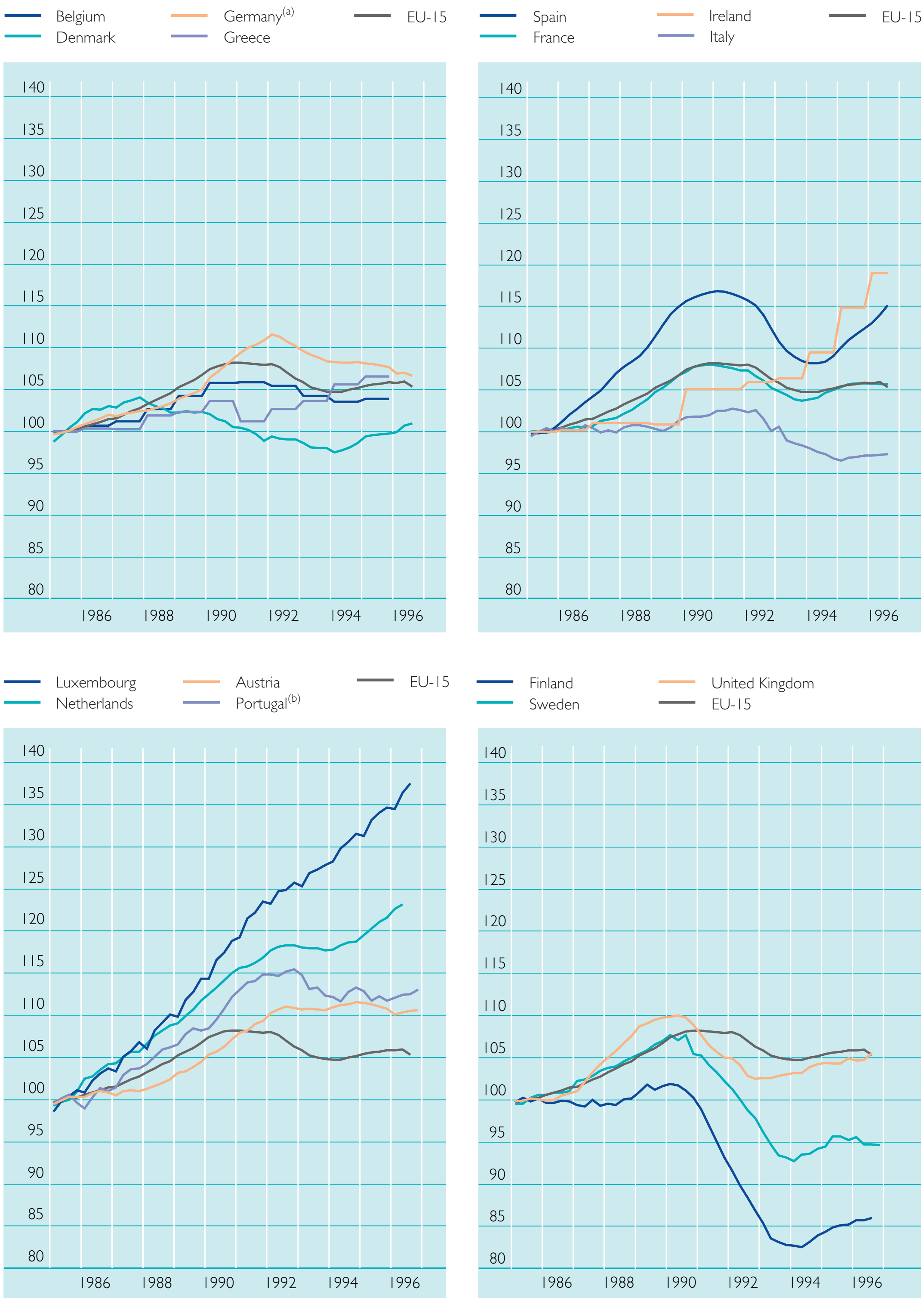
	Trade balance				Current account balance			
	1993	1994	1995	1996[a]	1993	1994	1995	1996[a]
Belgium[b]	.	.	4.4	4.4	.	.	4.4	4.4
Denmark	5.1	4.7	3.4	3.4	3.5	2.0	0.9	0.9
Germany	1.9	2.2	2.5	2.8	-0.7	-1.0	-0.9	-0.7
Greece	-13.7	-13.8	-15.0	-14.8	-0.8	-0.1	-2.5	-3.4
Spain	-3.8	-3.9	-3.9	-3.5	-0.4	-0.8	1.5	1.6
France	1.2	1.1	1.3	1.5	0.8	0.5	1.1	1.3
Ireland	14.9	15.5	18.9	19.2	3.9	2.7	2.5	1.2
Italy	3.4	3.5	4.1	4.9	1.1	1.5	2.5	3.6
Luxembourg[b]	-14.2	-12.0	-10.0	.	13.7	14.0	18.2	.
Netherlands	4.9	5.1	5.3	4.1	4.3	5.3	4.5	5.1
Austria	-3.5	-3.5	-3.1	-2.9	-0.4	-0.9	-2.0	-2.0
Portugal	-7.6	-7.6	-7.0	-7.5	0.4	-1.7	-0.7	-2.3
Finland	6.4	6.5	8.7	7.7	-1.3	1.3	4.3	3.4
Sweden	3.7	4.4	6.5	7.3	-2.0	0.4	2.2	2.6
United Kingdom	-1.5	-1.1	-0.8	-1.2	-2.0	-0.4	-0.6	-0.4
EU-15[c]	0.9	1.0	1.5	1.8	-0.0	0.0	0.5	0.8

Source: National data.
* Surplus (+), deficit (-).
(a) Provisional.
(b) Corresponding figures for BLEU are: for the trade balance: 2.6, 2.7, 3.6, 3.6; and for the current account balance: 5.0, 5.1, 5.2, 5.2.
(c) European Commission data (autumn 1996 forecasts). These data exclude intra-EU trade.

Chart 2

Employment levels in EU Member States

(quarterly data; index, 1985=100)*



Source: National data.

* Except for Belgium, Greece and Ireland, annual data.

(a) Western Germany up to 1991, unified Germany thereafter. The series has been break-adjusted.

(b) New series since 1992. The series has been break-adjusted.

There were improvements in current account balances (based on national data) in several Member States. In Italy and the Netherlands there were significant increases in the already sizable surpluses. Current account deficits increased in 1996 in Greece and Portugal in particular.

Little progress in employment generation

For the EU as a whole, real GDP growth since the 1992-93 recession has in general been accompanied by negligible job creation. While accumulated GDP growth over the past three years was around 7%, employment growth was virtually zero.

Chart 2 puts developments in 1996 in a medium-term perspective by highlighting the patterns of net job creation in EU countries over the period since 1985. It suggests that there was no employment growth in the EU as a whole in 1996, and growth of only around 5% over the period 1985-96 (whereas GDP expanded by 25%). In five Member States (Belgium, Germany, Greece, France and the United Kingdom) employment and GDP growth were close to the EU average since 1985 (although the pattern over time and the relative contribution of the public and private sectors differed). Employment growth appears to have been particularly strong over the period in Ireland, Luxembourg and the Netherlands. In each case this may be linked to sustained wage moderation. Greater labour market flexibility may also have played a role, particularly in the case of the Netherlands, while in Ireland and Luxembourg the strong growth in output was clearly a major factor. Employment growth was also above the EU average in Spain, Austria and Portugal. In the remaining countries, notably in Finland and, to a lesser degree, Sweden, as well as in Denmark and Italy, employment growth was significantly below the EU average. In Finland and Sweden, in particular, the unusual severity of the recession in the early 1990s was a key explanatory factor in the poor labour market performance. Of course, in all cases employment developments should also be seen against the background of differences in levels and changes in participation rates across Member States.

Unemployment in the EU remained at a high level

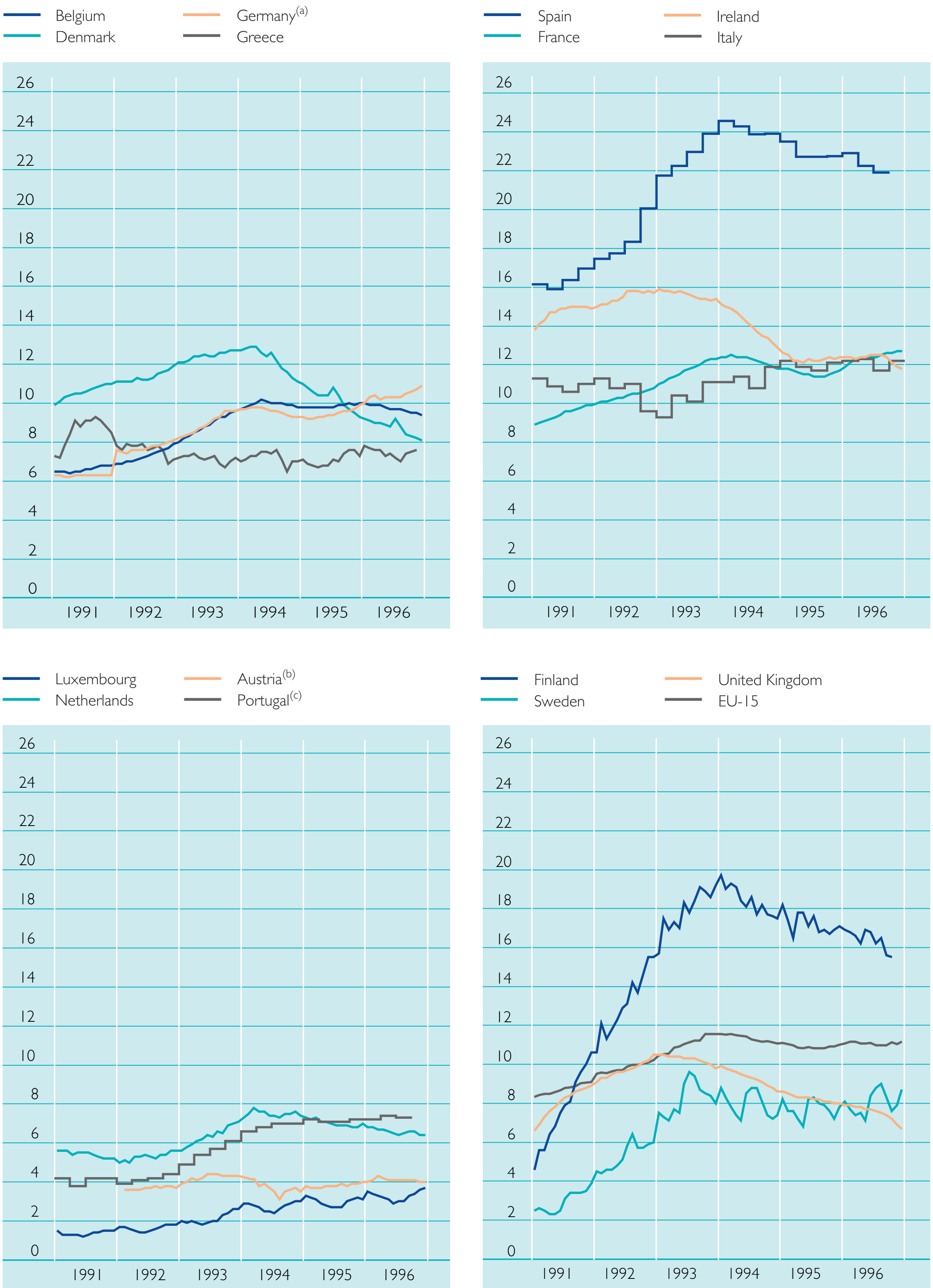
In line with weak employment and GDP growth, the unemployment rate in the EU has not fallen significantly since the 1992-93 recession. In the light of longer-term trends, it is clear that the bulk of EU unemployment is of a structural rather than a cyclical nature. Consequently, while some increase in employment can be expected as a result of further GDP growth, a reduction in structural rigidities in labour (and product) markets is a sine qua non for the alleviation of the unemployment problem in the EU (see Box 2).

Focusing on 1996, and measured on the basis of national data, the unemployment rate for the EU as a whole fell slightly during mid-1996, but rose to just over 11% towards the end of the year. While the overall unemployment rate at year-end was thus far from satisfactory, the outturns for individual Member States differed considerably. In Luxembourg and Austria the unemployment rate remained below 5%, while in Germany, France, Ireland, Italy and Finland it was higher than 10%, and in Spain, despite declines in recent years, it remained above 20%. During 1996 further progress in reducing unemployment rates was recorded in several countries, especially in Denmark and the United Kingdom but also, albeit to a lesser degree, in Belgium, Spain, Ireland, the Netherlands and Finland. In the remaining Member States unemployment was either unchanged or rose slightly (see Chart 3).

Chart 3

Unemployment rates*

(national definitions; as a percentage of the labour force)



Source: National data.
* Data for Spain, Italy, Luxembourg and Sweden are not seasonally adjusted. Monthly data except for Spain, Italy and Portugal, quarterly data.
(a) Western Germany for 1991, unified Germany thereafter.
(b) Structural break in definition in January 1994.
(c) New series since 1992.

Box 2

Labour market rigidities in EU Member States

Long-term macroeconomic developments in the EU as a whole indicate that a rather weak relationship prevails between GDP growth, employment and unemployment. This is illustrated in the table below, which shows developments in these EU aggregates from 1960 onwards over various sub-periods, on the basis of European Commission figures. The bulk of unemployment is evidently structural and not cyclical. Since the 1970s, there has been a clear and unbroken trend rise in EU unemployment. In effect, while GDP growth and employment growth were positively related to one another, the link was not strong enough to avoid a trend rise in unemployment given the rise in the number of people seeking employment over this period. If such past relationships continue to hold, the implication is that stronger GDP growth in 1997 and beyond will alone not be sufficient to bring about a sustained reduction in unemployment. In addition to continued wage moderation, reductions in labour (and product) market rigidities are a sine qua non for the alleviation of the unemployment problem in the EU. These should include a reduction of the disincentives created by the structure of social security contributions, taxes and transfer payments. This is all the more important as globalisation has increased competition dramatically. Such policies should also support monetary policies geared towards price stability.

Longer-term growth and employment trends in the EU*

(average of annual percentage changes)

	1960-73	1974-85	1986-90	1991-96
Real GDP	4.8	2.0	3.3	1.5
Employment	0.3	0.0	1.3	-0.5
Memo:				
Unemployment rate[(a)]	2.1	6.8	9.7	10.3

Source: European Commission (published in European Economy, No. 62, updated).

* EU-12 up to 1995, EU-15 thereafter. The EU aggregates are calculated using western German data to 1995, unified Germany thereafter.

(a) As a percentage of the labour force.

First steps have been taken in many Member States to reduce labour market rigidities in recent years. Since the mid-1980s, replacement ratios for unemployment benefits have fallen in Germany, Spain, Ireland, Austria, Finland, Sweden and the United Kingdom. Benefit duration has been reduced in Belgium, France, the Netherlands, Finland and the United Kingdom. There has been a relaxation of minimum wage regulations in a number of Member States (Belgium, France, Greece, the Netherlands, Spain and the United Kingdom); in two countries (Greece and the Netherlands) the indexation of minimum wages has been abolished, while in Belgium it has been tempered, inter alia through the introduction of a so-called "health index". In the United Kingdom, Wage Councils, which set minimum wage levels in a number of industries, have been abolished, with the exception of agriculture. In Italy, wage indexation was abolished in the context of a general reform of the bargaining system. Employment protection regulations have also changed in a number of Member States; the costs and/or administrative burden of dismissal have been reduced in Germany, France, Italy, Portugal, Sweden and the United Kingdom. Finally, employers' social security contributions and payroll taxes have fallen as a percentage of GDP since 1985 in Denmark, France, Ireland, Luxembourg, the Netherlands, Sweden and the United Kingdom, although in many cases they remain at very high levels. The overall incidence of non-wage labour costs has risen or remained broadly unchanged in other EU countries. In sum, however, as is clear from the development of labour market conditions, measures to date have generally been inadequate. Further progress remains an urgent necessity in order to revive labour markets and to reverse the pattern of low employment growth and increasing unemployment rates.

1.3 Price developments

Favourable price climate in most Member States

In this section price developments are analysed with reference to national consumer price indices, as these are still the main focus of individual countries' policies. However, when the Report addresses the issue of convergence in Section 3, reference is made to harmonised data, which do not yet provide a comprehensive measure of domestic inflation, but are more comparable than current national indices and thus provide a more uniform basis for assessing convergence. Accordingly, inflation rates for 1995 based on Interim Indices of Consumer Prices (IICPs) as well as the inflation rates resulting from newly generated Harmonised Indices of Consumer Prices (HICPs) for 1996 are reported in Table 9. Details of the progress towards the generation of HICPs are described in Box 7.

According to national consumer price indices, inflation in the EU as a whole fell to an average of 2.6% in 1996 (see Table 4). This compares favourably with the rate of 3.1% observed in 1995 and is also a major achievement in a historical context (see Box 3). Belgium, Denmark, Germany, France, Luxembourg, the Netherlands, Austria and Finland, which had inflation rates of close to or below 2% in 1995, broadly remained at that level in 1996. In Ireland and Sweden annual average inflation was reduced to below 2% from 2.5% or above in 1995. Among the remaining countries, annual average inflation in Spain and Portugal was reduced to 3.6% and 3.1% respectively, in both cases well below the level of 4.7% and 4.1% prevailing in 1995. Similarly, in Italy inflation fell from 5.4% in 1995 to 3.9% in 1996. Inflation (excluding mortgage interest payments) in the United Kingdom was unchanged at just under 3% in 1996. In Greece the downward trend in inflation continued, but at a slow pace, so that inflation still stood at 8.5% in 1996.

Annual average rates of inflation conceal some more divergent within-year patterns, as in a number of countries a degree of upward pressure was seen in inflation rates over the course of the year although inflation remained at modest levels (see Chart 4). Meanwhile, Sweden and Italy showed the steepest declining trends, with inflation falling at the end of the year to below zero in Sweden and to 2.6% in Italy. A somewhat more moderate reduction took place in Spain, where inflation diminished to 3.2% at the end of the year. In Portugal, inflation fluctuated around a slightly downward trend, to stand at 3.3% at year-end. The deceleration of Greek inflation which has been observed in recent years was temporarily interrupted in the early part of 1996 but resumed thereafter, and inflation reached 7.5% in December.

Supporting underlying factors

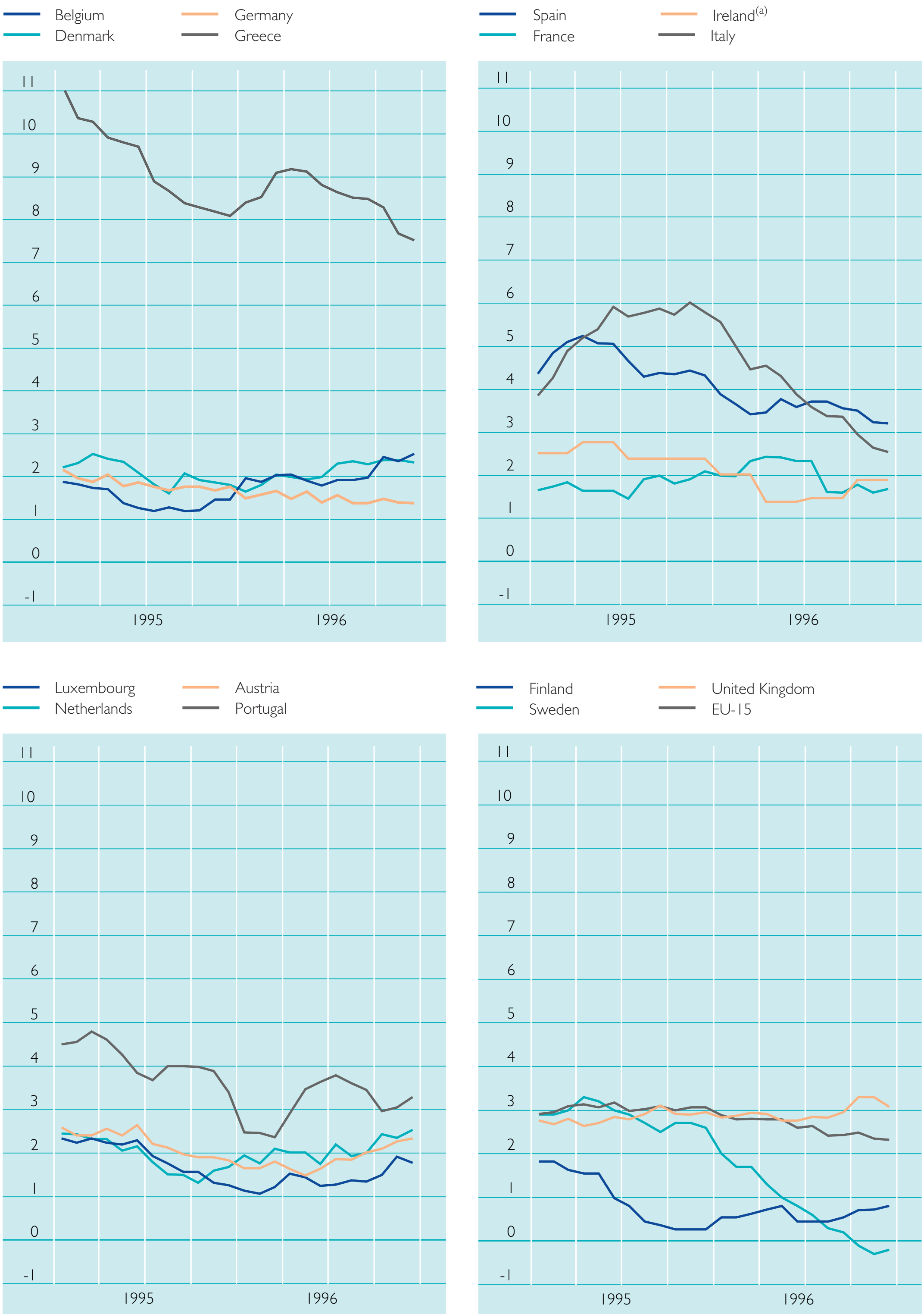
Although in the long term inflation is a monetary phenomenon, in the short run developments in consumer prices are affected by several cost and demand factors, as discussed below.

Growth in import prices slowed in the Union as a whole from 4.1% in 1995 to 1.1% in 1996 (see Table 4). This favourable pattern was mirrored in most Member States, and prevailed despite a sharp increase in commodity prices in late 1995 and early 1996. The dynamics of import prices benefited in a number of Member States from the appreciation of effective exchange rates. Among ERM countries import price growth remained low or negative in Denmark, Germany, France, Luxembourg, Austria and Portugal; in Spain and Ireland increases slowed significantly from 4% or above in 1995 to 2.1% and 1.3% in 1996 respectively, while in Italy

Chart 4

Consumer price inflation*

(monthly data; annual percentage changes)



Source: National non-harmonised data.

* For further explanation of the data used see footnotes to Chart 1.

(a) Based on quarterly data.

import prices remained stable in 1996 after rising by 11.8% in 1995. In contrast, an upward movement, although still at a modest level, was seen in Belgium and the Netherlands, as well as in Finland. Outside the ERM effective appreciations of the respective currencies during 1996 led to a significant reduction in import prices in Sweden and considerably lower increases in the United Kingdom. A similar pattern, albeit at a higher level, was found in Greek import price inflation, which decelerated

Table 4

Consumer price inflation and important determinants

(annual percentage changes)

		CPI[a]	Import prices	GDP deflator	Nominal unit labour costs[b]	Compensation per employee	Labour productivity
Belgium	1995	1.5	0.5	1.4	0.9	2.7	1.8
	1996	2.1	1.9	1.8	0.0	1.4	1.4
Denmark	1995	2.1	1.3	1.7	2.6	3.6	1.0
	1996	2.1	1.7	1.8	3.1	3.7	0.6
Germany	1995	1.8	0.5	2.2	1.3	3.6	2.3
	1996	1.5	0.8	1.0	0.1	2.6	2.5
Greece	1995	9.3	7.2	9.3	11.6	12.7	1.1
	1996	8.5	3.5	8.8	10.1	11.5	1.4
Spain	1995	4.7	4.2	4.9	1.1	2.2	1.1
	1996	3.6	2.1	3.3	3.2	3.7	0.5
France	1995	1.8	1.2	1.7	1.3	2.0	0.7
	1996	2.0	1.1	1.5	2.0	2.5	0.5
Ireland	1995	2.5	4.0	0.5	-9.3	2.2	11.5
	1996	1.6	1.3	1.6	-0.3	3.5	3.8
Italy	1995	5.4	11.8	5.0	2.1	6.0	3.9
	1996	3.9	0.0	5.0	4.7	5.4	0.7
Luxembourg	1995	1.9	1.4	1.1	3.3	2.2	-1.1
	1996	1.4	-0.2	2.1	1.4	1.7	0.3
Netherlands	1995	2.0	0.1	1.4	1.2	1.3	0.1
	1996	2.1	1.8	1.3	0.0	0.8	0.8
Austria	1995	2.2	0.9	2.1	1.7	3.8	2.1
	1996	1.9	1.2	1.9	0.9	2.4	1.5
Portugal	1995	4.1	1.7	5.0	2.9	5.8	2.9
	1996	3.1	1.1	2.8	3.1	5.6	2.5
Finland	1995	1.0	-0.1	2.2	2.6	4.9	2.3
	1996	0.6	1.5	1.0	1.7	2.3	0.6
Sweden	1995	2.9	6.2	3.7	2.1	3.4	1.3
	1996	0.7	-3.9	1.3	4.9	5.7	0.8
United	1995	2.9	7.2	1.8	1.9	3.4	1.5
Kingdom	1996	2.9	2.4	2.2	1.9	3.7	1.8
EU-15[c]	1995	3.1	4.1	2.9	1.7	3.6	2.0
	1996	2.6	1.1	2.4	2.1	3.5	1.4

Source: National data, partly estimated.
(a) For further explanation of the data used see footnotes to Chart 1.
(b) The growth in nominal unit labour costs is calculated as the change in compensation per employee less labour productivity growth.
(c) Import price data are obtained from the European Commission (autumn 1996 forecasts). These data exclude intra-EU trade.

rapidly as a result of the tight exchange rate policy, to fall to below 4% in 1996.

For the Union as a whole, domestic inflationary pressures (measured by the increase in the GDP deflator) declined from 2.9% in 1995 to 2.4% in 1996. In the majority of Member States inflation according to the GDP deflator was low, standing close to or below 2%. Domestic inflation decelerated in 1996 in Spain and Portugal to 3.3% and 2.8% respectively. In Italy inflation by this measure was 5.0%; in Greece it was 8.8%.

Although unit labour cost growth rose somewhat in the EU on average, it still remained rather subdued, at an average of 2.1% in 1996. Indeed, in many EU countries low unit labour cost growth was an important factor underlying the low growth in domestic costs. However, there were also contrasting developments as unit labour costs accelerated somewhat in Denmark, Spain and Portugal and were buoyant in Greece, Italy and Sweden (see Table 4). In some of these countries (particularly those where significant gains in price competitiveness had been recorded in 1993-95), the increase in unit labour costs was at least partly absorbed by profit margins.

In 1996 as a whole average wage growth in the Union was 3.5%, compared with 3.6% in 1995. In line with the pattern typical of a pause in economic growth, a fall in productivity growth took place in the EU, declining from an average of 2.0% in 1995 to 1.4% in 1996. This helps to explain why the general pattern of wage moderation did not feed through one-to-one to unit labour costs.

Changes in indirect taxes contributed to increases in prices in most Member States in 1996, including Belgium, Denmark, Spain, the Netherlands, Finland, Sweden and the United Kingdom. The strongest impact of changes in indirect taxes was seen in Greece, where they raised consumer prices by almost 1 percentage point. In 1996 inflation slowed in both the sheltered and non-sheltered (or "non-traded" and "traded") sectors of most EU economies, but disinflation was more pronounced in traditionally sheltered sectors; hence the gap in inflation between the sectors narrowed in 1996.

Overall, there are some indications that inflation expectations are gradually adapting to the current environment of low inflationary pressures. A crucial role has been played by an increased emphasis placed on medium-term-oriented monetary policies geared towards the achievement and maintenance of price stability. Moreover, the favourable price climate was supported by increased competition, both domestically as a result of privatisation or deregulation and internationally, partly related to European integration and, in some countries, to the effects of the opening-up of eastern Europe. In 1996 the reduction in inflation rates was also supported by slow growth in import prices and weaker domestic inflationary pressures, the latter linked to weak demand and low increases in unit labour costs in most Member States.

Box 3

Progress towards price stability in EU Member States

Average consumer price inflation in the European Union as a whole stood at 2.6% in 1996. Compared with past experience this represents progress towards price stability.

Some marked differences are apparent in the inflation records of individual EU countries over a long period. Over the whole period since 1960 inflation has been lowest in Germany, Luxembourg, the Netherlands, Austria and Belgium (see table below). The highest inflation rates have been observed in Portugal, Greece, Spain and Italy.

The ranking of volatility, measured by means of standard deviations of inflation rates, is more or less in line with the ranking of mean inflation rates: it was lowest for low-inflation countries such as Germany, Austria, the Netherlands, Luxembourg and Belgium, and highest for Portugal, Greece, Italy and Ireland, where the rise and subsequent fall of inflation rates were more pronounced.

It is evident that inflation has undergone a number of regime shifts over the past three decades. The first "break point", in 1972/1973, marks the first oil shock and the end of the system of fixed exchange rates under the Bretton Woods regime. The second break point, in 1987/1988, coincides with the fall in oil prices and the start of a period of stable ERM exchange rates. This justifies focusing on three sub-periods, namely 1961-72, 1973-87 and 1988-96. Over the first sub-period, 1961-72, inflation rates were 4.6% on average. In contrast, in the period 1973-87, mean inflation rates were much higher, standing on average close to 10%, and, in addition, were more volatile. In the last sub-period, 1988-96, mean inflation rates fell strongly in all countries, reaching an EU-wide average of slightly above 4%. The strongest declines in inflation have tended to occur in the countries which had the highest inflation over the whole period. Furthermore, volatility declined in the majority of Member States and the standard deviation of EU-15 inflation was low compared with earlier periods.

Convergence in inflation may also be analysed using EU countries' inflation rate differentials with Germany, the country with the lowest inflation rate over the whole period. Inflation rate differentials with Germany have been positive for all countries over all periods considered, apart from Greece during the period 1961-72, and Belgium, Denmark, France, Ireland, Luxembourg, the Netherlands and Austria in the period 1988-96. Using weighted averages, other EU-15 countries' differentials with Germany were 4% during the whole period 1961-96. In the sub-periods they were around 1.5% during the period 1961-72, just below 7.5% in the period 1973-87 and 1.5% during the period 1988-96. Hence convergence with German inflation rates during the most recent period has brought the average differential back to that prevailing prior to the first oil price shock.

On balance, the convergence of inflation rates is marked if 1988-96 is compared with the high-inflation years of 1973-87; inflation has fallen sharply, especially in countries with the highest inflation. However, achievements in the convergence of inflation rates are not exceptional if 1988-96 is compared with the former "low"-inflation period spanning from 1961 to 1972.

Means and standard deviations of CPI inflation rate levels in the EU

	BE	DK	DE	GR	ES	FR	IE	IT	LU	NL	AT	PT	FI	SE	UK	EU-15
1961-96																
Mean	4.6	6.4	3.4	12.1	9.4	6.0	7.8	8.6	4.2	4.3	4.4	12.2	6.7	6.4	7.3	7.1
Standard deviation	3.0	3.5	1.8	8.3	5.5	3.8	6.0	6.0	2.9	2.8	2.1	8.9	4.4	3.4	5.4	3.7
1961-72																
Mean	3.3	5.9	3.0	2.4	6.6	4.4	5.4	4.0	2.9	4.9	4.2	4.7	5.2	4.5	4.7	4.6
Standard deviation	1.4	1.6	1.3	1.8	3.3	1.5	2.6	2.0	1.4	2.5	1.3	3.0	2.7	2.0	2.3	1.5
1973-87																
Mean	6.8	8.9	4.0	18.7	14.2	9.3	12.6	14.1	6.2	5.2	5.3	20.5	9.9	8.8	11.0	9.7
Standard deviation	3.4	3.5	2.2	5.6	4.9	3.5	6.1	5.3	2.5	3.2	2.4	7.1	4.4	2.8	6.3	3.5
1988-96																
Mean	2.4	2.7	2.9	14.0	5.3	2.5	2.7	5.4	2.7	2.2	2.9	8.3	3.3	4.9	4.6	4.2
Standard deviation	0.8	1.2	1.4	4.2	1.1	0.7	0.9	0.9	0.9	0.9	0.8	3.7	2.3	3.3	2.7	1.0

Source: National data.

1.4 Fiscal developments

Enhanced efforts at fiscal consolidation

In the context of persistently high general government deficit and debt ratios in most Member States, the stance of fiscal policy in 1996 continued to be directed towards the need for consolidation. Consolidation was supported by improving economic conditions in the course of the year. The data commented on below are the official data from the European Commission as presented in its autumn 1996 forecast and shown in Table 5. However, these data rely on incomplete information about the year 1996 and are due to be updated in the spring, i.e. after the publication of this Report. Therefore, the latest available national data, which are nevertheless still of a preliminary nature, are also shown for information in Table 6. These more recent estimates of government deficits and debts are broadly in line with the Commission's November forecast. For Belgium, Denmark, France and Italy they suggest slightly higher deficit figures than estimated by the Commission in November. Germany, Greece, Ireland, the Netherlands, Austria, Finland, Sweden and the United Kingdom are expected to have lower deficits, with the most significant downward revision being in the case of Sweden. Higher debt ratios than were expected earlier are foreseen in Greece, Spain, Italy and Sweden, whereas other countries for which data are available now estimate lower debt ratios. The most considerable revisions are for Spain, Ireland, Austria and Finland.

In the EU as a whole fiscal deficits have continued to decline since their peak in 1993 (see Table 5). Nevertheless, the average general government deficit-to-GDP ratio in 1996 was still expected to stand well above 4%, thus remaining a matter of serious policy concern. The performance of individual countries was more similar in 1996 than in the past, as the general government deficit ratio appears to have declined in all countries except Germany. The biggest deficit reduction, of more than 4 percentage points, was observed in Sweden (where the estimated deficit stands more than 8 percentage points below its 1993 level). According to Commission estimates, budgetary improvements in the EU were at least partly based on reductions in structural deficits; Ireland was the main exception.

The average debt ratio in the EU has increased steadily from below 60% in 1991 to well above 70% in 1996 (see Table 5). Some individual countries have nonetheless managed to reduce their debt ratios in recent years. Denmark and Ireland have recorded falling debt ratios since 1993 and this was also the case for Belgium, although its general government debt ratio remains the highest in the Union. In 1995 and 1996 there were successive reductions in the debt ratio of Sweden and in the still very high ratio of Italy. In 1996 some reduction in debt ratios was also seen in the Netherlands and Portugal; a decline was also expected in the very high ratio prevailing in Greece.

Structure of consolidation less favourable

Whereas the momentum towards lower deficits continued in 1996, the composition of fiscal consolidation was a ground for concern from the perspective of the sustainability of developments in government expenditure and revenue (see Box 4). This becomes apparent from recent trends in expenditure and revenue growth. As regards performance during the early 1990s, highlighted by EU-wide developments, it can be seen from Chart 5 that the increase in deficit ratios until 1993 was accompanied by rises both in receipts and in expenditures as a percentage of GDP. More recently, in 1994-95, some correction took place, which was reflected in falling deficit ratios mainly driven by expenditure restraint. In 1996, however, the momentum shifted away from cuts in expenditure and towards increases in revenues.

Commission estimates suggest that in 1996 only three Member States reduced their deficit ratios via lower expenditure ratios while at the same time being able to lower their revenue ratios: namely Ireland, the Netherlands and the United Kingdom. In Belgium, Greece, Spain, Austria, Finland and Sweden deficit reduction was partly

Table 5

Government budgetary positions

(as a percentage of GDP)

	General government net lending (+)/net borrowing (-)					
	1991	1992	1993	1994	1995	1996[a]
Belgium	-6.5	-7.2	-7.5	-5.1	-4.1	-3.3
Denmark	-2.1	-2.9	-3.9	-3.5	-1.6	-1.4
Germany	-3.3	-2.8	-3.5	-2.4	-3.5	-4.0
Greece	-11.5	-12.3	-14.2	-12.1	-9.1	-7.9
Spain	-4.9	-3.6	-6.8	-6.3	-6.6	-4.4
France	-2.2	-3.8	-5.6	-5.6	-4.8	-4.0
Ireland	-2.3	-2.5	-2.4	-1.7	-2.0	-1.6
Italy	-10.2	-9.5	-9.6	-9.0	-7.1	-6.6
Luxembourg	1.9	0.8	1.7	2.6	1.5	0.9
Netherlands	-2.9	-3.9	-3.2	-3.4	-4.0	-2.6
Austria	-2.6	-1.9	-4.2	-4.4	-5.9	-4.3
Portugal	-6.7	-3.6	-6.9	-5.8	-5.1	-4.0
Finland	-1.5	-5.9	-8.0	-6.2	-5.2	-3.3
Sweden	-1.1	-7.8	-12.3	-10.8	-8.1	-3.9
United Kingdom	-2.6	-6.3	-7.8	-6.8	-5.8	-4.6
EU-15	-4.3	-5.1	-6.2	-5.4	-5.0	-4.4

	General government gross debt					
	1991	1992	1993	1994	1995	1996[a]
Belgium	129.4	130.6	137.0	135.0	133.7	130.6
Denmark	64.6	68.7	80.1	76.0	71.9	70.2
Germany	41.5	44.1	48.2	50.4	58.1	60.8
Greece	92.3	99.2	111.8	110.4	111.8	110.6
Spain	45.8	48.4	60.5	63.1	65.7	67.8
France	35.8	39.6	45.6	48.4	52.8	56.4
Ireland	95.0	92.0	94.5	87.9	81.6	74.7
Italy	101.4	108.5	119.3	125.5	124.9	123.4
Luxembourg	4.2	5.2	6.2	5.7	6.0	7.8
Netherlands	78.8	79.6	80.8	77.4	79.7	78.7
Austria	58.7	58.3	62.8	65.1	69.0	71.7
Portugal	71.1	63.3	68.2	69.6	71.7	71.1
Finland	23.0	41.5	57.3	59.5	59.2	61.3
Sweden	53.0	67.1	76.0	79.3	78.7	78.1
United Kingdom	35.7	41.9	48.5	50.4	54.1	56.2
EU-15	56.1	60.4	66.1	68.1	71.3	73.5

Source: European Commission (autumn 1996 forecasts).
(a) European Commission projections.

Table 6

Government budgetary positions in 1996 – latest national projections

(as a percentage of GDP)

	BE	DK	DE	GR	ES	FR	IE	IT	LU	NL	AT	PT	FI	SE	UK[a]
Fiscal balance*	-3.4	-1.6	-3.9	-7.4	-4.4	-4.1	-1.0	-6.8	1.9	-2.1	-4.1	-4.0	-2.6	-3.0	-4.3
Gross debt**	130.0	69.8	60.7	111.8	69.3	55.4	73.3	123.7	6.8	78.5	70.0	70.3	58.0	78.6	55.3

Source: National data.

* General government net lending (+) / net borrowing (-).

** General government gross debt.

(a) Fiscal balance: Calendar year interpolation of financial year forecasts.
Gross debt: 1996 Budget forecast for financial year, end-March 1997.

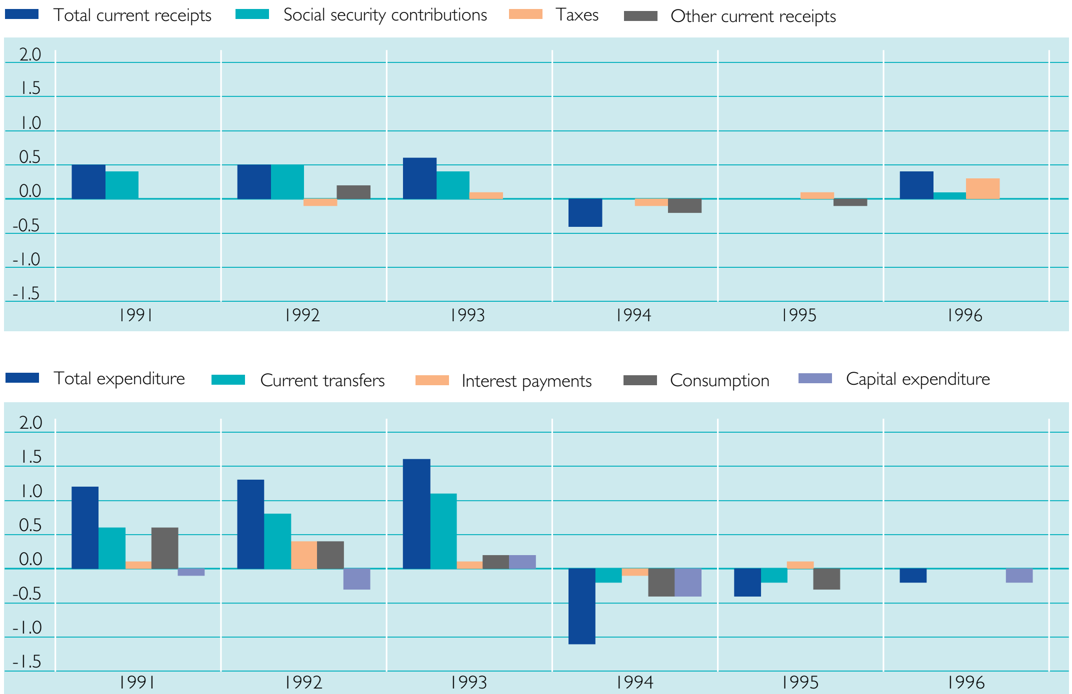
based on expenditure restraint and partly on higher revenue ratios. Denmark, France, Italy and Portugal are expected to have higher expenditure ratios in 1996, and deficit ratios are only expected to decline as a consequence of larger, albeit at times temporary, increases in government receipts.

Within total government receipts, the EU average share of social security contributions increased particularly strongly during the 1990-93 period and could not be brought down from this high level thereafter (see Chart 5). At the country level, social security contributions as a share of GDP have declined since 1990 only in Ireland and Sweden. However, for

Chart 5

Changes in the structure of general government receipts and expenditure in the EU*

(annual change as a percentage of GDP)



Source: European Commission (autumn 1996 forecasts).

* Excluding Luxembourg.

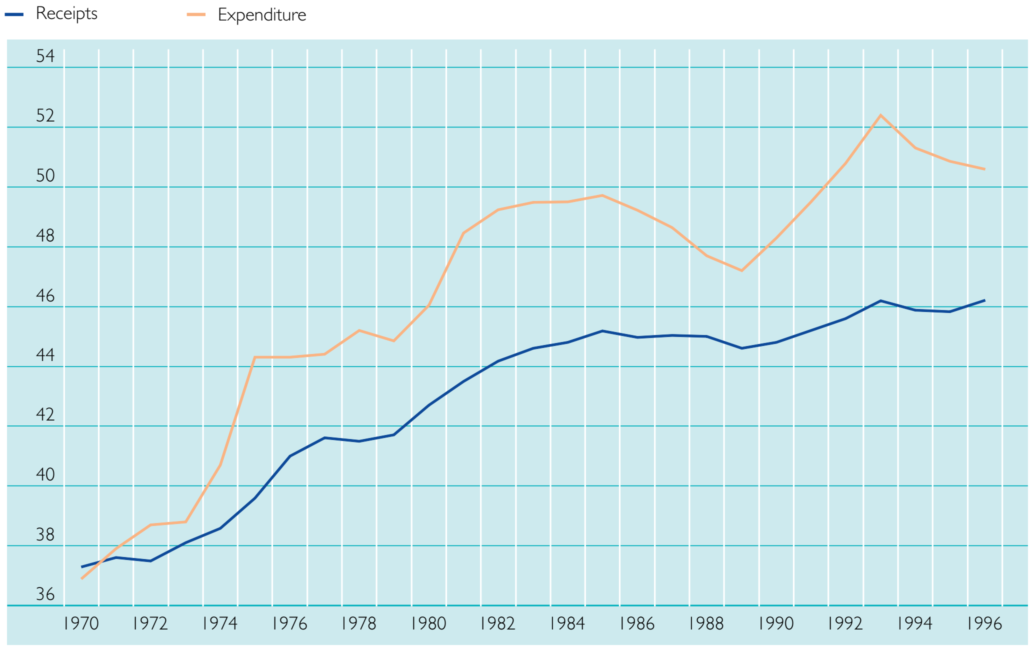
Box 4

Trends in fiscal expenditure and revenue ratios and the issue of sustainability

The broad tendency for government expenditure and revenue ratios to increase since the early 1990s reflects a continuation of past trends. Although there are important differences across countries, the average expenditure ratio in the EU increased from 37% in 1970 to more than 50% in 1996, even faster than the average share of government receipts in GDP, which increased from 37% to 46% (see chart below). Hence, a growing proportion of economic resources in the EU has been absorbed by government activity.

General government receipts and expenditure in the EU*

(as a percentage of EU GDP)



Source: European Commission (autumn 1996 forecasts).

* Expenditure exclude Luxembourg to 1993, receipts exclude Greece, Portugal and Finland to 1973 and Luxembourg to 1993. Western Germany up to 1991, unified Germany thereafter.

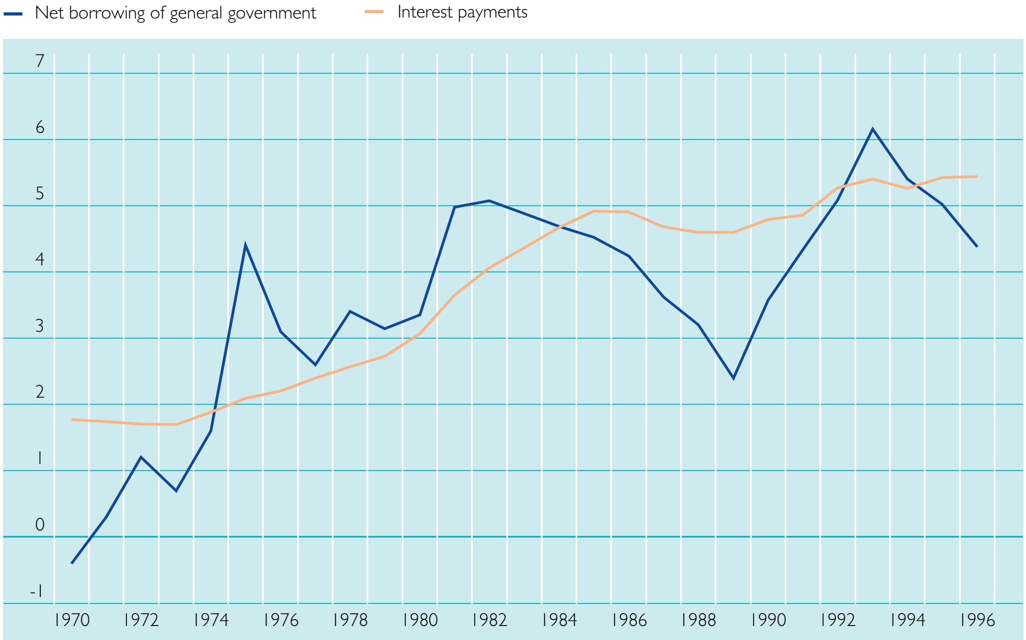
An implication of government spending permanently growing faster than output is that either revenue or deficit ratios have to adjust upwards. In both cases, however, private activity may be crowded out, thus damaging long-term growth prospects. Also, looking at the composition of government expenditure, a growing part of government outlays is used for interest payments, adversely affecting the flexibility of fiscal policies in the short and medium term. Interest payments on government debt as a percentage of GDP in the EU increased from below 2% in 1970 to above 5% in 1996; the share of interest payments in total government expenditures doubled during the same period. In most years since 1984 interest payments required more financial resources than were generated by government net borrowing (see chart below).

Whereas such trends in government finances can hardly be judged as sustainable in the longer term, a more precise analytical approach is needed to assess sustainability in a comprehensive manner. In this context, it is suggested that material for an assessment of sustainability can be derived from various analytical procedures which focus on budgetary balance requirements over different time horizons. Suggestions can also be made concerning the appropriate balance between expenditure cuts and revenue increases in the achievement of consolidation.

A short-term indication of the sustainability of fiscal consolidation strategies can be obtained by distinguishing between measures with permanent or only short-term effects on trends in revenues and expenditures. Short-term or one-off measures, which are only effective in one year, improve the current budgetary situation at the expense of future budgets, or have mere presentational effects, cannot be regarded as contributing to sustainability.

General government net borrowing and interest payments in the EU*

(as a percentage of EU GDP)



Source: European Commission (autumn 1996 forecasts).
* Net borrowing data exclude Greece, Portugal and Finland to 1973 and Luxembourg to 1993.
Western Germany up to 1991, unified Germany thereafter.

In the medium term the feasibility of given budgetary objectives may be considered by estimating the fiscal adjustments that would be necessary to reach these goals. The emphasis here is on the correction of those items which are generally seen as being under the control of governments, i.e. the primary balance resulting from all expenditure items, excluding interest payments, as well as revenues. For instance, the actual primary balance of a government may be compared with the primary balance which would be required to reduce the debt-to-GDP ratio during the current year. This concept, referred to as the “primary (or debt convergence) gap”, may be supplemented by the calculation of the primary balance required to reduce the debt ratio to a specific value within a given time period (see the EMI’s report on “Progress towards convergence 1996”, November 1996). In addition, the adjustment of the expenditure and revenue figures for cyclical and non-structural effects gives an indication of the degree to which a given deficit reduction reflects genuine fiscal consolidation efforts. However, it should be noted that calculations of structural expenditure and revenue data differ according to the methods applied, and figures for the level are typically less reliable than figures for year-to-year changes. Furthermore, certain non-recurrent elements such as one-off measures may distort the estimations.

As regards long-term issues of sustainability, the budgetary situation must be judged in the light of projections and forecasts of demographic and economic developments which are of relevance to government finances. The state of government finances under unchanged tax and transfer policies may face severe challenges when the expected problems of an ageing population emerge over the next few decades. A valuable concept which is increasingly being used to capture the relation between fiscal policy and demographic changes and the inter-generational redistribution resulting from tax and benefit policies is known as “generational accounting”.

In each case, in view of the high burdens of tax and social security contributions in the EU, fiscal consolidation should primarily be based on expenditure restraint. Higher revenue ratios would exacerbate existing distortions. They might also be perceived by private agents as unsustainable in the long run and could thus damage confidence, not least in financial markets. However, not all forms of expenditure reduction may be seen as equally sustainable. For example, systematic cuts in government capital expenditure may harm longer-term growth prospects owing to the positive growth effects of certain types of government infrastructure investment.

the EU as a whole, the main source of the increase in government receipts in 1996 was taxation rather than social security contributions.

As regards expenditures, marked increases in government transfer payments were seen on average in the early 1990s, whereas growth rates were slightly negative thereafter. Hence a pattern similar to that for social security contributions on the revenue side can be observed on the expenditure side. Overall, therefore, the financial positions of social security sectors are imposing an increasing burden on the budgetary situations of many EU countries, as well as posing risks for the future in the light of the ageing of the population.

In 1996 adjustments in fiscal positions appear to have been related strongly to cuts in government investment; capital expenditures were the only category of expenditure to be reduced in the EU on average. While relatively "painless" in the short run, this may run the risk of burdening economic and budgetary positions in the longer term. Looking at individual countries, only Ireland has increased government capital expenditures as a share of GDP since 1993 while also managing to reduce its deficit ratio. On the other hand, particularly sizable parts of deficit reductions since 1993 were borne by a reduction in capital expenditure in Greece and Spain, although their levels remain close to and above the EU average respectively.

1.5 Intra-EU exchange rates

Relatively calm conditions within the ERM, greater volatility of some non-ERM currencies

During 1996 exchange rate developments within the ERM were characterised by relatively calm conditions. In particular, between the end of May and mid-October 1996, the bilateral exchange rates between the participating currencies remained within relatively narrow bands (see Chart 6). In the last quarter the maximum bilateral divergence from central rates widened, to reach around 7-8% in December. Exchange rate volatility among EU currencies declined significantly compared with 1995; most ERM currencies recorded their lowest volatility against the Deutsche Mark since the widening of the ERM fluctuation bands in August 1993.

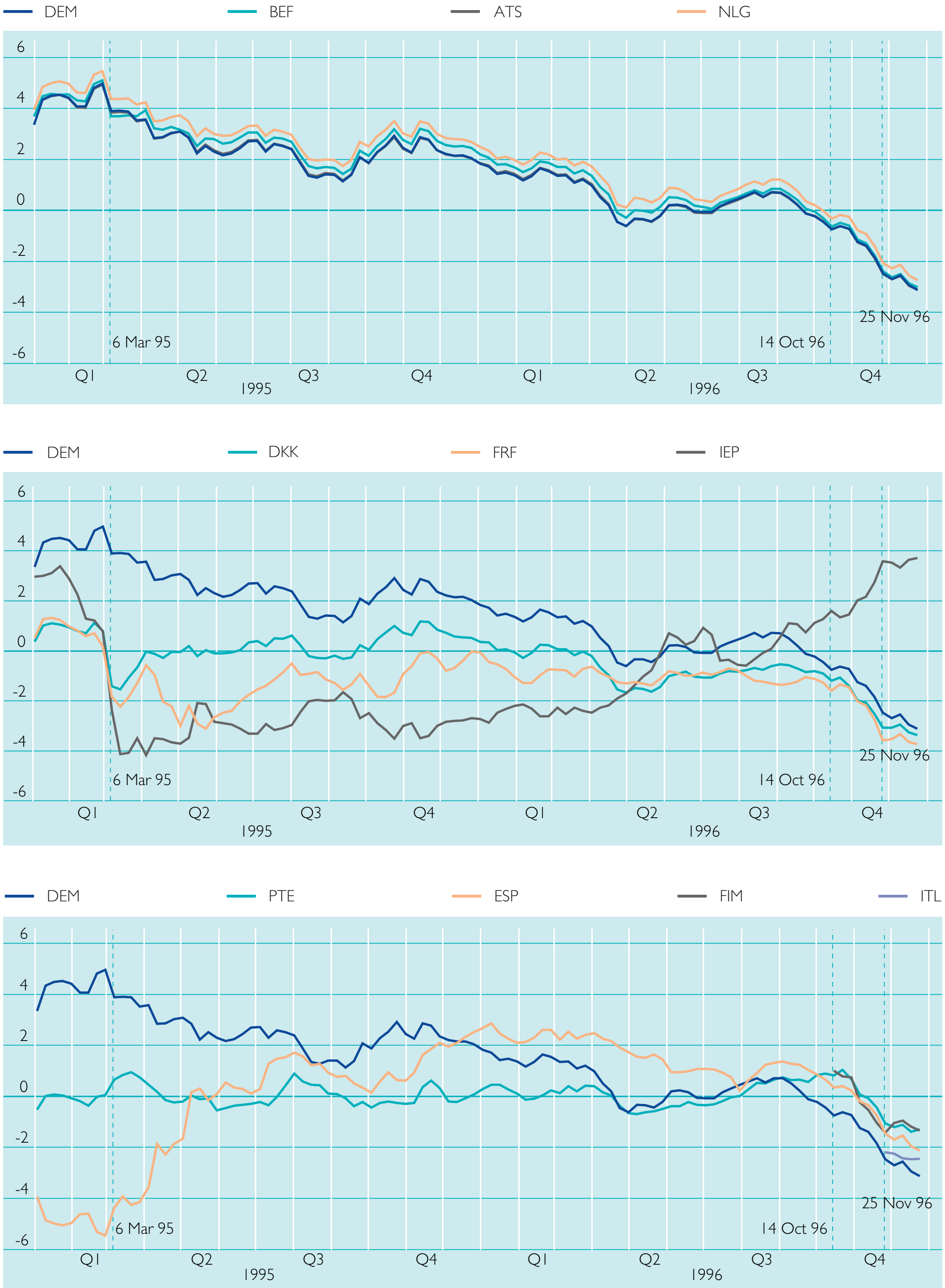
One group of currencies - the Belgian/ Luxembourg franc, the Deutsche Mark, the Dutch guilder and the Austrian schilling - remained closely aligned, with the respective short and long-term interest rate differentials, which were already small, narrowing further. From early May onwards the French currency alternated with the Danish krone as the weakest currency in the grid, while both remained relatively close to their ERM central rates vis-à-vis the Deutsche Mark throughout 1996. The French franc experienced some temporary and limited downward pressures between mid-July and early September and, to a lesser extent, in late November/early December. From January until September 1996 the Spanish peseta remained relatively stable as the strongest currency in the grid, albeit close to the mid-point of its fluctuation band. Thereafter, the Irish pound, which had been the weakest currency in the grid during the first four months of 1996 and had subsequently risen steadily against the other ERM currencies, became the strongest currency in the ERM. The Portuguese escudo strengthened, while remaining within a fluctuation range of ± 2% against its central rate vis-à-vis the Deutsche Mark throughout 1996.

In 1996 two further currencies joined the ERM: the Finnish markka with effect from 14 October, and the Italian lira on 25 November. The Finnish markka continued

Chart 6

Position of currencies in the ERM

(in percentage points)



Source: National data.

Vertical lines show realignments of PTE and ESP on 6 March 1995, the entry in the ERM of FIM on 14 October 1996 and the re-entry of ITL on 25 November 1996. The position of a currency in the fluctuation band is determined by its deviation with respect to the mid-point between the strongest and weakest currencies in the ERM. The deviation between two currencies represents the percentage difference between their market exchange rate and their bilateral central parity.

its downward movement during the first four months of 1996, but recovered during the summer. Its ERM entry rate of FIM 3.04 vis-à-vis the Deutsche Mark was slightly below the market rate prevailing at the time, and the Finnish currency thereafter remained stronger than its Deutsche Mark ERM parity. The Italian lira continued its steady recovery in the first half of 1996, breaching the ITL 1,000 level vis-à-vis the Deutsche Mark, and fluctuated around this level in the following months. After resuming participation in the ERM at a central rate vis-à-vis the Deutsche Mark of ITL 990, which was slightly above the market rate prevailing at the time, the Italian currency remained slightly above it for the remainder of 1996.

Developments in currencies not participating in the ERM followed a broadly common pattern until the autumn of 1996. After a phase of virtually continuous appreciation over the first half of 1996, non-ERM currencies lost a little ground vis-à-vis the strongest ERM currencies during July and August. Subsequently, the Greek drachma recovered significantly, ending 1996 at levels close to those recorded in mid-1996. The Swedish krona initially recouped its losses, but depreciated in the last months of 1996, ending the year slightly stronger than at the start. The pound sterling experienced stronger upward pressure in the last four months of the year, which brought the UK currency to its highest level against the Deutsche Mark for the past three years.

Favourable underlying international and intra-EU factors

Several factors appear to have contributed to the exchange rate developments summarised above. The upward trend in the US dollar, which represented a correction of the earlier depreciation of the US currency, coupled with lesser volatility, contributed to exchange rate stability within the ERM. Progress towards convergence, combined with reiterated expressions of strong political commitment to the EMU process - as highlighted by the conclusions of the Madrid, Florence and Dublin European Councils - have gradually raised market expectations that Stage Three of EMU will start as scheduled (the latter expectation was also reflected in the ECU market, see Box 5). However, it appears difficult to disentangle markets' positive assessment of member countries' overall macroeconomic performance and the sustainability of their economic policies from market expectations about their potential participation in Stage Three. In any event, substantial capital flows into some of the former high-yielding ERM and non-ERM currencies took place, fuelling upward pressure on their exchange rates and downward pressure on the respective interest rates relative to those prevailing in Germany. For some EU currencies anticipation of ERM entry may also have played a strengthening role. Furthermore, in an environment of low inflationary pressures in continental EU countries, further gradual monetary easing in Germany up to late August 1996 facilitated substantial cuts in official interest rates in most other EU countries.

Corrective movements in effective exchange rates

Reflecting limited inflation differentials, real effective exchange rate developments during 1996 closely mirrored fluctuations in nominal effective exchange rates (see Chart 7). Most ERM currencies, including the Finnish markka, depreciated in real effective terms.[1] In contrast, the Irish pound and the Italian lira appreciated. For the Spanish peseta and the Portuguese

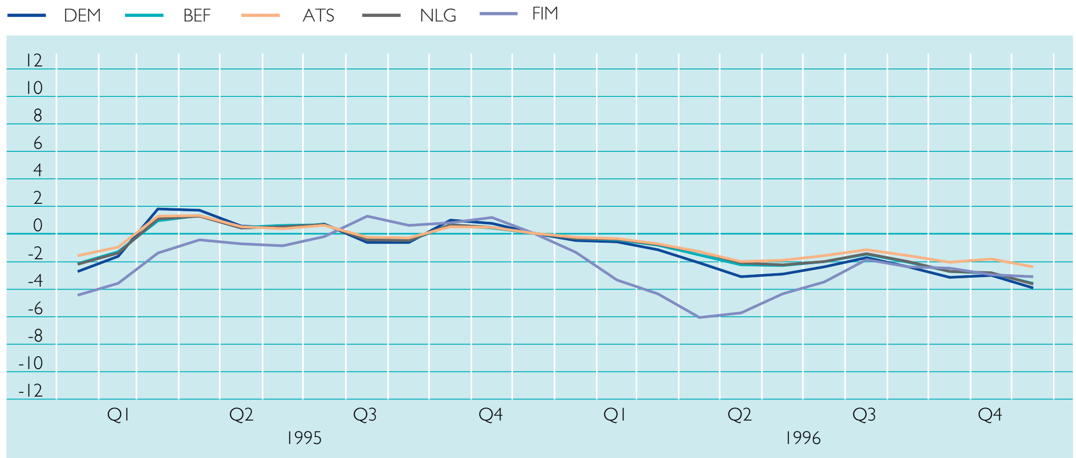
1 The calculation of real effective exchange rates is based on the following deflators: consumer price index, producer price index and unit labour costs in the manufacturing sector.

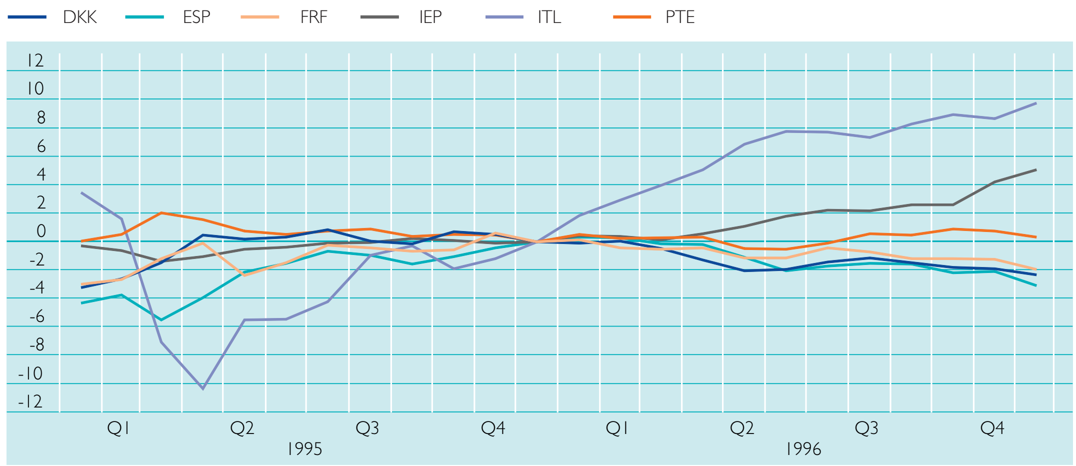
Chart 7

Nominal effective exchange rates*

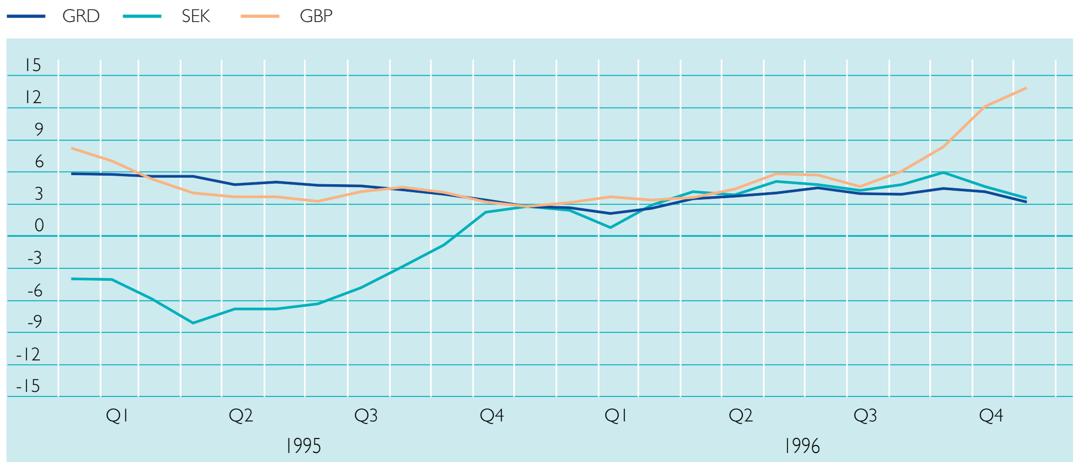
(monthly averages; in percentage changes relative to December 1995)

ERM currencies





Non-ERM currencies



Source: BIS.

* Against a basket comprising the currencies of 26 industrialised countries.

Box 5

Private ECU markets

In 1996 the private ECU banking and financial markets contracted for the fourth successive year (see table below). The estimated total market size declined by 8.6% between end-September 1995 and end-September 1996, to stand at ECU 153.6 billion. This level is 20.5% below the peak recorded in September 1992. A fall in the volume of outstanding international bond issues, from ECU 62.5 to 51.8 billion between end-September 1995 and end-September 1996, was largely responsible for the overall contraction of the market. Repayments of maturing bonds continued to be high and in excess of new issues. Against the background of buoyant issuing activity on international bond markets, the contraction of the international ECU bond market brought the currency's share in the total down from 3.8 to 2.8% over the twelve months to end-September 1996. Other sectors of ECU activity were more buoyant. The value of outstanding domestic ECU bonds, which reflected mainly new issues by the public sector, increased from ECU 56.6 to 58.3 billion. Short-term instruments outstanding increased slightly over the same period due to a pick-up in ECU-denominated Euronote issues. Here again, however, the global volume of Euronotes rose more rapidly than the ECU segment, implying a decline in market share from 1.9 to 1.5%. Estimated bank lending in ECUs (total final bank lending and lending to banks outside the BIS reporting area) declined by 11.0%, to stand at ECU 51.0 billion at end-September 1996, compared with ECU 57.3 billion at end-September 1995. On the liabilities side, ECU deposits held by non-banks contracted by 9.1%. The ECU's

ECU financial markets

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

	1992	1993	1994	1995	1996			
	Q3	Q3	Q3	Q3	Q1	Q2	Q3	Q4
Bonds, *of which*	130.3	124.5	125.4	119.1	111.7	110.8	110.1	109.5
- international	*86.3*	*78.2*	*69.1*	*62.5*	*55.7*	*53.6*	*51.8*	*50.1*
- domestic	*44.0*	*46.3*	*56.3*	*56.6*	*56.0*	*57.2*	*58.3*	*59.4*
(National) Treasury bills	6.9	8.3	4.7	3.5	3.5	3.5	3.5	3.5
Euro-CPs and Euro-notes	8.6	6.5	6.4	8.2	9.3	8.8	9.0	9.9
Estimated bank lending[a]	67.5	66.6	59.9	57.3	55.9	53.2	51.0	.
Estimated total market size[b]	193.3	185.9	176.4	168.1	160.4	156.3	153.6	.
Bank assets, *of which:*	198.0	196.0	178.4	164.5	153.1	144.3	141.6	.
- vis-à-vis non-banks[c]	*61.6*	*61.0*	*55.6*	*52.6*	*50.0*	*48.4*	*46.5*	.
Bank liabilities, *of which*:	200.7	191.9	174.7	157.7	148.3	140.2	136.5	.
- vis-à-vis non-banks[c]	*34.9*	*30.9*	*27.1*	*23.1*	*24.6*	*22.6*	*21.0*	.
Memorandum items:								
Central banks' holdings of private ECUs	18.9	19.1	24.0	23.3	19.9	20.0	21.8	22.8
Turnover of ECU securities[d]	1473.6	333.6	402.0	479.6	474.1	422.9	392.5	418.5
% of total turnover in all currencies	*13.3*	*6.1*	*6.9*	*7.4*	*5.3*	*4.8*	*4.1*	*4.3*

Source: BIS, Euroclear and Cedel.

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

(b) ECU 20 billion are deducted for estimated double counting: there is an overlap between the securities and banking markets owing to the role of banks as issuers and holders of ECU securities. In the absence of comprehensive data, this overlap may only be estimated.

(c) Identified non-banks only.

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

market share in total international banking assets and liabilities dropped further from 2.4 to 1.9% (assets) and from 2.3 to 1.8% (liabilities).

The spread between the ECU market and theoretical or "basket" exchange rates has traditionally remained in a range of ±20 basis points, except during periods of exchange market turbulence. In early 1996 the negative spread widened markedly to reach over -3%, the largest discount ever (see chart below). However, from March onwards, a rapid and marked reversal of this trend was recorded, bringing the spread back to around -0.5% by December 1996. The spread between the ECU market bond yield and the theoretical bond yield widened from around zero in early 1996 to -0.2 percentage point in April and remained around that level for the remainder of the year.

The sharp widening of the exchange rate spread by early 1996, at a time when exchange rate tensions were not marked, may have reflected various factors, most notably uncertainties about the starting date and expected initial composition of Stage Three of EMU, as well as the legal status of the private ECU and the continuity of ECU contracts. The subsequent marked narrowing of the exchange rate spread since the first quarter of 1996 may be the result of a lowering of tensions and uncertainties, as reflected in stable conditions within the EMS. It may also mirror the increased optimism in financial markets about the likelihood of EMU, as well as the agreement reached at the European Council meeting held in Dublin on 13-14 December 1996 on the legal framework for the use of the euro.

Difference between market and theoretical exchange rates of the ECU
(in percent)

Source: National data.

escudo the evidence was mixed, depending on the indicators used. All non-ERM currencies, and most notably the pound sterling, experienced an appreciation of their real effective exchange rates. Overall, at end-1996 many EU currencies may be considered to have moved towards exchange rate levels that are more sustainable with respect to underlying competitive positions. A crucial factor in this regard may have been declining inflationary expectations coupled with the limited degree of passthrough of earlier depreciations to domestic inflation.

Nuanced policy responses

Monetary authorities responded to the quiet market conditions prevailing during 1996 in different ways, reflecting varying domestic economic needs and monetary and exchange rate policy strategies (see also Section 2 of this chapter). Notably, upward pressure experienced by a number of currencies vis-à-vis the Deutsche Mark was accommodated by means of a combination of approaches - allowing currencies to appreciate, reducing short-term interest rates and effecting intervention purchases of foreign reserves - the relative weight of which differed between countries.

Some EU central banks permitted a sizable appreciation of their exchange rates in order to support an anti-inflationary policy stance or to contain potential inflationary pressures in the light of a buoyant domestic economy. In many member countries interest rate differentials vis-à-vis the Deutsche Mark declined sharply along the yield curve. Overall, foreign exchange intervention activity was higher than in 1995. A few EU central banks bought significant amounts of foreign currencies in order either to replenish reserves or to preserve orderly market conditions, while keeping monetary conditions in line with domestic policy requirements.

1.6 Securities markets in EU countries

Declining long-term interest rates and differentials

Nominal yields on 10-year bonds declined over the course of 1996 in all EU countries, with the exception of the United Kingdom. On average, bond yields in the EU decreased by 1.1 percentage points (see Table 7). There were marked cross-country variations: long-term interest rates in Italy, Portugal and Spain declined by 3.3, 2.9 and 2.8 percentage points respectively, while in Sweden they declined by 1.7 percentage points. In Belgium, Denmark, France, Ireland, Luxembourg and Finland 10-year bond yields dropped by around 0.7 to 1.0 percentage points. The decline was less pronounced in Germany, the Netherlands and Austria, where interest rate levels were already low.

Two broad themes emerge from an analysis of factors underlying bond market developments in the EU in 1996. One is the role played by the US market. Given its size, developments in the US bond market generally tend to play a key role in the determination of short-term movements of bond yields in the EU. However, fundamental factors which influenced bond market developments in the EU in 1996 differed somewhat from those in the United States, making room for a partial "decoupling" from the US market. Whereas the differential between US 10-year bond yields and those in Germany has fluctuated within a very narrow range by historical standards since 1990, mainly reflecting the influence of the longer-term improvement in the inflation performance of the United States, this differential moved from negative to positive during 1996 as US bond yields rose above those in Germany for the first time since late 1994 (see Chart 8). The principal underlying factor was the differing cyclical positions of the United States and most EU countries, which in turn led to differing expectations about the future course of short-term interest rates. In addition, the recovery of the US dollar throughout the year played a supportive role in this development. Differing expectations of short-term rates linked to the current cycle also accounted for the difference in nominal bond yields between the United Kingdom and Germany.

A second theme relates to the development of intra-EU bond yield differentials. In all EU countries with the exception of the United Kingdom, long-term interest rate differentials against countries with the lowest bond yields narrowed significantly during the course of 1996 (see Chart 8). In the early part of the year long-term interest rate differentials tended to narrow, particularly for high-yielding countries, despite the upturn in international bond yields. This development contrasted with previous episodes of increasing international bond yields, which are usually coupled with widening differentials. Together with the declining volatility in the bond markets of high-yielding countries, this was indicative inter alia of declining inflation risk premia in these countries.

In particular, those countries which had the largest differentials at the beginning of the year and where risk premia may correspondingly have been highest, such as Spain, Italy, Portugal and Sweden, tended to demonstrate the greatest narrowing of

Table 7

Long-term interest rates

(long-term bond yields; end-month; in percentages)

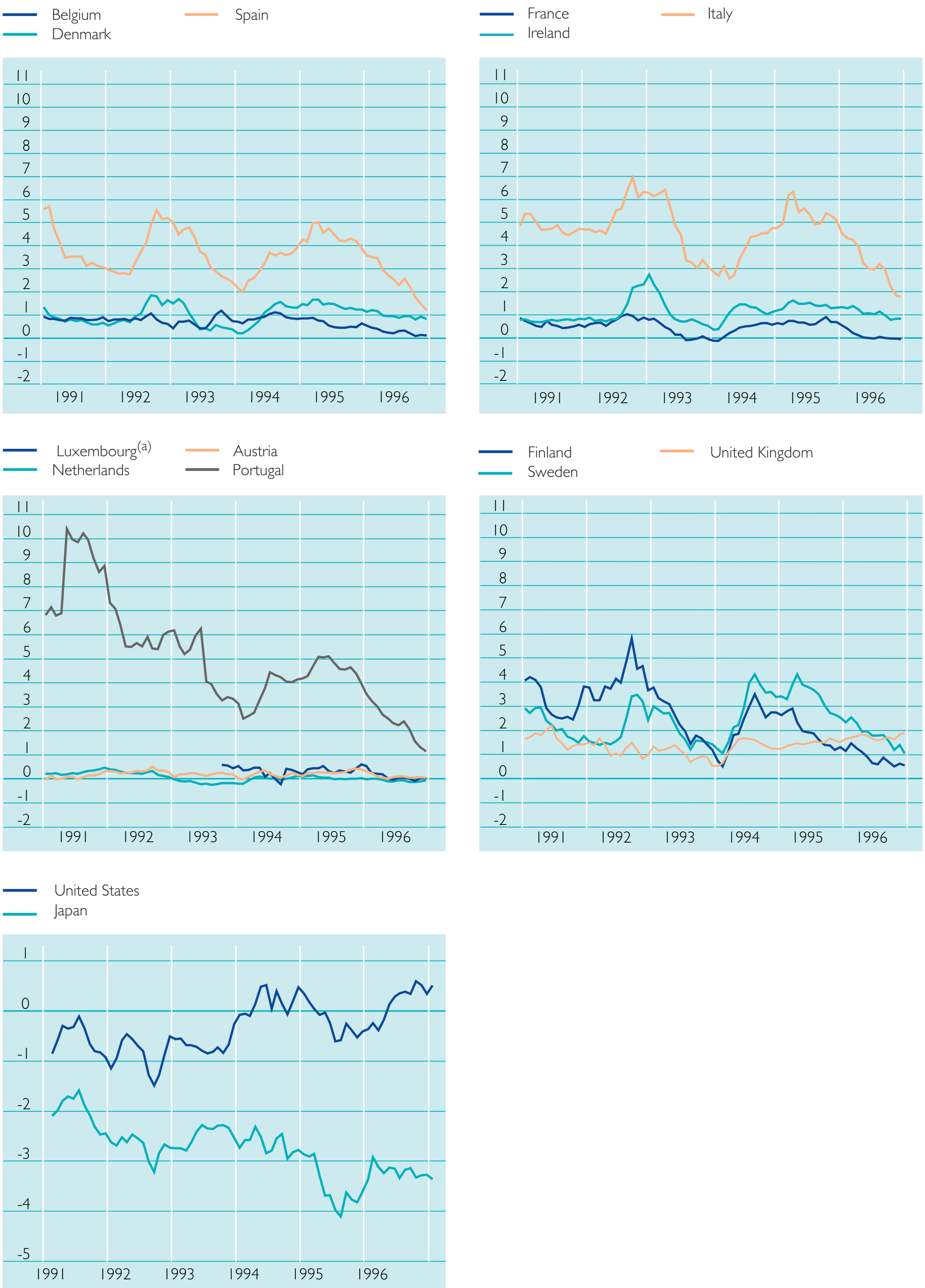
	December 1994	December 1995	June 1996	December 1996	Change[a] 1995	Change[a] 1996
Belgium	8.34	6.69	6.80	5.86	-1.65	-0.83
Denmark	9.14	7.23	7.44	6.52	-1.91	-0.71
Germany	7.66	6.02	6.56	5.77	-1.64	-0.25
Greece[b]	19.00	.	.	.	.	.
Spain	11.79	9.70	8.90	6.89	-2.09	-2.81
France	8.28	6.64	6.47	5.82	-1.64	-0.82
Ireland	8.76	7.34	7.49	6.58	-1.42	-0.76
Italy	12.40	10.87	9.44	7.55	-1.53	-3.32
Luxembourg	7.78	6.68	6.55	5.78	-1.10	-0.90
Netherlands	7.76	6.01	6.41	5.67	-1.75	-0.34
Austria	7.63	6.36	6.64	5.84	-1.27	-0.52
Portugal	11.81	9.77	8.74	6.86	-2.04	-2.91
Finland	10.09	7.20	7.06	6.21	-2.89	-0.99
Sweden	10.88	8.41	8.11	6.68	-2.47	-1.73
United Kingdom	8.87	7.53	8.03	7.64	-1.34	0.11
EU-15	9.49	7.80	7.68	6.67	-1.69	-1.13
United States	7.84	5.58	6.73	6.43	-2.26	0.85
Japan	4.59	2.91	3.17	2.57	-1.68	-0.34

Source: For the EU-15, harmonised convergence criteria bond yields (see also footnote (b)). For the United States, 10-year bond yield and for Japan, 10-year benchmark bond yield.
(a) Percentage points, end-year less end-year.
(b) Interest (coupon) rate at issue of five-year government bonds (linked to the twelve-month Treasury bill rate). Such bonds were not issued in every month hence the missing entries.

Chart 8

Differentials against German long-term bond yields*

(monthly average data; in percentage points)



Source: National data.

* For further explanation of the data used see footnotes to Table 7. For the United States, 10-year bond yield and for Japan, 10-year benchmark bond yield. For reasons of comparability, Greek data are not shown.

(a) Comparable data are only available from 22 October 1993.

differentials. A combination of factors appears to account for this trend, including a significant reduction in expected inflation differentials within the EU, perceptions of progress towards fiscal consolidation, the relative stability of exchange rates and a decrease in political uncertainty in a number of countries. These factors were seen by the markets as improving the prospects for EMU - an element which may in turn have played an independent role in the narrowing of differentials, both directly and by further improving prospects for exchange rate stability.

Strong performance of EU equity markets in 1996

In most EU countries equity price indices increased by 20-25% during 1996. This similar development is, to some extent, indicative of broadly similar expectations regarding real macroeconomic trends in EU countries. However, the rise did not solely relate to expectations regarding corporate earnings.

One important influence on this development appears to have been a perception that stock prices in many EU countries had moved out of line with both US stock prices and EU bond markets during the course of 1995 rather than revisions of expectations regarding trends in corporate earnings. To some extent, therefore, there may have been an element of catch-up with US developments during 1996, with international fund managers increasing their EU portfolio weightings as US equity prices continued to rise.

Bond yields may also have played a role. The gap between long-term bond yields and dividend yields can offer an indication of the influence of bond market developments on the equity market and hence can provide information about expected future dividend growth or changes in the equity risk premium. In contrast to the United States, this gap tended to narrow in many EU countries during 1996. This suggests that not only expectations about future earnings in the EU but also the decline in long-term bond yields played an important role in the equity markets.

2 Monetary policies in Member States

This section describes the changes in monetary conditions in individual EU countries in 1996. Its content reflects the EMI's task in Stage Two of EMU to strengthen the co-operation between the national central banks and the co-ordination of the monetary policies of Member States, with the aim of ensuring price stability. Linked to these responsibilities, the appropriateness and compatibility of current monetary and foreign exchange policies are reviewed in regular discussions at the EMI.

In most EU countries the economic and financial environment in 1996 allowed for further steady but cautious easing of monetary policies via reductions in official and key interest rates (see Chart 9, Chart 10 and the chronology in the Annex); the rate of expansion of the broad money supply (in terms of harmonised M3) in the Union as a whole rose from 2.9% in 1995 to 6.4% in 1996. On balance, in the majority of Member States (namely Belgium/Luxembourg, Denmark, Germany, France, the Netherlands, Austria, Finland and Sweden) official and key interest rates declined to low and very similar levels. The convergence of short-term interest rates and inflation rates in 1996, in conjunction with the achievement of a high degree of exchange rate stability, suggests the emergence of a closely aligned stance of monetary policies among these EU countries. In most of the remaining EU countries economic and exchange rate conditions in 1996 gradually became more supportive of an easing of monetary policies. As a result, their short-term interest rate differentials against the Deutsche Mark narrowed considerably (see Chart 10). This led to a progressive convergence of the more differentiated monetary policy stance which had been warranted for much of 1995 to counter rising inflationary pressures and/or renewed exchange rate turbulence in some EU countries. The exceptions were Ireland, which, later in the year, chose to adopt a more strict monetary stance, and the United Kingdom, which raised official interest rates in the second half of 1996.

In Germany the prospect of inflation remaining at a level seen as being consistent with price stability allowed the Deutsche Bundesbank to pursue further monetary easing. The securities repurchase rate, which stood at 3.75% at the start of 1996, was allowed to fall to 3.4% at the end of January and was set at 3.3% from February onwards. In April the central bank decided to reduce the official discount rate by 0.5 percentage point to the historically low level of 2.5%. At the same time, the lombard rate was lowered from 5.0 to 4.5%. With the inflation outlook continuing to be favourable, the securities repurchase rate was again reduced in August, to stand at 3.0% for the rest of the year. In addition, further correction of the major appreciation of the Deutsche Mark which had taken place in early 1995 was observed.

The expansion of the broad money supply M3 remained the key variable guiding the monetary policy decisions of the Deutsche Bundesbank. In the fourth quarter of the year the annual rate of M3 growth was 8.1% and thereby exceeded the 4-7% target range (see Table 8). This was attributable to a slight recovery of bank lending to the private sector and, above all, to a hesitant demand for long-term financial assets not included in M3. However, as M3 growth was around 5% on average over the past three years, the underlying monetary trend appeared to be broadly in line with the objectives and was not considered to be a serious ground for concern. As a consequence of the occasional distortions to M3 growth in recent years, the central bank placed increasing emphasis on the medium-term trend in monetary growth (see Box 6). To take account of the greater volatility of short-term monetary developments, the Deutsche Bundesbank also decided to widen the target corridor for M3 growth in 1996 from 2 to 3 percentage points. Furthermore, due consideration was given to the information contained in supplementary indicators of future inflation.

The downward movement of German official interest rates was mirrored in several other EU countries. The strength of the Dutch guilder allowed De Nederlandsche Bank to maintain its key interest rates somewhat below their German equivalents throughout the year. This position was reflected in slightly negative short-term interest rate differentials vis-à-vis the Deutsche Mark (see Chart 10). Money market rates in Austria remained closely linked to those in Germany, consistent with the strong focus on maintaining a stable relation between the schilling and the Deutsche Mark.

Table 8

Monetary policy targets and guidelines of Member States

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

	Reference variable	1995 Target/ guideline(a)	1995 Outturn	1996 Target/ guideline(a)	1996 Outturn	1997 Target/ guideline(a)
Germany	M3	4-6	2.1	4-7	8.1	3.5-6.5
Greece	M3	7-9	10.3	6-9	9.0	6-9
Spain	ALP	<8	9.2	<8	6.5	≤7
France	M3	5.0	4.0	5.0	-1.5	5.0
Italy	M2	5.0	1.9	5.0	2.6	<5
United Kingdom	M0	0-4	7.1	0-4	5.6	0-4
	M4	3-9	5.5	3-9	9.8	3-9

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.

b) Formal inflation targets
(annual percentage changes)

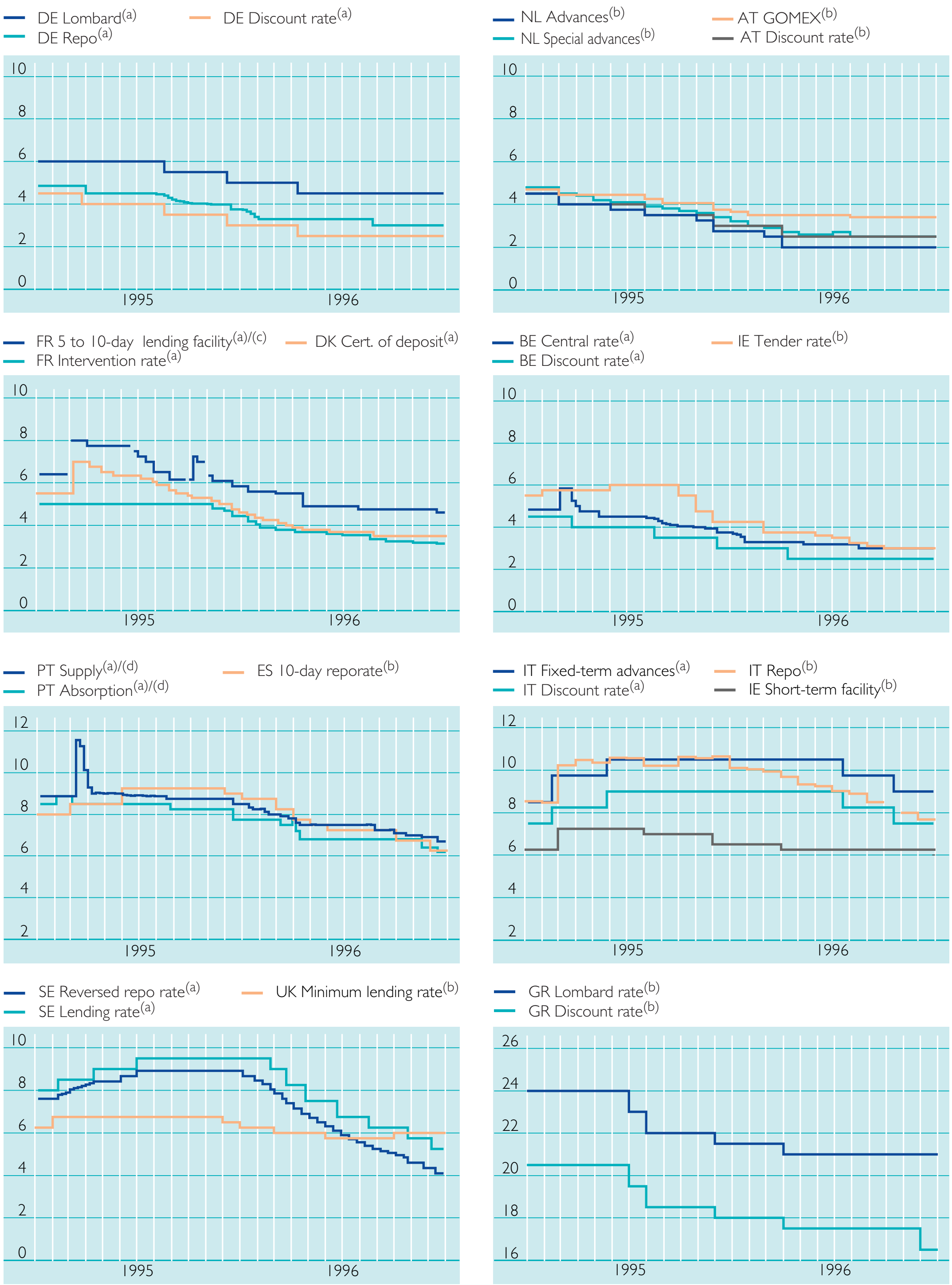
	Target variable(a)	1995 Target	1995 Outturn	1996 Target	1996 Outturn	1997 Target	Medium-term target
Spain	CPI	-	4.7	3.5-4(b)	3.7	<3	2(c)
Finland	CPIY	~2	-0.1	~2	0.2	~2	~2
Sweden	CPI	2 ± 1	2.9	2 ± 1	0.7	2 ± 1	2 ± 1
United Kingdom	RPIX	1-4	2.9	1-4	2.9	≤2.5(d)	≤2.5

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) Applies to 1998.
(d) Lower half of 1-4% range by spring 1997; 2.5% or less thereafter.

Chart 9

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) Break in series from 8 March to 21 June 1995 inclusive and from 6 October 1995 to 8 November 1995 inclusive, when the Banque de France suspended its 5 to 10-day lending facility and replaced it with a 24-hour repo facility.

(d) If the announcement of regular rate of supply of liquidity is suspended, the interest rate corresponds to the rates on occasional operations.

Economic fundamentals underpinned the high degree of stability of the Belgian/ Luxembourg franc vis-à-vis the Deutsche Mark. During the year the Belgian three-month interest rate spread over Germany fluctuated in a narrow range around zero. Following the strengthening of their respective currencies within the ERM, the central banks of both Denmark and France gradually brought their official rates down to levels not far above those in Germany, the Netherlands, Austria and Belgium.

A specific feature in the case of France was the marked deceleration of broad money growth during the year, as the steep yield curve triggered a widespread shift from short-term deposits into longer-term assets and other substitutes for money such as certain forms of contractual savings. In the fourth quarter of 1996 M3 declined at an annual rate of 1.5%, which compares with the Banque de France's objective of accommodating an annual increase of 5% over the medium term (see Table 8). At the same time, formation of liquidity was dynamic; the narrow money aggregates M1 and M2, which cover transactions balances and liquid savings, showed annual growth rates of 3.7% and 6% respectively in the fourth quarter of 1996. The growth rate of gross total domestic debt, which the Banque de France monitors as an indicator of financing provided to the economy, decelerated from 5.0 to 3.6%.

In Finland evidence of very subdued inflationary pressures provided scope for Suomen Pankki to bring its tender rate down further, while continuing to comply with its objective of stabilising underlying inflation at around 2% (see Table 8). From October onwards, money market rates stood virtually in line with those in Germany. On the entry of the Finnish markka to the ERM on 14 October 1996, the central bank declared that while monetary policy decisions would continue to be taken with a view to the inflation target, greater attention would henceforth be given to the objective of ensuring exchange rate stability.

Outside the ERM Sveriges Riksbank undertook a monetary easing beginning in early January 1996 in response to the rapidly improving inflation outlook in Sweden following the strong recovery of the krona and the restrictive fiscal stance. The pace of the subsequent step-wise reduction in official interest rates was conditional on the continued observance of the Riksbank's 2% inflation target (with a fluctuation margin of 1 percentage point on either side). Over the year as a whole the Swedish three-month interest rate fell in anticipation of lower key rates while the securities repurchase rate declined by a total of 481 basis points to 4.1%.

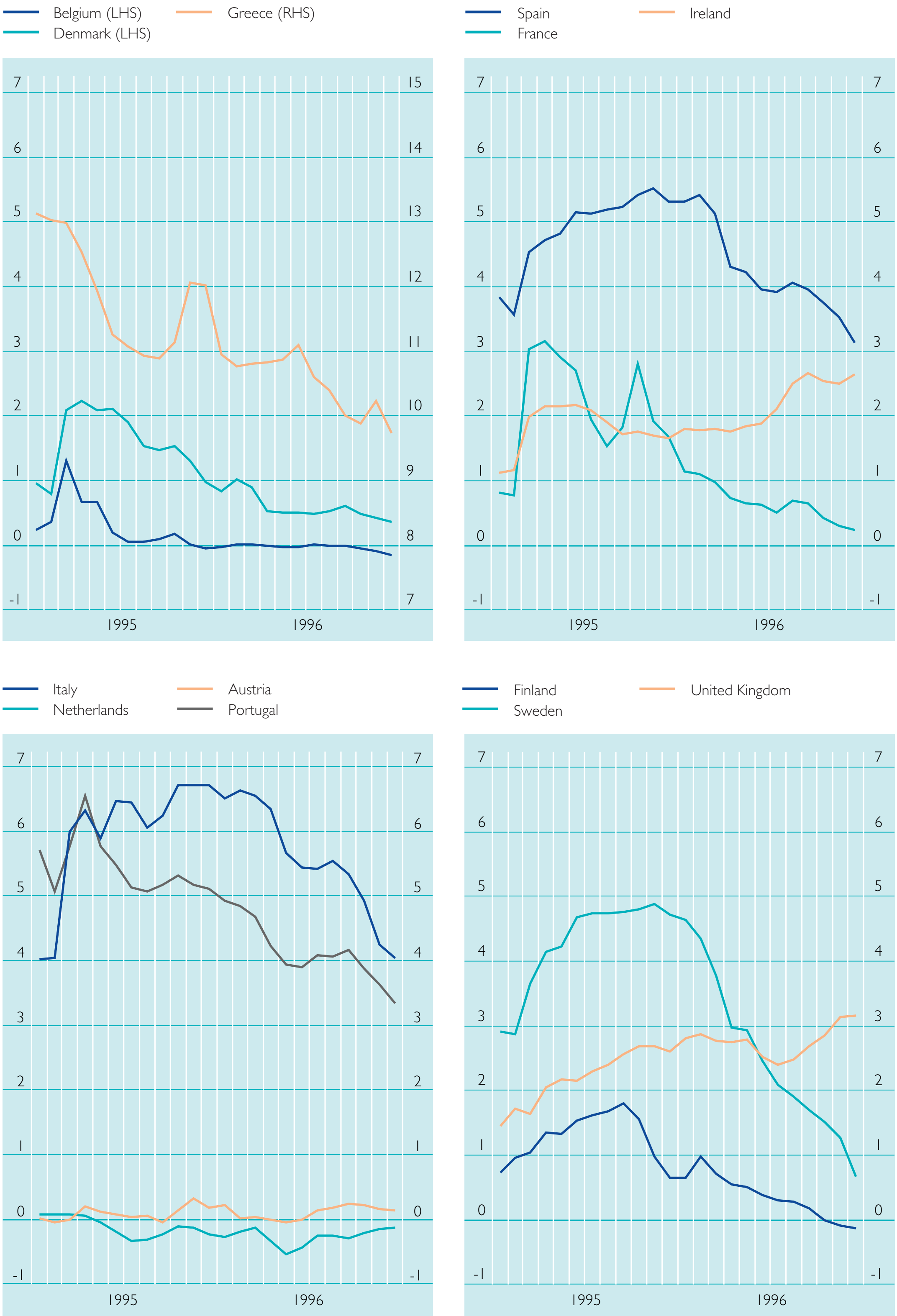
Among the remaining countries, in Portugal evidence of progress towards fiscal consolidation and wage developments in line with incomes policy agreements contributed to favourable inflation prospects, which underpinned the steady upward trend of the escudo within the ERM. This paved the way for a reduction in official interest rates broadly in line with several other ERM currencies and an appreciable narrowing of the three-month interest rate spread over Germany (the repo rate declined by a total of 180 basis points to 6.7%).

The Banco de España also saw scope to continue the cautious monetary easing it had initiated in December 1995, while ensuring that the downward trend of current and expected Spanish inflation stayed in line with its objective to bring the rate of inflation steadily below 3% in 1997. Two key factors supporting this assessment were the stable position of the peseta within the ERM and the decline of the growth rate of ALP (liquid assets held by the public) to 6.5%, well below the medium-term ceiling of 8% (see Table 8). Moreover, the adoption of a restrictive budget entailed a notable improvement in the policy mix. Accordingly, the intervention rate was brought down in

Chart 10

Short-term interest rate differentials against Germany

(3-month interbank rates; in percentage points)



Source: National data.

several steps, from 9.0% at the start of the year to 6.25% in December. While the associated decline in short-term interest rates significantly reduced the spread of Spanish rates over Germany, the wide margin still suggested a relatively strict monetary stance.

The Banca d'Italia had announced that it would seek to ensure a rate of consumer price inflation (net of indirect taxes) of below 4% in 1996 and of less than 3% in 1997. Consequently, the satisfactory price performance - which was supported, inter alia, by a strong recovery of the lira - allowed the central bank gradually to lower short-term interest rates during the course of 1996. Moreover, the expansion of the M2 money supply remained well below the reference target of 5% (see Table 8). After mid-year both the discount rate and the fixed-term advances rate were reduced in two steps, by 75 basis points on each occasion, to 7.5% and 9% respectively. Subsequently, short-term market rates declined further after the lira's return to the ERM grid, which took place on 25 November 1996, although the reduction in short-term rates was less than that in long-term rates, thus signalling a restrictive monetary policy stance.

The Bank of Greece gradually lowered its interest rates, as a reflection of both the broadly stable position of the drachma against the ECU - the central bank's key intermediate objective - and the prospect of inflation resuming its downward trend. High fiscal deficits and structural rigidities, however, continued to act as a constraint on monetary policy and prevented the attainment of a more appropriate policy mix. In particular, the resultant relatively high level of interest rates encouraged strong capital inflows, even though interest rate differentials against other EU countries narrowed considerably. To arrest the attendant rapid credit expansion, in addition to continuously absorbing excess interbank liquidity, the central bank was forced to tighten its minimum reserve requirements from June onwards. Largely as a result of this countermeasure liquidity conditions gradually normalised, credit expansion slowed down, and the annual rate of M3 growth fell to within the 6-9% target range.

The more advanced cyclical upswing led to a somewhat more differentiated monetary policy stance in the United Kingdom. In the first part of the year the inflation outlook appeared to be broadly consistent with the Government's medium-term objective of bringing underlying (RPIX) inflation down to 2.5% or less. This prompted the authorities to proceed further along the path towards monetary easing on which they had embarked in December 1995. Accordingly, the minimum lending rate was reduced on three occasions by a total of 75 basis points, and stood at 5.75% at the end of the first half of the year. In the course of 1996, however, inflation prospects deteriorated as the cyclical recovery gathered pace and broad money growth (in terms of M4) remained strong. Against this background, and following the advice of the Bank of England, the Chancellor of the Exchequer decided at the end of October to raise the minimum lending rate again by 25 basis points to 6.0%.

Finally, Ireland also observed the closely aligned stance of monetary policy characteristic of the majority of EU countries in the first months of 1996. In April the central bank was still in a position to participate in the general round of official interest rate reductions, trimming its short-term facility rate by 25 basis points to 6.25%. Later in the year, however, it chose to adopt a more strict monetary stance by letting money market rates rise in response to the buoyant growth of monetary and credit aggregates and economic activity. This went in parallel with a steadily appreciating Irish pound.

Box 6

Recent experience of monetary targeting and inflation targeting

For many years monetary policies in the larger industrial countries made prominent use of intermediate monetary targets. The major EU countries were no exception; by the end of the 1970s they had all publicly announced monetary targets as the centrepiece of their national frameworks for monetary policy. In contrast, smaller Member States generally adhered to an exchange rate objective and refrained from setting monetary targets in their pursuit of the common objective of price stability. Against the backdrop of the changing financial environment and the increased focus on exchange rate stability, most of the larger EU countries downgraded the practice of monetary targeting in the course of the 1980s. Only in Germany did monetary targeting retain its previous pre-eminent position. The fact that, in addition to Germany, several other Member States (namely Greece, Spain, France, Italy and the United Kingdom) nonetheless continued to announce quantitative monetary guidelines, reference values or monitoring ranges suggests that they still attached a prominent role to key monetary aggregates.

In the early years of the 1990s the process of financial liberalisation and innovation continued at an even faster pace, raising important questions about the interpretation of and control over more volatile short-term movements in monetary aggregates. Moreover, in Germany monetary growth was distorted by influences resulting from unification and by other special factors, e.g. modifications to the tax framework. The Deutsche Bundesbank has adjusted to these trends by increasingly assessing current monetary developments in Germany from a medium-term perspective and in the light of supplementary inflation indicators. With the help of this strategy the Deutsche Bundesbank was able to reduce the inflation rate, which had risen in the wake of unification, in the following years to a level which is broadly seen as consistent with price stability. The monetary authorities of other EU countries under review have generally responded by (further) reducing the prominence given to monetary aggregates in the formulation of their monetary policies. They nonetheless continue to see monetary aggregates as a very useful - and in some cases preferred - indicator of the longer-term risks of future inflation. As such, monetary aggregates have retained their function as an indispensable policy guide.

In some cases the shift in policy focus described above has occurred as part of the changeover to a monetary regime in which explicit inflation targets perform the role of providing an anchor for inflation expectations. Over the past few years four Member States have formally adopted such a monetary framework, namely Spain, Finland, Sweden and the United Kingdom. While the rather recent date of the changeover precludes a conclusive assessment of the effectiveness of direct inflation targeting, the experience of the early years nevertheless allows some observations to be made. In general, the inflation performance in these EU countries has been markedly better than in the past and the announced (interim) inflation targets have often been achieved ahead of time. As a note of caution, however, it should be borne in mind that these good results may also have reflected in most cases the tight monetary policies which had been pursued towards the end of the previous exchange rate targeting regimes, the global experience of disinflation and supply-side policies.

This general qualification notwithstanding, all four of the above Member States had a rather favourable policy record in the first few years of implementing a direct inflation targeting strategy. This policy record (as documented, for example, in the EMI's previous two Annual Reports) shows that, in the course of 1994-95, the monetary authorities in Spain, Finland, Sweden and the United Kingdom responded to a deterioration in prospects for inflation by tightening the policy stance in an alert and pre-emptive manner. To account for the uncertainties of inflation forecasting and inflation control, they have tended to adopt a cautious monetary policy stance on the basis of all relevant information (generally including monetary aggregates), while explaining their actions and objectives in detailed inflation reports and related publications. Available indicators for 1996 indicate that some success has been achieved in establishing credibility for this new monetary strategy.

3 Economic prospects and challenges for convergence

More favourable conjunctural outlook, while structural adjustment needs persist

Economic forecasts released by international organisations at the end of 1996 point to a benign external environment and a more favourable conjunctural outlook for the EU in 1997.

As regards the external environment, world output growth is expected to maintain the same sustained pace in 1997 as it did in 1996, with the US economy continuing to expand at a steady rate, although activity in Japan may decelerate. World trade should maintain the relatively high growth rate attained in 1996. The prices of raw materials are not expected to pose a major threat to price stability.

In the European Union GDP growth is expected to pick up in 1997, reflecting a projected recovery of both domestic and foreign demand. Domestic demand - in particular private investment - should benefit from a number of positive developments during 1996, inter alia: progress towards price stability; a significant decline in long-term interest rates; and corrective movements of exchange rates followed by increased stability on foreign exchange markets. Moreover, continued wage moderation and favourable profitability should contribute to an acceleration in activity. Net exports are also expected to increase their positive contribution to growth, albeit slightly, inter alia as a result of forecast high extra-EU growth. Private consumption may remain more subdued.

In contrast to the more favourable conjunctural outlook, however, the process of structural adjustment is still at an early stage. In particular, the situation in labour markets is forecast to remain highly unsatisfactory in most EU countries. Although employment is expected to grow to some extent in 1997, after stagnating in 1996, unemployment rates in the EU may decrease only marginally, thus remaining at historically high levels. For this reason, considerable emphasis has been placed over the past few years on efforts to increase labour market flexibility in Europe (see Box 2). Some countries, such as Denmark, Spain, Ireland, the Netherlands, Finland and the United Kingdom, may be expected to perform better than average in this respect, owing in several cases to progress in labour market reforms. However, in most countries such reforms still seem to be too marginal to significantly improve labour market trends. Even in countries where substantive measures have been undertaken, more time will be necessary for the effects of such reforms to be fully assessed.

While structural reform is indeed seen to be the key to addressing the unemployment problem in most Member States, it is obvious that there is no uniform European labour market. This explains why there have been considerable differences in the form, intensity and timing of labour market reforms in the individual Member States. However, it is common to almost all these reforms that they have focused on social security (particularly the unemployment benefits system), regulations concerning working hours, contract terms and the use of temporary workers, and aspects of the collective bargaining systems. It is in these fields that a wide range of institutional rigidities account for the weak performance of European labour markets, and it will be a major challenge for most Member States to tackle them in a decisive and sustained manner.

The state of convergence

In November 1996 a comprehensive report entitled "Progress towards convergence 1996" was released by the EMI. The report, which for the first time was produced for the EU Council under Article 109j (1) of the Treaty, concluded that "at present a majority of Member States do not fulfil the necessary conditions for the adoption of a single currency". In mid-December 1996 the Council, meeting in the composition of the Heads of State or Government, took its decision under Article 109j (3) of the Treaty and confirmed that the procedure laid down in Article 109j (4) will be applied as early as possible in 1998, with a view to the commencement of the third stage of EMU on 1 January 1999. This decision requires that the Council, meeting in the composition of the Heads of State or Government, will confirm in early 1998 which Member States fulfil the necessary conditions for the adoption of the single currency. The Treaty provides for this assessment to be preceded by reports by the EMI and by the Commission.

As regards the state of convergence, the EMI's November 1996 Report saw the environment of low cost and price pressures as favourable. Most Member States were enjoying relatively low inflation, and many had virtually achieved price stability. Other countries had recorded a slowdown in inflation, which was seen as having contributed to a tendency towards reduced risk premia in financial markets, and thereby to a higher degree of exchange rate stability and a reduction in long-term interest rate differentials. By contrast, progress in fiscal consolidation was generally regarded as too slow. Most countries had not yet achieved a situation which, in a broader view, might be judged as sustainable in the medium term. With regard to the issue of sustainability, it was emphasised that the improvement of the deficit by measures with a one-off effect does not ensure sustainable consolidation and that great attention would have to be paid to the substance and not only to the accounting methods used to measure both deficits and debts; that consolidation efforts needed to be all the more resolute, the higher the initial stock of debt; and that sustainable fiscal consolidation would have to cope with two challenges: first, high and persistent unemployment and, second, those arising from demographic trends.

The data presented below (see Table 9) give a brief update of this examination related to 1996. In this context, it should be noted that the data for the examination of convergence are to be provided by the Commission and no new Commission data are yet available for the outcome of fiscal policies in 1996. Therefore, reference is still made to the data published by the Commission in November 1996. For the criteria on price stability and on convergence of long-term interest rates, the data have been updated to include the months to December 1996. Furthermore, new data on Harmonised Indices of Consumer Prices have been included for 1996, while for 1995 inflation rates are only available on the basis of Interim Indices of Consumer Prices (see Box 7).

Progress towards price stability

Prospects for sustained low inflation in the EU are rather favourable. A number of factors underlie this judgement: the growth of monetary aggregates does not give cause for concern; in most countries there remains spare capacity and wage growth appears to be moderate. Moreover, in some countries where wages are more buoyant, there may still be some scope for their inflationary consequences to be at least partly absorbed by reductions in profit margins or increases in productivity.

Table 9

Economic indicators and the "Maastricht Treaty" convergence criteria

(excluding the exchange rate criterion)

1995		IICP inflation[a]		Long-term interest rate[b]		General government surplus (+) or deficit (-)[c]		General government gross debt[c]
Belgium	***	1.4	***	7.5		-4.1		133.7
Denmark[d]		2.3		8.3	#	-1.6		71.9
Germany		1.5		6.9		-3.5	#	58.1
Greece		9.0		17.3		-9.1		111.8
Spain		4.7		11.3		-6.6		65.7
France		1.7		7.5		-4.8	#	52.8
Ireland[e]		2.4		8.3	#	-2.0		81.6
Italy		5.4		12.2		-7.1		124.9
Luxembourg		1.9		7.2	#	1.5	#	6.0
Netherlands	**	1.1	**	6.9		-4.0		79.7
Austria		2.0		7.1		-5.9		69.0
Portugal		3.8		11.5		-5.1		71.7
Finland	*	1.0	*	8.8		-5.2	#	59.2
Sweden		2.9		10.2		-8.1		78.7
United Kingdom		3.1		8.3		-5.8	#	54.1
EU-15		3.0		8.9		-5.0		71.3

Sources: EUROSTAT (IICP, HICP), national data (long-term interest rates), European Commission (general government surplus or deficit, general government gross debt).
The statistical data to be used in assessing whether the Member States meet the convergence criteria will be provided by the European Commission; the above fiscal data date from autumn 1996.
*,**,*** = first, second and third best performer in terms of price stability. As far as inflation in 1996 is concerned, the three best performers have been chosen among the countries for which HICP data are available. The three best performers are chosen on the basis of data with a higher degree of precision than that presented in the table.
= public deficit not exceeding 3% of GDP or public debt not exceeding 60% of GDP.
(a) Annual percentage changes. For further explanation of the data used see Box 7.
(b) In percentages, annual average. For further explanation of the data used see footnotes to Table 7.
(c) As a percentage of GDP. Provisional for 1996. (European Commission autumn 1996 forecasts).
(d) General government gross debt figures are not adjusted for the assets held by the Danish Social Pension Fund against sectors outside general government, and for government deposits at the central bank for the management of foreign exchange reserves. According to

Besides these largely temporary factors, some structural improvements have been observed which support the view that the prevailing low inflation rates can be sustained in the context of appropriate monetary policies geared towards the objective of price stability. These structural changes include increasing competition in goods and services markets linked to privatisation, deregulation and international integration; the fact that, in countries where inflation rates have traditionally been high, both fiscal and monetary policies are regarded as having helped to bring about a structural improvement in inflation expectations; and labour market reforms in some countries, which have contributed to improving wage and employment flexibility. As described above, however, the evidence in this respect suggests that further measures to increase labour market flexibility are urgently warranted, particularly in the light of the high levels of unemployment in Europe.

Upward risks for inflation still remain, as is evidenced by significant increases in unit labour costs in some countries. While estimates of output gaps in the EU point to the existence of spare capacity in most countries, owing to difficulties of adjustment, a rapid reduction of the output

1996	HICP inflation[a]	Long-term interest rate[b]	General government surplus (+) or deficit (-)[c]	General government gross debt[c]
Belgium	1.8	6.5	-3.3	130.6
Denmark[d] [e]	1.9	7.2	# -1.4	70.2
Germany	*** 1.2	6.2	-4.0	60.8
Greece[f]	7.9	14.8	-7.9	110.6
Spain	3.6	8.7	-4.4	67.8
France	2.1	6.3	-4.0	# 56.4
Ireland[e] [g]	.	7.3	# -1.6	74.7
Italy	4.0	9.4	-6.6	123.4
Luxembourg	** 1.2	6.3	# 0.9	# 7.8
Netherlands	1.5	6.2	# -2.6	78.7
Austria	1.8	6.3	-4.3	71.7
Portugal	2.9	8.6	-4.0	71.1
Finland	1.5	7.1	-3.3	61.3
Sweden	* 0.8	8.0	-3.9	78.1
United Kingdom [g]	.	7.9	-4.6	# 56.2
EU-15	2.4	7.5	-4.4	73.5

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 12.0% of GDP in 1995 and are expected to be 10.0% of GDP in 1996. 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 6.5% of GDP in 1995 and is expected to be 6.2% of GDP in 1996. If corrected by these items, the debt level at end-year would stand at 53.4% of GDP in 1995 and an expected 54.0% in 1996.

(e) In 1995 and 1996 Ireland was not the subject of an EU Council decision under Article 104c (6) of the Treaty that an excessive deficit exists. In 1996 this was also the case for Denmark.

(f) Greek interest rate data is the rate of a single issue of bonds on 14 February 1996.

(g) HICP inflation rates not available for 1996.

gap may create temporary inflationary pressures, even if productive capacities in the economy are not yet fully utilised. However, it should be noted that reliable estimation of the output gap after a major recession is very difficult. Furthermore, external developments could pose risks.

The key role of sustainable fiscal positions

Against the background of fiscal positions in 1996, many governments have taken initiatives to strengthen their consolidation efforts with a view to the outcome in 1997. It is too early to judge the effect these measures will have on outturns in 1997 and beyond. However, in general, more and durable progress is needed in order to ensure sustainable fiscal positions. If present assumptions about the improved conjunctural outlook turn out to be well founded, the necessary continuation and strengthening of structural adjustments should be facilitated. At the same time, the temptation to relax adjustment efforts in the light of seemingly diminishing constraints must be avoided at all costs.

In a broader context, the decisive achievement of government objectives can also make a major contribution to the

Box 7

Harmonised indices of consumer prices

The Treaty requires the sustainable convergence of EU economies on a high degree of price stability to be measured by consumer price indices calculated 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 which affect the comparability of the national results.

To meet the requirement for comparability set out in the Treaty, in October 1995 the EU Council adopted a Regulation concerning Harmonised Indices of Consumer Prices (HICPs). Based on this regulation, a first step towards producing harmonised indices of consumer prices was taken in 1996 with the publication of the Interim Indices of Consumer Prices (IICPs) by EUROSTAT. In a second step, from January 1997 onwards HICPs are calculated using comparable definitions and procedures.

The HICPs will form the basis for the assessment of inflation convergence in early 1998 and will also be essential for the conduct of the single monetary policy in Stage Three.

The conceptual work on the harmonisation of consumer price indices is being carried out by the European Commission (EUROSTAT) in close liaison with the National Statistical Institutes. As a key user, the EMI is closely involved in this work. In addition to the Council Regulation, the European Commission has prepared two comprehensive Regulations to define the version of the HICPs that is available now. The Commission Regulations concern - inter alia - the initial coverage of HICPs in 1997, initial standards for the procedures of quality adjustment and the treatment of new goods and services, as well as a common set of formulae for the calculation of elementary price indices (i.e. those for individual products). Moreover, a harmonised classification for HICP sub-indices has been agreed, which will enable the publication of a fully comparable detailed breakdown for the fifteen Member States. Although these measures are a substantial step towards fully comparable consumer price indices in the EU, it has not proved possible to solve all the conceptual and technical questions in time for 1997. Further measures for achieving fully harmonised HICPs are therefore required and will need to be implemented in the next few years.

Consumer price inflation in 1996 based upon harmonised indices (HICPs) and national indices (CPIs)

(annual percentage changes)

	BE	DK	DE	GR	ES	FR	IE[(a)]	IT	LU	NL	AT	PT	FI	SE	UK[(a)]
HICP	1.8	1.9	1.2	7.9	3.6	2.1	.	4.0	1.2	1.5	1.8	2.9	1.5	0.8	.
CPI[(b)]	2.1	2.1	1.5	8.5	3.6	2.0	1.6	3.9	1.4	2.1	1.9	3.1	0.6	0.7	2.9
Difference	-0.3	-0.2	-0.3	-0.6	0.0	0.1	.	0.1	-0.2	-0.6	-0.1	-0.2	0.9	0.1	.

Sources: EUROSTAT, national data.

(a) HICP inflation rates for Ireland and the United Kingdom are not available in 1996. The 12-months percentage change figures for these countries in January 1997 are 1.9% and 2.1% respectively.

(b) For further explanation of the national data used see footnote to Chart 1.

Monthly HICPs are published from January 1997, including back data for the years 1996 and 1995. This allows calculation of HICP inflation rates from January 1996 onwards. Though not all of the harmonisation measures implemented with effect from January 1997 can be introduced for data for the period before 1997, HICPs for 1995 and 1996 are nonetheless based on comparable coverage of goods and services, thus removing one of the main differences between national CPIs. The results are shown in comparison to the national CPIs in the table above.

The general pattern of HICPs is close to that given by the national CPIs, with the differences in the figures being generally small (in the range of -0.3 percentage point to 0.1 percentage point). In only a few countries (Greece, the Netherlands and Finland) does the difference exceed this interval.

Differences in the results obtained using HICPs and using CPIs reflect differences in the coverage of the two indices, in price developments in the respective sub-groups, and in methodological standards. Furthermore, the significance of these factors varies across countries, thereby affecting, to a greater or lesser extent, the difference between the HICP and the CPI in each individual Member State.

reduction of risks linked to the state of public finances. First, if consolidation is implemented so as to promote credibility regarding a durable shift towards sound budgetary developments, negative short-term effects on demand may well be counteracted by positive confidence effects. Second, durable consolidation will also have lasting effects on potential growth. It is this link between successful fiscal adjustment and an improvement of growth perspectives over the medium term which justifies viewing consolidation efforts not only against the background of the requirements of the convergence criteria, but also as necessary in themselves. While such efforts must continue to be primarily focused on governments' deficit and debt positions, they must also include structural measures on the expenditure and revenue side to promote strong economic performance and employment and to underpin an environment of non-inflationary growth.

Increased exchange rate stability and reductions in yield spreads

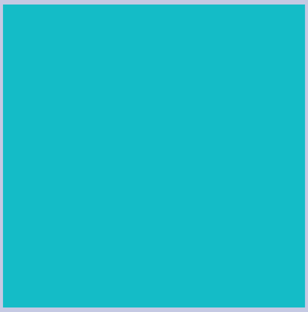
While recent developments, reflected in broadly stable conditions in the ERM and a significant reduction in long-term interest rate differentials among EU Member States, are partly related to market expectations concerning EMU participation, they also reflect the increasing degree of nominal convergence which has been achieved. In the latter respect, exchange rate corrections and subsequent stability and the development of bond yields reflect inflation convergence and can be seen as an indication that private sector expectations are gradually adapting to the lower rates of inflation that have been achieved, thereby also contributing to the reduction of risk premia.

However, the impact of EMU expectations on financial asset prices also entails some risks. Setbacks in the consolidation of public finances or other factors that may reduce confidence in the EMU process may negatively affect bond markets, with possible spillovers to foreign exchange markets.

Decisive period ahead as Stage Three deadlines approach

As the deadlines for moving to Stage Three approach, the essential requirement of achieving a high degree of sustainable convergence will have to be fulfilled. This is all the more important since agents are starting to look beyond the year 1999 and to form expectations about likely longer-term developments in the euro area. At stake is the macroeconomic environment in which the ECB will have to take its first steps in ensuring price stability.

These considerations make it all the more essential that monetary policies remain vigilant with a view to ensuring price stability. The stance adopted in the period ahead will be particularly important in that it will increasingly affect inflation in 1999 and thereafter, and hence price expectations for the euro area. As regards budgetary policies, it must be kept in mind that the necessary strict compliance with the fiscal criteria also implies ensuring the sustainability of government financial positions as a precondition for the adoption of the single currency. As agreed by the European Council in Dublin in December 1996, the maintenance of sound budgetary positions in Stage Three will take place within the framework of the Stability and Growth Pact. The EMI endorses the objective of strengthening the credibility and effectiveness of the Excessive Deficit Procedure under Article 104c. This framework should be as transparent and precise as possible, in accordance with the principles of the Treaty, and the procedures to be enshrined in the EU Council Regulation should be strong and credible and contribute decisively to the sound conduct of fiscal policy in Stage Three. The paramount importance of sustainable budgetary positions also stems from the future burden which will arise from the interaction between interest payments on the accumulated debt stocks, high and persistent unemployment, and demographic trends. Finally, exchange rate stability remains an element in judging the degree of sustainable convergence both before and after 1999. As part of the future monetary and exchange rate policy co-operation between the euro area and non-participating EU countries, a new ERM will be established. Membership will be voluntary; nevertheless, EU Member States with a derogation can be expected to join the mechanism.



Chapter II

Preparatory work for Stage Three

1 Monetary policy

In accordance with Article 7 of its Statute, the EMI is required to report annually on the adaptation of monetary policy instruments and the preparation of the procedures necessary for conducting the single monetary policy in Stage Three of EMU. Furthermore, Article 109f (3) of the Treaty requires the EMI to specify, at the latest by 31 December 1996, the regulatory, organisational and logistical framework necessary for the ESCB to perform its tasks in Stage Three. In publishing the report on "The single monetary policy in Stage Three - Specification of the operational framework" in January 1997, the EMI provided the public and the counterparties of the national central banks (NCBs) with information of interest regarding the operational aspects of monetary policy. In addition, the publication of the document "Elements of the monetary policy strategy of the ESCB in Stage Three of EMU" in February 1997 provided further information regarding the choice of strategy to be followed in Stage Three. This section provides a brief summary of the main issues covered in these reports, both of which are available from the EMI on request.

1.1 Monetary policy strategy

The Treaty unambiguously states that the primary objective of the ESCB is to maintain price stability. In the pursuit of this final objective, the ESCB will have to develop a monetary policy strategy. Five candidate strategies for monetary policy in Stage Three (exchange rate targeting; interest rate pegging; nominal income targeting; monetary targeting; and direct inflation targeting) have been examined by the EMI. Taking into account a number of guiding principles (effectiveness, accountability, transparency, medium-term orientation, continuity and consistency with the ESCB's independence) and considering the environment likely to prevail in the euro area, the list of potential candidate strategies has been narrowed down to two, namely monetary targeting and direct inflation targeting.

While pure forms of monetary and direct inflation targeting can be clearly distinguished at a theoretical level, their application in different countries has shown that several variants integrating elements of both strategies exist. Moreover, all central banks that pursue either of these two strategies monitor a wide and similar set of economic and financial variables as indicators in the determination of the monetary policy stance. The EMI is not in a position, nor is it necessary, to determine more specifically at this stage which strategy should be the preferred one to be adopted by the Governing Council of the ECB.

Whichever choice will be made in terms of monetary policy strategy, a number of key elements have been identified as being an indispensable part of any strategy: a quantified definition of the final objective of price stability and of the specific targets against which to assess the ESCB's performance in terms of meeting the objective; a communication policy for the ESCB to explain its strategy to the general public; the availability of a broad set of indicator variables to help assess the risks to future price stability; detailed information on and a prominent role for monetary aggregates, provided that money demand is sufficiently stable in the long run in the euro area; and tools to allow forecasts for inflation and other economic variables pertaining to the euro area.

The EMI and the NCBs are undertaking preparatory work to ensure that the ESCB will have the statistical and analytical infrastructure at its disposal to pursue either of the above strategies.

1.2 Implementation of the single monetary policy

Instruments and procedures

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 for an infrastructure allowing the ECB to impose minimum reserve requirements if it wishes to do so.

Four types of open market operations will be at the disposal of the ESCB: main refinancing operations (viz. regular liquidity-providing reverse transactions with a weekly frequency and a maturity of two weeks); longer-term refinancing operations (viz. liquidity-providing reverse transactions with a monthly frequency and a maturity of three months, intended to cater for a limited part of the global refinancing volume); fine-tuning operations (adapted to the prevailing circumstances and to the specific objectives of managing the liquidity situation in the market or of steering interest rates); and structural operations (intended to affect the structural liquidity position of the banking system vis-à-vis the ESCB). Table 10 sets out the main features of the open market operations of the ESCB.

Two standing facilities will be available to provide (in the case of the marginal lending facility) or to absorb (in the case of the deposit facility) overnight liquidity. These facilities will bound overnight market

Table 10

Open market operations

Monetary policy operations	Type of transaction: Provision of liquidity	Type of transaction: Absorption of liquidity	Maturity	Frequency	Procedure
Main refinancing operations	• Reverse transactions	-	• Two weeks	• Weekly	• Standard tenders
Longer-term refinancing operations	• Reverse transactions	-	• Three months	• Monthly	• Standard tenders
Fine-tuning operations	• Reverse transactions • Foreign exchange swaps	• Reverse transactions • Foreign exchange swaps • Collection of fixed-term deposits	• Non-standardised	• Non-regular	• Quick tenders • Bilateral procedures
	• Outright purchases	• Outright sales	-	• Non-regular	• Bilateral procedures
Structural operations	• Reverse transactions	• Issuance of debt certificates	• Standardised/ non-standardised	• Regular and non-regular	• Standard tenders
	• Outright purchases	• Outright sales	-	• Non-regular	• Bilateral procedures

interest rates and the interest rates applied to them will help signal the general stance of monetary policy.

The minimum reserve system which will also be available could be used for stabilising money market interest rates, creating or enlarging a structural liquidity shortage in the money market and possibly contributing to the control of monetary expansion. The EMI is undertaking the necessary technical preparatory work in order to put the ECB in a position to use this instrument should it decide to do so.

Eligible counterparties and assets

In order to secure a single monetary policy stance and a level playing-field for counterparties across the whole of the euro area, the EMI has worked out common eligibility criteria, both for the counterparties and for the assets to be used in their operations with the ESCB. No technical preparations are being undertaken at this stage for remote access to monetary policy operations, allowing counterparties in the euro area to have direct access to operations with an NCB of a jurisdiction where they have no physical presence.

Table 11

Features of eligible assets

Criteria	Tier one	Tier two
Type of asset	• ESCB debt certificates; • Other marketable financial obligations.	• Marketable financial obligations; • Non-marketable financial obligations; • Equities traded on a regulated market.
Settlement procedures	• Assets must be centrally deposited in book-entry form with NCBs or a CSD fulfilling ECB minimum standards.	• Assets must be easily accessible to the NCB which has included them in its tier two list.
Type of issuer	• ESCB; • Public sector; • Private sector. • International and supra-national institutions.	• Public sector; • Private sector;
Financial soundness	• The issuer (guarantor) must be financially sound.	• The issuer/debtor (guarantor) must be financially sound.
Location of issuer	• EEA.[1]	• Euro area; • Location in other EEA countries can be accepted subject to ECB approval.
Location of asset	• Euro area.	• Euro area; Location in other EEA countries can be accepted subject to ECB approval.
Currency of denomination	• Euro.[2]	• Euro;[2] • Other EEA or widely traded currencies can be accepted subject to ECB approval.

[1] The requirement of location in the EEA does not apply to international and supra-national institutions.
[2] Euro or the national denominations of the euro.

It is envisaged that an appropriate legal instrument will cover the uniform conditions under which a broad range of counterparties will participate in the ESCB's open market operations and standing facilities. A broad range of eligible counterparties is consistent with the principle of decentralisation in the execution of the ESCB's monetary policy operations. It will enhance policy efficiency and equal treatment and facilitate the smooth functioning of the payment system. Only in the case of fine-tuning operations may operational efficiency advocate dealing with a limited range of counterparties.

The Treaty requires all ESCB credit operations to be based on adequate collateral. With regard to the actual choice of assets eligible for use in the ESCB's liquidity-providing monetary policy operations, the ESCB will establish two types of lists. Both of them will contain public and private assets which as a rule will be eligible throughout the euro area. The tier one list will consist of marketable assets which fulfil uniform euro area-wide eligibility criteria specified by the ECB. In addition, the list will include debt certificates issued by the ESCB, if any. The list will be established and maintained by the ECB. Tier two lists will consist of additional assets, either marketable or non-marketable, which NCBs consider particularly important for their national financial markets and banking systems. Subject to ECB guidelines, NCBs will establish and maintain national lists of eligible tier two assets. Together, the lists will allow for the use of a wide set of assets, which is also desirable for the smooth functioning of the domestic RTGS systems and TARGET. All lists will be available to the public. Table 11 sets out the main features of tier one and tier two assets.

Preparatory work following the specification of the operational framework

As the operational framework of the single monetary policy in Stage Three has been specified and made public, the EMI is now preparing a detailed specification of all the technical features of the different instruments and procedures. In addition, the distribution of responsibilities within the ESCB, and the legal acts and agreements regulating the relationships between the NCBs and the ECB, and between the ESCB and its counterparties, are already being prepared.

In the course of 1997 the EMI intends to publish further material relating to the specification of the ESCB's operational framework for the conduct of the single monetary policy and to the fields of monetary policy strategy, monetary policy instruments and procedures, the TARGET system and securities settlement systems.

2 Foreign exchange policy

2.1 Exchange rate policy co-operation between the euro area and other EU Member States

In 1996 the broad lines of the future exchange rate relationships between the euro area and other EU Member States were defined. The EMI submitted a report on this issue, which was forwarded by the ECOFIN Council to the Dublin meeting of the European Council in December 1996, at which it was endorsed. The European Council invited the ECOFIN Council to prepare a draft Resolution for the European Council meeting to be held in Amsterdam in June 1997 setting out the fundamental elements of the new exchange rate mechanism (ERM II), following the precedent set in 1978 in relation to the present ERM. The EMI has been invited to prepare, in parallel, a draft for the agreement between central banks, for submission to the ECB and to the central banks of the Member States not forming part of the euro area.

The ERM II will form part of the future exchange rate policy co-operation between the euro area and other EU countries. Membership will be voluntary; nevertheless, EU Member States with a derogation can be expected to join the mechanism. The main features of the new exchange rate mechanism are described in the EMI's report on "The single monetary policy in Stage Three - Specification of the operational framework".

2.2 Foreign exchange intervention

Preparatory work is being conducted by the EMI and the NCBs with a view to ensuring that the ESCB will be in a position to avail itself of the two basic organisational arrangements for the conduct of its foreign exchange operations: centralisation and decentralisation. Irrespective of the chosen degree of centralisation/decentralisation, the selection of counterparties will follow a uniform approach, based primarily on prudence and efficiency. The pool of potential counterparties will be sufficiently large and diverse to guarantee the necessary flexibility in the conduct of the ESCB's intervention operations. Further details are given in the EMI's report on "The single monetary policy in Stage Three - Specification of the operational framework".

2.3 Management of the ECB's foreign exchange reserves

Article 105 (2), third indent, of the Treaty stipulates that one of the basic tasks of the ESCB shall be to hold and manage the official foreign reserves of the Member States participating in the euro area. Article 30.1 of the ESCB/ECB Statute stipulates that the ECB shall be provided by the euro area NCBs with foreign reserve assets, other than Member States' currencies, ECUs, IMF reserve positions and SDRs, up to an amount equivalent to EURO 50 billion. The proportion to be called up, following the ECB's establishment and at later dates, shall be decided by the ECB Governing Council.[3] Article 30.1 of the ESCB/ECB Statute also stipulates that the ECB shall have the full right to hold and manage the foreign reserves that are transferred to it and to use them for the purposes set out in the ESCB/ECB Statute.

[3] *Further calls beyond the EURO 50 billion limit may be effected by the ECB within limits and under conditions to be laid down in Community secondary legislation.*

Building upon the EMI's earlier work as described in its Annual Report 1995, further preparation is currently being conducted with the aim of ensuring that the ECB will be in a position to set the reserve management policy and to monitor its implementation from the start of Stage Three.

2.4 Guidelines for the NCBs' and Member States' operations in foreign reserve assets

Article 31 of the ESCB/ECB Statute stipulates that the euro area NCBs' operations in their remaining foreign reserve assets and Member States' transactions with their foreign exchange working balances shall, above a certain limit, to be set in the framework of guidelines by the ECB, be subject to approval by the ECB in order to ensure consistency with the single exchange rate and monetary policies. The ECB Governing Council shall issue guidelines with a view to facilitating such operations.

Building upon the principles outlined in the EMI's Annual Report 1995, these draft guidelines are currently being drawn up for approval by the ECB Governing Council. At a technical level, follow-up work is proceeding with regard to the information systems support required for the exchange of the related data within the ESCB.

3 Statistics

3.1 Statistical requirements to enable the ESCB to carry out its functions in Stage Three

The Treaty requires the ECB to collect, with the assistance of the NCBs, the statistical information needed for the conduct of the single monetary policy and foreign exchange operations of the euro area. One of the functions of the EMI is to make the necessary statistical preparations.

The EMI, where appropriate in consultation with the Commission, has prepared a statement of statistical requirements for Stage Three. These requirements were set out in a detailed document which the EMI released in July 1996 for the use of banking associations and others involved in statistical preparations, and were summarised for more general use in an explanatory booklet published at the same time.[4] The main points of the requirements are given briefly below. Since statistical preparations take a long time, Member States were strongly encouraged to begin implementation promptly.

The statistical information needed for the conduct of policy in Stage Three will be wide-ranging. In addition to monetary and balance of payments statistics and financial accounts, the ECB will use - as national central banks do now - a variety of statistics on costs and prices, government finance, output and demand, and the labour market. Forward-looking data (orders, business surveys) will also be relevant.

Much of this information is already available at the national level. However, the compilation of aggregates covering the euro area will raise questions of *harmonisation* and *consolidation*.

The EMI and subsequently the ECB are specifically charged with the task of *harmonising* statistics where necessary within their area of competence. Harmonisation is required because there are differences of definition and statistical practice, which, if not attended to, would yield inconsistent aggregates. The aim is to achieve consistent statistics of good quality, but without imposing uniform concepts disregarding differences in the structure and functioning of national financial systems.

Appropriate *consolidation* is necessary for the compilation of certain aggregates since - in particular - the money stock and its counterparts and the balance of payments of the euro area as a whole will not simply be the sums of the national money stock and its counterparts and the balance of payments of the participating countries, even if the underlying concepts and statistical practices are fully harmonised.

Thus the money stock of the euro area will include cross-border holdings of deposits and other monetary instruments within the area; the counterparts to money will be defined and compiled correspondingly. The balance of payments of the euro area will comprise only transactions with residents of countries outside the area, excluding all transactions within the area; the international investment position (the stock of external assets and liabilities of the area) will be defined in the same way. In each case, more information will be needed to enable appropriate consolidation to be carried out. The task is complicated by the fact that the composition of the euro area will not be known for some time, and that it may subsequently change.

[4] *See EMI, "The statistical requirements for Monetary Union", July 1996.*

The requirements will have to be met by participating Member States in time for Stage Three to start in January 1999. However, to prepare for the single monetary policy, serious policy planning will need to begin some months earlier, and some data will be needed, which should be as harmonised as possible, well in advance of the start of Stage Three.

Money and banking statistics

A consolidated balance sheet will be established on a monthly basis, containing data on the business of the Monetary Financial Institutions (MFI) sector,[5] in sufficient instrument, maturity and sectoral detail to allow flexibility in the calculation of monetary aggregates and counterparts covering the single currency area. Since money and its counterparts will be closely monitored, irrespective of whether a monetary aggregate is targeted, reliable, closely harmonised and timely statistics will be needed. These aggregates for the euro area will be compiled as amounts outstanding (i.e. stocks) and as flows derived from them, with procedures to adjust for different accounting practices where necessary. Further data will be required on a quarterly basis, including more information on the maturity of assets and liabilities and on the sector of counterparties. The balance sheet statistics from which the monetary statistics will be drawn will also provide the liabilities base for a system of reserve requirements in the single currency area, should the ECB choose to introduce one. The statistical framework is designed to conform to the European System of Accounts (ESA 95).

Balance of payments statistics

A monthly balance of payments of the euro area will be established, showing the main items relevant to the ECB's judgement on monetary conditions and exchange markets. Summary items only would be shown for the current account, though somewhat more detail will be required for the financial account. More detailed information will be provided on a quarterly basis to permit further analysis of external transactions.

For the purpose of monetary policy and exchange market analysis, and to assist in the compilation of balance of payments flows, a statement of the external assets and liabilities of the euro area as a whole, i.e. the international investment position, will be compiled annually.

As far as possible, data will correspond to international standards set out in the 5th edition of the IMF Balance of Payments Manual.

Financial and related statistics other than money and banking and balance of payments statistics

These statistics will satisfy the ESCB's requirements for data on interest rates; data on financial intermediaries which are not MFIs, and on capital issues, commercial paper and similar instruments; financial accounts conforming to the ESA 95; and government finance statistics. Financial accounts set monetary developments in the context of broad financial developments. Balance sheet data may throw light on spending and saving patterns and are essential to judgements about the functioning and development of the financial system and its client sectors. The

[5] *The full definition of MFIs is "resident Credit Institutions as defined in Community Law, and all other resident Financial Institutions whose business is to receive deposits and/or close substitutes for deposits from entities other than MFIs, and, for their own account (at least in economic terms), to grant credits and/or to make investments in securities". A list of MFIs, which form a sub-sector in the European System of Accounts (ESA 95), is being prepared.*

financial accounts required under the ESA 95 will be drawn up on a national basis. It will not be possible to compile a financial account for the euro area from this source owing to problems of consolidation. The EMI is investigating the possibility of compiling a partial but properly consolidated financial account for the area from monetary, balance of payments and other sources that will be available.

Furthermore, like the national central banks conducting monetary policy at present, the ESCB will monitor government finance and government expenditure and receipts closely, because government financial positions and deficits exert important influences on financial conditions.

Statistics relating to prices and costs; background economic statistics

Statistics on prices and costs will be central to the main policy responsibility of the ESCB. A preliminary harmonised index of consumer prices (HICP) for all EU countries is already available for the purpose of assessing convergence. The ESCB may be expected to use the HICP in the form of an index covering the euro area as a whole (with sub-indices as necessary) as a main measure of prices. In addition to the need to have inflation data as measured by the change in the consumer price index, the ECB will require a variety of other measures of prices to support its primary objective of maintaining price stability as well as in the context of general economic assessments. These will include commodity prices, foreign trade prices, producer and wholesale prices, and construction prices. House prices and survey data may give an advance indication of inflationary pressures. Wage costs (including pay settlements, average earnings, and unit labour costs) will also be used as indicators of inflationary pressures, as well as for assessing competitiveness. The European Commission's plans to develop a European employment cost index are relevant in this connection. Sectoral wage data will be required for monitoring the effects of wage costs on output prices.

Background economic statistics include national accounts, monthly statistics on output and demand, and labour market statistics. The Council Regulation on short-term indicators which is in preparation will be helpful in this area.

3.2 Organisation of statistical work at the European level

As noted in the EMI's Annual Report 1995, the EMI and prospectively the ECB have primary responsibility at the European level for money and banking and related statistics, and share responsibility with the Commission (EUROSTAT) for balance of payments statistics and financial accounts. These are the types of statistics for which central banks are usually responsible in EU Member States, or share responsibility with the national statistical institute, and in which they are likely to take the lead, or be closely involved, in making the necessary statistical changes in preparation for the euro area. Statistics relating to the convergence criteria and other economic statistics are the Commission's responsibility. The EMI and EUROSTAT have undertaken to co-operate closely in all areas of common interest.

As far as the organisation of statistical work within the ESCB in Stage Three is concerned, Article 5.2 of the ESCB/ECB Statute states that the NCBs should carry out this task, to the extent possible. To provide the statistics needed for the ESCB to perform its functions, the NCBs will collect data in their national territory, within a common framework, aggregate the data, and send the aggregates to the ECB, where statistics covering the euro area will be compiled. While the ECB will take the lead in developing statistical concepts, the NCBs will continue to be involved at the conceptual stage, since they will retain considerable expertise in statistical matters, remain close to the reporting agents, and continue to be responsible for most of the practical statistical work.

The ESCB will need a rapid, secure and reliable means of exchanging statistical data with the NCBs, the Commission (EUROSTAT) and certain other bodies. An electronic data exchange project is under way.

3.3 Legal aspects

Article 5.4 of the ESCB/ECB Statute states that the EU Council must define the natural and legal persons subject to reporting requirements, the confidentiality regime, and the appropriate provisions for enforcement. It is envisaged that the ECB will submit a recommendation to the EU Council to this effect following its establishment.

The EMI has already prepared the text of a draft EU Council Regulation which meets these requirements. The Treaty allows the ECB to issue regulations where this is necessary for the ESCB to undertake its tasks, with binding power in the EU Member States participating in the euro area, subject to the terms of complementary legislation of which this draft Regulation would form part. Articles concerning the right of verification of data, the compulsory collection of statistical information, and sanctions in the event of non-compliance would apply only in participating EU Member States. The Regulation as drafted requires EU Member States not participating in the euro area to design and implement at the national level all the measures they consider appropriate in order to collect the statistical information needed to fulfil the ECB's statistical reporting requirements in good time for their entry into the euro area. There are strict provisions to protect the confidentiality of individual reported data.

The text of this draft Council Regulation was appended to the EMI's report on "The single monetary policy in Stage Three - Specification of the operational framework", which was published in January 1997.

4 Payment systems

4.1 The TARGET system

In August 1996 the EMI released the "First progress report on the TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) project". The report provided some additional information on the organisational features of the system. It mainly addressed the following issues concerning the implementation of the TARGET system: the provision of intraday liquidity; pricing policies; operating time; the provision of settlement services to other large-value transfer systems; the organisational framework of the project; and technical specifications for the common procedures (Interlinking system).

On the first issue, it was agreed that *intraday liquidity* will be provided by NCBs of the euro area to the eligible ESCB counterparties participating in their domestic payment systems by making use of two facilities: intraday overdrafts and intraday repurchase agreements, which are considered to be equivalent. Participants in RTGS systems may also rely on free reserves and develop an interbank market for intraday liquidity, if they so wish. Finally, if reserve requirements are imposed for monetary policy reasons, reserve balances will be available for payment systems purposes. Intraday liquidity will be potentially unlimited, apart from the limitations stemming from Article 18 of the ESCB/ECB Statute, which requires central bank credit to be based on adequate collateral. It was also agreed that it would be possible for collateral to be mobilised in a cross-border context and that it would be the same for central bank intraday and overnight credit (see Table 11). Intraday liquidity is expected to be provided by NCBs free of interest charges.

The options for NCBs outside the euro area to grant intraday credit in euro to TARGET participants are still under discussion. In this respect, the EMI Council decided in December 1996 to prepare three mechanisms which aim at preventing intraday credit, if granted to non-euro area NCBs, from spilling over into overnight credit.[6] The final decision on which mechanism to implement will be taken by the Governing Council of the ECB.

The *TARGET pricing policy* will be based on the cost recovery principle. It should not affect the implementation of the single monetary policy; it should maintain a level playing-field between participants and it should contribute to risk reduction policies in payment systems. Moreover, the TARGET pricing policy has to be compatible with EU competition law.

Concerning *operating time*, it has been agreed that TARGET will open, as a general rule, at 7 a.m. and close at 6 p.m. C.E.T. Domestic RTGS systems may open at an earlier time for processing domestic payments only. This harmonisation, based on the current longest operating hours in the EU, will allow for a larger overlap between TARGET and the payment systems of the major financial centres in North America and the Far East, thereby supporting the efforts made by credit institutions and central banks world-wide to limit cross-currency settlement risk. The common closing time will also avoid the risk of substantial payments taking place outside the common operating hours and thus leading to "regional"/segmented movements in interest rates in the euro area.

Concerning the fourth issue - relations with other transfer systems - *all large-value net settlement systems (NSS) will* be

[6] *See the EMI's Report on "The single monetary policy in Stage Three - Specification of the operational framework", Chapter III Section B 3.1.*

required to settle in central bank money. As regards the provision of settlement services to these systems operating in euro, it was agreed that the settlement procedures of cross-border NSS could be based on normal TARGET transfers between the ordinary (RTGS) account of the participating credit institutions and a special (centralised) account for the NSS within the ESCB. Settlement services to domestic NSS may be provided by NCBs according to other methods, provided that the solution does not entail risks for the other members of the ESCB.

The development phase of the TARGET project started, as scheduled, in July 1996 after the successful completion of the specification phase (completed in mid-1996). The testing phase will start in mid-1997 and be completed in June 1998. The subsequent simulation phase will be completed in December 1998. Regular audit reports are submitted to the EMI Council on the development of the TARGET project.

A technical description of the common procedures of TARGET (the Interlinking system) is contained in the set of technical documents annexed to the "First progress report on the TARGET project".

4.2 Securities settlement systems

As part of the work to establish instruments and procedures for the single monetary policy and to ensure the smooth functioning of payment systems in Stage Three of EMU, the EMI assessed the adequacy of securities settlement systems and of their linkages with payment systems. The main conclusions are contained in the EMI's report entitled "EU securities settlement systems – Issues related to Stage Three of EMU", released in February 1997, which describes three agreed lines of action.

The first line of action foresees that in Stage Three no credit will be granted before the final transfer of securities has occurred, in order to prevent the ESCB from incurring inappropriate risks in conducting monetary policy operations and/or in providing liquidity for the smooth functioning of payment systems. This will ensure the same level of safety for central bank operations, which are currently settled in different ways throughout the European Union.

In Stage Three, some central bank operations (for example, operations to provide intraday liquidity to domestic RTGS systems or some monetary policy operations) will need to be settled intraday and will be processed through the TARGET system. In this case, in order to meet the above requirement, the securities associated with such operations will also need to be transferred with intraday finality. No major changes with respect to the current situation are necessary prior to the start of Stage Three of EMU to ensure that central bank operations can be settled securely and efficiently.

The second line of action concerns the operating hours of securities settlement systems or central securities depositories (CSDs), which will have to be consistent with the operating hours of the single money market and with those of the TARGET system.

The third line of action consists of preparatory work for implementing two models (the correspondent central banking model and the guarantee model) for the cross-border use of collateral in ESCB credit operations.[7]

7 *For the description of the two models see the EMI's Reports "The single monetary policy in Stage Three – Specification on the operational framework", Annex 13, and "EU securities settlement systems – Issues related to Stage Three of EMU", Chapter 3.*

The EMI has started discussions with the European national and international CSDs on the extent to which the present and possible future links between them might be used to enable central banks to take collateral held abroad. The EMI will also be considering in more detail the risks involved in such linkages and in other aspects of securities settlement and the possible need for the harmonisation of principles concerning soundness and efficiency in settlement procedures. This work will form the basis of new minimum standards which European national and international CSDs will be expected to meet.

5 Preparation of euro banknotes

After concluding its preparatory work in 1995 with respect to the selection of design themes and features for the euro banknotes (see the EMI's Annual Report 1995), the EMI launched a design competition on 12 February 1996. Professional banknote designers nominated by fourteen EU central banks were invited to submit draft designs for all seven euro banknote denominations on the basis of two themes: "Ages and styles of Europe", and an "abstract/modern" design. Altogether twenty-nine designers or design teams had submitted their draft designs when the competition closed on 13 September 1996, twenty-seven design series for the "Ages and styles of Europe" theme and seventeen for the "abstract/modern" design theme.

The designers had to comply with detailed technical specifications which included a number of obligatory design features and a wide range of advanced security features, which will be incorporated to ensure that the euro banknotes will be at least as well protected against counterfeiting as existing banknotes. The technical specifications also took into account the needs of the blind and partially sighted.

The draft designs had to be sent to the EU central bank which had nominated the designer by 13 September 1996. After having checked the draft designs for printability and compliance with the "design briefs", the central banks sent the accepted design series to a notary in Frankfurt/Main. The notary removed all remaining indications of authorship and attributed a random three-digit number to each draft design series before sending them to the EMI on 24 September 1996. At all subsequent stages of the selection process the draft design series remained anonymous.

On 26 and 27 September 1996 an international jury consisting of renowned experts in marketing, design (including industrial design) and art history met at the EMI under the chairmanship of the Secretary General of the EMI. The jury members had been selected by the President of the EMI from a list of candidates submitted by the EU central banks.

The jury appraised all forty-four designs and recommended two shortlists comprising the five best design series for each of the two design themes. The principal criteria for the jury's appraisal were creativity, aesthetics, style, functionality, likely public perception and acceptability. Subsequently, a public consultation exercise was organised by an experienced company, EOS Gallup Europe, and carried out in fourteen Member States, in order to gauge public opinion on the ten shortlisted design series. The public survey was conducted between 7 and 13 October 1996.

On 3 December 1996 the EMI Council selected one of the ten shortlisted design series, taking into account in particular the advice of the jury and the results obtained from the public consultation exercise. This selection will be the basis for the final designs which will be submitted to the ECB Governing Council for decision. On 13 December 1996 the President of the EMI informed the European Council at its meeting in Dublin of the outcome of the selection process. The European Council welcomed the selection made by the EMI. On that day, the selected design series were presented to the public by the EMI at two simultaneous press conferences in Dublin and Frankfurt.

The EMI is currently carrying out the work of developing the design sketches into the final designs. This includes working with the designer to facilitate the banknote production and to ensure that all requirements are met, for example the avoidance of national bias and the incorporation of security features. Subsequently, the origination process - that will turn completed designs into printing plates - will begin and other preparatory work will be undertaken to ensure that the production process can get under way in a timely manner. In principle, all printing works of the countries participating in the euro area from the start of Stage Three and currently involved in the production of national banknotes can take part in the production of the initial stock of euro banknotes. Other practical issues related to the introduction of the euro banknotes are currently being addressed.

In 1998 the Governing Council of the ECB will launch the printing process in order for the euro banknotes to be ready to be put into circulation by 1 January 2002 at the latest. The exact date for the introduction of the euro banknotes will be announced before 1 January 1999.

In anticipation of the situation in which euro banknotes will not be available at the start of Stage Three, Article 52 of the ESCB/ECB Statute obliges the NCBs of the Member States participating in the euro area to exchange their respective national banknotes at par value. Against this background, and together with the national banking and finance communities, the EMI is currently exploring ways in which to organise the exchange of banknotes in Stage Three. At present, the bulk of retail transactions in foreign banknotes are handled by commercial banks and by specialist bureaux de change. It will be necessary to assess how, after the start of Stage Three, the exchange of national banknotes circulating within the euro area can be organised so as to differentiate it from the exchange of banknotes of countries not participating in the euro area.

6 Accounting issues

The Treaty contains various provisions requiring the publication of consolidated financial data for the ESCB. In addition to these, there will be regular consolidated reports for the internal needs of the ESCB. These reports will require a consolidation of the assets and liabilities of the ECB with those of the participating NCBs. For such reports to be meaningful, the figures for the ECB and the individual NCBs need to be prepared on a harmonised basis.

In 1996 the EMI Council approved the accounting principles for the financial reporting of the ESCB. According to these principles, the balance sheet will be based on market values, but unrealised gains arising from revaluation will not be recognised as income. Unrealised losses will be taken to the profit and loss account if they exceed previous revaluation gains registered in the revaluation account. Such losses may only be reversed on subsequent realisation and not against any future unrealised gains. These principles combine transparency with prudent recognition of income and are appropriate for the nature and conduct of central banks' activities.

Application of these accounting principles will be mandatory for all items material to the operations of the ESCB, for all items of the ECB's financial statements, and for the calculation of monetary income. Nevertheless, NCBs might continue to draw up and publish their financial statements according to their own accounting rules.

Further work will be undertaken during 1997 to develop the necessary techniques so as to enable individual NCBs and the ECB to adapt their accounting procedures and systems in order to apply the accounting principles for the financial reporting of the ESCB. The reporting framework for the ESCB will also be elaborated upon to ensure that the harmonised accounting data are properly reflected in all the published and internal reports of the ESCB.

A related area of work concerns the development of an appropriate method for the determination of the income arising from the performance of the ESCB's monetary policy function (monetary income). This income is to be allocated among the participating NCBs in accordance with the provisions of the Treaty. The EMI Council has come to the conclusion that it is unlikely that the balance sheet structures of participating NCBs will permit, from the start of Stage Three, the measurement of monetary income according to the method provided for in Article 32.2 of the ESCB/ECB Statute. This method identifies monetary income as being equal to the annual income derived from earmarked assets held against banknotes in circulation and deposit liabilities to credit institutions ("direct method"). Hence, preparatory work is being undertaken for the implementation of an alternative method which may be applied under Article 32.3 of the Treaty for a period of up to five years. Such an alternative method will consist in calculating monetary income by reference to a rate of return specified according to a pre-determined rule applied to the monetary liabilities ("indirect method"). Further research on a calculation method in line with Article 32.2 will be pursued at a later stage.

7 Information and communications systems

Information and communications systems support is required for a number of operational and policy functions to be conducted in the ESCB context involving the ECB and the national central banks. Further progress in the definition of the necessary information systems support has meant that the basic outline of the future ESCB's information and communications systems is emerging.

Following the establishment of a dedicated project team at the start of 1996, a Europe-wide open tender procedure was carried out with the aim of identifying a new secure high-capacity teleconference system for the ESCB. In November the EMI Council approved a technical solution to provide the new teleconference services for the ESCB. Further detailed negotiations are taking place with the selected equipment and services suppliers to investigate the best way of extending the new teleconference system beyond the ESCB, in particular to the non-EU central banks participating in the "Concertation Group".

For both the synchronous (real-time) and the asynchronous exchange of data within the ESCB, agreement has been reached during 1996 on the main architectural choices for the communications infrastructure linking the ECB with the national central banks. This common infrastructure will carry the majority of the information exchanges between the institutions concerned. The functional and technical specifications of the necessary infrastructure are being elaborated and the infrastructure is planned to be put in place towards the end of 1997 in order to allow testing of the different applications that will be using this infrastructure to commence shortly thereafter.

On the applications side, the primary policy areas have finalised the user requirements for the functioning of the main policy instruments. By the end of 1996 specification work had reached a stage that should allow development of the necessary information systems support for the conduct of decentralised monetary policy open market operations based on tender procedures as well as to enable the monitoring of decentralised monetary policy interventions based on bilateral procedures and of foreign exchange interventions to be carried out from the start of Stage Three. Other needs for the exchange of operational data among the entities of the ESCB have been identified and may give rise to further specific application development.

A number of other business functions of the ECB and the ESCB also require the support of data exchange and data processing systems. One example is the interlinking of national RTGS systems in the TARGET system. In 1997 the EMI will provide a centralised test centre against which the Interlinking components of the national central banks will be tested. Other areas on which work has focused include provision of the necessary support for the management of the ECB's foreign exchange assets, and systems to allow the smooth exchange of statistical data among the entities of the ESCB.

1996 has also brought additional insight into the information and communications systems requirements of the ECB itself. Identification of the relevant issues has led to the establishment of a number of project definitions for which more detailed plans will now be outlined and implemented in the months ahead so as to ensure that the ECB will be able to commence its operations from the beginning of Stage Three.

8 Banking supervision

In Stage Three prudential supervision will remain a competence of the national authorities and the supervisory framework laid down at the EU level will not be altered. Nevertheless, the Treaty and the ESCB/ECB Statute assign to the ESCB/ECB some functions related to the prudential supervision of credit institutions. These 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 issues above;

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

The preparatory work of the EMI in this field is intended to identify the possible ways in which Article 105 (5) of the Treaty and Article 25 (1) of the ESCB/ECB Statute could actually be implemented as well as to make a preliminary assessment of how the ECB could define its position in respect of the provision under Article 105 (6) of the Treaty. Work on these aspects is under way within the EMI with the assistance of the Banking Supervisory Sub-Committee.

9 Legal issues

Legal work has concentrated on five areas: secondary Community legislation, legal convergence, project support, advisory functions (see Chapter III Section 5) and administrative matters. Some of the highlights are addressed below.

9.1 Secondary Community legislation

The EMI co-operated with the European Commission in the elaboration of secondary Community legislation on the introduction of the euro. On 11 June 1996 it transmitted to the Commission a document containing building blocks for the two EU Council Regulations in this area, which the Commission proposed and which were endorsed by the European Council in December 1996.

One Council Regulation, based on Article 235 of the Treaty, is intended to be adopted shortly and to become effective in 1997 and deals with issues such as the replacement of the ECU, as referred to in Article 109g of the Treaty and as defined in Council Regulation (EC) No. 3320/94, by the euro at a rate of one to one, the continuity of contracts and technical rules for the conversion rates, including rounding. This Regulation will be applicable in all Member States.

A second Council Regulation, based on Article 109l (4) of the Treaty, is intended to be adopted as soon as the participating Member States are known and to become effective on 1 January 1999. This Regulation will be applicable in all Member States, subject to Protocols Nos. 11 and 12 on the United Kingdom and Denmark and Article 109k (1) of the Treaty referring to the status of Member States with a derogation. It addresses matters such as the substitution of the euro for the currencies of the participating Member States, transitional provisions with respect to the national currency units and the issue of banknotes and coins.

The EMI delivered an opinion on these two pieces of secondary Community legislation on 29 November 1996 in a consultation procedure under Articles 109f (6) and 109f (8) of the Treaty (see Chapter III Section 5). Two issues still need to be specified: the exact timing of the introduction of euro banknotes and coins; and the scope of provisions to enable the redenomination in the euro unit of outstanding debt of general government denominated in the national currency units of other participating Member States and also of bonds and other forms of securitised debt of other issuers which are negotiable in the capital markets. Such provisions will be included in the Council Regulation based on Article 109l (4) of the Treaty before the European Council meeting in Amsterdam in June 1997.

In addition, the EMI formulated recommendations for secondary Community legislation under Articles 5.4 (statistical information), 19.2 (minimum reserves) and 34.3 (sanctions) of the ESCB/ECB Statute. This resulted in draft texts of:

- a Council Regulation (EC) concerning the collection of statistical information;
- a Council Regulation (EC) concerning the application of minimum reserves;
- a Council Regulation (EC) concerning the powers of the ECB to impose sanctions.

The EMI will advise the ECB to submit the three draft Regulations in the form of recommendations to the EU Council for adoption under Article 106 (6) of the Treaty and Article 42 of the ESCB/ECB Statute. In order to advance the adoption procedure, the EMI released the documents to the Commission and the Monetary Committee so as to allow informal discussions to start.

The preparation of the three draft Regulations was part of the EMI's work on the regulatory framework for the single monetary policy in Stage Three, which, under Article 4.2 of its Statute, the EMI was required to prepare by the end of 1996.

9.2 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. The EMI is required under Article 109j (1) of the Treaty and Article 7 of its Statute periodically to assess, in addition to the fulfilment of the economic convergence criteria, this process of legal convergence (as is the Commission). The results of the 1996 assessment were laid down in the report on "Progress towards convergence 1996", of November 1996. The legal chapter of that report distinguished between the statutes of the NCBs and other legislation which may need to be adapted in the light of Treaty and ESCB/ECB Statute provisions.

With regard to the statutes of the 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. The EMI developed a list of features of central bank independence of an institutional, personal, functional and financial nature which could serve as guidance for national legislators when adapting the statutes of NCBs in this field. The EMI also 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. Such adaptations need to become effective at the latest at the date of the establishment of the ESCB/ECB.

Furthermore, the EMI pointed out the need for statutes to be adapted to ensure the necessary degree of integration of NCBs in the ESCB in accordance with Article 14.3 of the ESCB/ECB Statute. This Article states that NCBs will become an integral part of the ESCB and are required to comply with the ECB's guidelines and instructions. This implies in particular that statutes of NCBs should not contain any provisions which are not compatible with the exclusive competence of the ECB in certain areas (e.g. authorisation of the issue of banknotes) or which, if adhered to by an NCB, would prevent such an NCB from complying with rules adopted at the level of the ECB (e.g. on the deployment of monetary policy instruments). The adaptation of the statutes of NCBs in this area needs to become effective at the start of Stage Three or, for Member States with a derogation or a special status, at the start of their full participation in Monetary Union. The EMI will continue to act as a forum for an exchange of views between NCBs in this field and to refer to this issue in future reports.

The timely adoption of the necessary adaptations of national legislation is a point of concern to the EMI. Whereas in almost all Member States preparations are under way to adapt the statutes of NCBs, no major activities have been noted as far as the scrutiny of other legislation on compatibility with Treaty and ESCB/ECB Statute requirements is concerned. As 1997 and early 1998 are the periods in which such adaptations would need to materialise, legislative action should, where appropriate, not be postponed for much longer.

10 Changeover to the euro

The EMI has continued to monitor progress in the preparatory work for the introduction of the euro, following the adoption of the changeover scenario by the European Council at its meeting in Madrid in December 1995. The EMI provides a forum for the exchange of information between central banks on four main topics: NCBs' internal preparatory work for the establishment of the ESCB; changeover preparations by financial market participants; euro-related activities performed by the public authorities; and the provision of information on the changeover to the general public. Taking into account the national specificities in financial markets and banking structures, the NCBs constitute the main channel of dialogue regarding the latter three areas between the monetary authorities and financial market participants. Furthermore, there is an ongoing exchange of views between the EMI, in co-operation with the NCBs, and the banking and financial community to assess the need for co-ordination at the EU level concerning the process of the changeover to the single currency.

In the course of the summer months of 1996 the EMI, through the intermediary of the EU central banks, consulted the banking and financial community on the highly technical question of rounding in the conversion of amounts expressed in the different denominations of the single currency that will be in use in the transitional period of Stage Three of EMU. Conversion will occur from euro to national denominations and vice versa, as well as between national denominations in use in the countries participating in the euro area. The intention was to assess the extent to which rounding inaccuracies might cause difficulties for the equivalence between the different denominations of the single currency and to determine possible solutions to minimise such problems.

In September 1996 the EMI Council endorsed a set of guidelines which it forwarded to the European Commission as a further contribution by the EMI to the draft legislative framework on the introduction of the euro which was under preparation at the time (see also Section 9.1). The objective of the guidelines was to present a set of minimum requirements which would significantly limit the scope for the occurrence of rounding differences when undertaking conversion operations. The guidelines were not intended to replace the rounding conventions already in use in mono-currency or foreign exchange transactions.

The following guidelines were laid down: conversion rates shall contain six significant figures; they shall be expressed in terms of a sum of national currency units for one euro; they shall never be rounded or truncated; no use shall be made of inverse conversion rates; for the computation of conversions between two national denominations, a fixed algorithm shall be followed involving a division (rounded to not less than three decimals) cum multiplication of the euro conversion rates of the two national denominations involved, although alternative methods can be used provided the result is exactly the same.

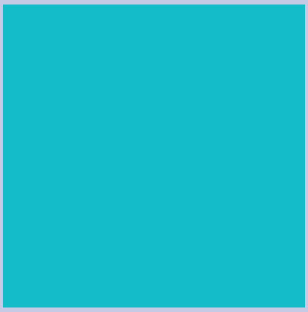
The Commission took these guidelines on board in a draft EU Council Regulation on some provisions relating to the introduction of the euro. This Regulation was endorsed by the European Council at its Dublin meeting in December 1996 (see Section 9.1), with a view to giving early guidance to financial markets so as to ensure a smooth changeover to the single currency.

In the period ahead, the EMI intends, inter alia, to assess whether differences in countries' changeover actions could in any way threaten the smooth functioning of the euro area-wide money market which will be created at the start of Stage Three. Specific issues relating to the changeover for Member States joining the euro area at a later stage will also be investigated.

Table 12

Changeover to the euro

	Delineation of periods	Main action points within each period
	early 1998	
1st period	Decision by the Heads of State or of Government on the Member States participating in the euro area	■ Establish the ECB and the ESCB and make them operational ■ Adopt secondary legislation with respect to the establishment of the ESCB ■ Decide on, and undertake final testing of, the framework for the ESCB to operate entirely in euro from day one of Stage Three ■ Start the production of euro banknotes and coins and announce their date of introduction ■ Launch a wide-ranging public information campaign
	1 January 1999	
2nd period	Start of Stage Three of EMU: ■ Irrevocable fixing of conversion rates among the currencies of participating Member States and the euro ■ Entry into force of a Council Regulation on the introduction of the euro (based on Article 109 l (4) of the Treaty) ■ Euro introduced in non-cash form	■ Conduct of the single monetary and foreign exchange policy in euro by the ESCB as from day one ■ Start of operation of the TARGET system ■ Provide conversion facilities to counter-parties which have not been able to equip themselves to translate amounts from euro into national currency units and vice versa ■ Exchange banknotes at par value (Article 52 of the ESCB/ECB Statute) ■ Monitor progress in the changeover of the private sector and give guidance where appropriate ■ New tradable public debt issued in euro (redenomination of part of the outstanding public debt stock possible) ■ Prepare changeover of the public administration
	1 January 2002	
3rd period	Latest date for introduction of euro banknotes and coins All references to national currency unit in legal instruments become references to the euro	■ Withdraw national banknotes and coins from circulation ■ National banknotes and coins lose legal tender status
	1 July 2002 at the latest	



Chapter III

Other tasks of the EMI

1 Central bank co-operation in the field of payment systems

The EMI has continued to facilitate co-operation between the EU central banks in three major areas of payment systems: remote access; standardisation; and electronic money.

These issues are analysed in the EMI's report on "Developments in EU payment systems in 1996", which will be released in April 1997.

1.1 Remote access

In July 1995 the EMI Council agreed that, within the framework of Community legislation (in particular the Second Banking Co-ordination Directive), credit institutions would be entitled to gain remote access to foreign interbank funds transfer systems (IFTS) in Stage Two of EMU, although this right could not be automatic. It was also agreed that in order to allow for remote access to IFTS, central banks would grant access to settlement account facilities to remote participants on a non-discriminatory basis. Central banks may also consider granting intraday credit, provided that the risks they would incur from remote participants do not exceed those relating to domestic participants.

So far, remote access to IFTS has only been granted in Belgium, Germany and the Netherlands. One Luxembourg bank was granted remote access to the Belgian RTGS system ELLIPS in December 1996. In Germany fifteen EU credit institutions located near Germany's borders use their accounts held at Deutsche Bundesbank branches mainly for cash operations and funds transfers to German credit institutions. Two participants, however, use their accounts for the paper-based, and one for the paperless, collection of cheques. In the Netherlands, fourteen foreign banks currently have access to the Dutch RTGS system, primarily to facilitate the execution of social security payments abroad.

In December 1996 the EMI Council agreed that remote access to IFTS and to central bank account facilities would continue to be granted in Stage Three of EMU in all EU IFTS and to all EU remote applicants on a non-discriminatory basis, as a consequence of the Single Market legislation. It has yet to be decided whether and under what conditions remote access to intraday credit in euro will be granted to credit institutions.

1.2 Standardisation

The EMI considers that in view of the start of Stage Three it will be important for it to maintain contact with international standardisation bodies, international banking associations and other major players in the field of cross-border money transfers, in order to avoid - in those cases where the efficiency of the market would thereby be compromised - the proliferation of non-compatible standards for cross-border payments and to build the TARGET system in such a way that it will support standardisation to the largest possible extent.

In the area of retail payments, the EMI has continued to follow the work of the European Committee for Banking Standards. However, this work is progressing at a slow pace.

1.3 Electronic money

In May 1994 the EMI published a report on prepaid cards, which recommended that only credit institutions should be allowed to issue electronic purses.

This 1994 report was drafted at a time when developments in prepaid card schemes were at a preliminary stage. Since then, in almost all EU countries a variety of different prepaid card schemes has been developed and started operation. Furthermore, in addition to new prepaid card schemes, another new means of payment has emerged: electronic network money. At present, two types of electronic money can be distinguished: electronic money stored on a chip card (card money) which may be used face-to-face or via telecommunications networks; and electronic money stored on the hard disk of a computer and used over networks (network money).

Central banks are currently reviewing the analysis of the effects electronic money may have on the conduct of monetary policy, the stability and integrity of payment systems, and financial markets as a whole, and are considering the 1994 recommendation in the light of recent developments in prepaid cards and other forms of electronic money. For the sake of their analysis, central banks have broadly defined electronic money as "an electronic store of monetary value on a technical device that may be widely used for making payments, without necessarily involving bank accounts in the transaction but acting as a prepaid bearer instrument".

2 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. In 1996 the system processed about 6,000 transactions per day with an average turnover of ECU 50 billion.

The oversight of the ECU Clearing and Settlement System has the fundamental objective of seeking to ensure that the ECU Banking Association (EBA), which manages the system, takes the necessary measures to ensure that the system does not pose unacceptable risks either to participants in the system or to the ECU market or domestic markets in the EU.

Within this framework, the major line of action of the EMI is to ensure that adequate action is taken to improve the system's compliance with the safety standards laid down in the 1990 Report on Interbank Netting Schemes, which was prepared by the central banks of the G-10 countries. In this respect, the most important reforms implemented in 1996 were the establishment of a system of binding limits on the multilateral net position which a participant is allowed to incur at any moment during the clearing process and the revision of membership and exit criteria.

2.1 The implementation of the new risk control system

On 16 September 1996 the EBA fully implemented ECU 3, the new system providing for binding intraday limits, whereby no payment can be delivered to a receiving bank unless both the sending and receiving banks have net positions which are within the multilateral debit and credit limits which have been established for both banks. The multilateral limits now form the new basis of the liquidity and loss-sharing arrangements. Only if a bank remains within its multilateral limits do the clearing rules allow for the activation of the liquidity-sharing and loss-sharing arrangements. Therefore, the establishment of ECU 3 was an essential element in improving the compliance of the system with the G-10 standards concerning credit and liquidity risk management.

The new system may also increase compliance with the safety standard which focuses on the operational reliability of technical systems and the availability of backup facilities capable of completing daily processing requirements. In this respect, the EBA has implemented an operational backup site where all its essential equipment is duplicated. While the previous system, ECU 2, had a maximum capacity of 3,000 payments an hour, the new system is able to process 12,000 payments an hour.

2.2 Legal issues

In 1996 the EBA requested advice from external legal counsel to develop a legal structure which would provide the ECU Clearing and Settlement System with a sound and enforceable legal basis and which would also be suitable for Stage Three. In this respect, new legal structures were considered to regulate a multilateral netting scheme without a central counterparty.

The EBA has also expressed its intention of introducing collateral as a means of supporting the daily settlement, and thereby improving compliance with the G-10 standard concerning liquidity risk management. Detailed proposals from the EBA are expected in early 1997 and will require in-depth analysis.

2.3 Settlement of the EBA Clearing and Settlement System in Stage Three

In accordance with the "Report on Minimum Common Features for Domestic Payment Systems" of November 1993, which states that all large-value payment systems have to settle in central bank money, the EBA has started discussions with the EMI on issues related to the settlement of the EBA Clearing and Settlement System via TARGET in Stage Three. A joint informal workshop with representatives of the EBA and the EMI/EU central banks has been established to identify all issues related to the settlement of the EBA Clearing and Settlement System in Stage Three.

3 Co-operation in the field of banking supervision

In accordance with Article 109f (2), fourth indent, of the Treaty the EMI also held consultations in 1996 among banking supervisory authorities on a number of issues affecting the stability of financial institutions and markets. The most important topics were the internal control systems of credit institutions and supervisory early warning systems. As far as central credit registers are concerned, co-operation among the interested NCBs has continued.

Internal control systems

Internal control systems (ICSs) have always represented an important element of the operational and management structure of credit institutions. Over the past few years a number of factors (the globalisation of markets, the internationalisation of credit institutions, financial innovation and the development of information technology) have rendered banking activity more complex. Consequently, the internal control function has become more important for credit institutions and, for their part, supervisory authorities are also putting more emphasis on the adequacy of ICSs in relation to the specific features of some recent banking failures. Against this background, the issue of the ICSs of credit institutions was analysed in depth, with the main objective being the identification of elements which could assist in particular banking supervisors in assessing the features and effectiveness of these systems. The main outcome of the work conducted in this area was the selection of a set of basic principles relating to all the relevant aspects of an ICS which are regarded as being appropriate to promote the establishment and maintenance of effective ICSs at credit institutions. To this end, it was necessary to strike a balance between the need to ensure the adequacy of ICSs and the need to avoid an excessive burden on credit institutions. In addition, a specific merit of the work was the provision of a comprehensive overview of the main aspects of an ICS.

The work focused on three main topics. First, a common understanding of the concept of an ICS was pursued which draws upon the work undertaken in this field by international organisations of professionals. Second, a set of basic principles relating to all the relevant aspects of a sound ICS was identified. These principles refer to an ICS as a whole and four main related aspects, namely: administrative organisation, risk control, information systems and electronic information systems. Most of these principles mirror standards widely accepted at the international level for companies of all types, whereas others are specifically devised for credit institutions. Given the significance assumed by information technology in the banking business, particular attention was devoted to the selection of principles for the electronic storage and use of data. Third, consideration was given to the role of the various bodies involved in the field of ICSs. The crucial role of the decision-making bodies of a credit institution (board of directors and senior management) is underlined. The board of directors bears ultimate responsibility for ensuring an effective ICS, whereas senior management is in charge of implementing the strategy set by the board in this area. Particular reference is made to the positive role which, in some countries and depending on certain conditions, could be played by an audit committee as an advisory body to the board. Furthermore, the important function carried out by internal auditors, as well as the role which should be played by external auditors in favouring the adoption and maintenance of adequate ICSs at credit institutions, is spelt out.

Given the importance of the subject, the report prepared on the matter, following the approval of the EMI Council, was sent for consideration to the Basle Committee on Banking Supervision and the Banking Advisory Committee, as well as to a number of non-EU banking supervisory authorities.

Supervisory early warning systems

By way of fact-finding, the state of the art for supervisory early warning systems (EWSs), notably the methods used by EU banking supervisors to detect, at an early stage, financially fragile credit institutions, has been analysed. The survey showed that there are no fundamental differences in the basic approach to early warning methods. The entire day-to-day supervisory process is geared towards the identification of financially fragile institutions and is based on comprehensive qualitative and quantitative information on all aspects which could potentially give rise to financial fragility in individual institutions. This reflects the fact that financial fragility may result from any of the wide range of risks inherent in banking.

As regards the main features of EWSs used by banking supervisors, the following elements deserve consideration. First, early warning is performed through the identification of actual or potential breaches of quantitative and qualitative standards. Less "tangible" and less formal aspects may also be important in the early warning process. Second, peer group comparisons play a central role in the evaluation of institutions. Peer group analysis is conducted to alert supervisors to a deterioration in the situation of an individual institution's position relative to its peer group. Third, in all EU countries supervisors use a host of quantitative data (e.g. relating to capital, asset quality, profitability, liquidity, business concentration (e.g. large exposures and sectoral exposures)) and qualitative data (e.g. on the quality of the management, internal control systems, business strategy). However, data used differ in detail and differences were observed in particular in the use of macroeconomic data in the supervisory early warning process.

Although there are no fundamental differences in the underlying approach to early warning, the degree of formalisation of the risk assessment varies. Some countries have developed more formalised EDP-based risk assessment systems. However, even where formalised EWSs are used, the "output" of the systems (ratings, rankings or assessments of institutions) does not lead to an automatic supervisory reaction because judgmental or subjective factors may be of crucial importance in the supervisory process. These systems represent one of the many tools which serve the early warning process.

Given that asset quality is crucial for the financial soundness of credit institutions, definitions of both "bad and doubtful loans" and requirements for value adjustments ("provisioning") were analysed in greater detail in the context of the survey. In this respect, the EU accounting Directives form the basis of national legislation and accounting practice in all Member States. However, the EU Directives do not provide a specific definition of the concept of bad and doubtful loans. Specific definitions of bad and doubtful loans and specific requirements for provisioning are laid down in Member States' legislation. Legislation and practices vary in a number of respects. In general, some countries appear to follow a more prescriptive approach and oblige credit institutions to make a specified level of provisioning if certain conditions are fulfilled, while other countries rely more heavily on the credit institutions' management and their external auditors' assessment.

The survey serves as a reference document for internal use by the EU banking supervisory authorities and has contributed to co-operation in the further development of supervisory early warning systems, an area in which follow-up work is envisaged. A more detailed investigation of the use of macroeconomic data in the supervisory early warning process and of developments in industry-wide practices concerning provisions for bad and doubtful loans is planned.

Central credit registers

Co-operation among the central credit registers currently existing in seven Member States (Belgium, Germany, Spain, France, Italy, Austria and Portugal) continued. The main objective in this field remains the opening-up of the registers on a cross-border basis in order to grant reporting institutions access to the data stored in all the EU registers. As regards the legal framework, in Portugal the regulation concerning the national register was amended in 1996 to lift the legal obstacles preventing it from providing information on a cross-border basis. Therefore, at this stage, there are no legal restrictions to the opening-up of the registers on a cross-border basis in four countries, whereas in the remaining three the respective NCBs remain committed to promoting the adoption of the necessary measures to remove the legal obstacles at the earliest opportunity.

The tools and modalities used by the registers are subject to a periodic updating and revision process. This is a necessary step to ensure that the systems maintain a satisfactory degree of effectiveness in the context of the continuous evolution of the financial world. Co-operation between registers aims to monitor this process with a view to pursuing the possible convergence of its main features, where appropriate. In this context, the question of the possible inclusion in the registers of data concerning the credit risk associated with derivatives transactions has been addressed. This was triggered by the fact that in three countries it was recently decided to extend, although in different forms, the reporting areas of the registers to include derivatives operations. Co-operation on this specific subject represents an opportunity for the other registers to obtain useful information for their reflections on the possibility of following the same path.

Credit registers are a valuable source of information which can also be exploited from a statistical perspective with a view to analysing some aspects of national financial systems. A first attempt in this direction was made by conducting a survey in four EU countries which focused on the relationship between credit institutions and customers and, in particular, on the issue of "multiple exposures", namely a situation in which the financial needs of an enterprise are met by a large number of financial institutions.

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.

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 enclosed with this Report.

In 1996 the Finnish markka joined the ERM with effect from 14 October, and the Italian lira resumed participation in the mechanism with effect from 25 November. Since both countries had already been participating in the swap mechanism on a voluntary basis, their ERM entry had no impact on 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 10 January 1997, reached ECU 60.1 billion. Compared with January 1996, the stock of ECUs increased by nearly ECU 6 billion. The increase was mainly due to: first, a rise in the USD/ECU exchange rate; 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.

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 1996 such transfers resulted in a decrease of ECU 7.98 billion to 63.5 million in net ECU positions. The remaining balance reflects the acquisition of ECUs through swap operations of the Swiss National Bank with two EU central banks, given its status of "Other Holder" of ECUs. The ECU mobilisation mechanism has not been activated since 1986. No use was made of the VSTF in 1996, nor of the Short-Term Monetary Support mechanism. The latter has not been activated since 1974.

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 1996 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 capital, interest, commission and expenses on outstanding loans. The following table shows the total of outstanding Community lending operations as at 31 December 1995 and 1996.

Table 13

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	
	1995	1996	1995	1996	1995	1996
Greece	536	...	740	500	1,024	500
Italy	3,900	3,900	1,975	1,475	4,045	3,479
Total	4,436	3,900	2,715	1,975	5,069	3,979

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

Sixteen requests for consultations were received in 1996. Six came from the Council of the European Union, three were received from the European Commission and seven originated from national authorities.

The table below summarises the consultation procedures in which the EMI delivered opinions.

Table 14

Consultation procedures

No.	Originator	Subject
1	European Commission	Harmonised Indices of Consumer Prices
2	EU Council	Reorganisation and winding-up of credit institutionsand deposit guarantee systems
3	Sweden	Termination of bank support
4	Ireland	Statute of the Central Bank of Ireland
5	Finland	Statute of Suomen Pankki
6	European Commission	Harmonised Indices of Consumer Prices
7	EU Council	Solvency Ratio Directive
8	EU Council	First Banking Directive, Solvency Ratio Directive and Capital Adequacy Directive
9	EU Council	Settlement finality and collateral security Directive
10	Belgium	Statute of the National Bank of Belgium
11	EU Commission	Harmonised Indices of Consumer Prices
12	Denmark	Undertakings for Collective Investment in Transferable Securities (UCITS)
13	EU Council	Introduction of the euro
14	EU Council	Excessive deficit procedure
15	Sweden	Collateral
16	Belgium	Statute of the National Bank of Belgium

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

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

In 1996 the EMI continued to monitor central banks' fulfilment of their obligations under Articles 104 and 104a of the Treaty and Council Regulations (EC) Nos. 3603/93 and 3604/93.[1] The European Commission monitors Member States' compliance with these provisions.

In 1996 the Treaty requirements continued to be largely respected by the EU central banks. 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 in the course of 1996 and at the beginning of 1997.

The EMI also monitors central banks' secondary market purchases of public sector debt instruments. Although the acquisition of debt instruments of the public sector in the secondary market is in general in compliance with the Treaty, such purchases must not be used to circumvent the objective of Treaty Article 104.

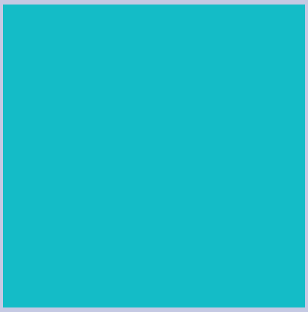
[1] *For further background information on the legal framework of this topic see the EMI's Annual Report 1994, Chapter III B.*

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 a number of levels. The President of the Council of the European Union 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 Council of the European Union 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 ERM II and the determination of the monetary and exchange rate policy co-operation between the euro area and other EU Member States (see Chapter II Section 2.1) were discussed. The President also attended the EMU parts of the June and December meetings of the European Council. He has also appeared before the European Parliament to present the EMI's Annual Report 1995 to a plenary session in June 1996 and the EMI's report on "Progress towards convergence 1996", to the Sub-Committee on Monetary Affairs in November 1996.

At the working level, senior representatives of the EMI have regularly attended the meetings of the Monetary Committee as observers. Close working relationships exist with the competent Directorates General of the European Commission, representatives of which also attend meetings of some EMI working groups. In the field of statistics the EMI has further enhanced its co-operation procedures 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 are responsible for producing the coins which will circulate alongside the euro banknotes in Stage Three.

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 and Switzerland have continued, and a good relationship exists with the IMF and the World Bank. Important links have also been retained with the Bank for International Settlements (BIS). In 1996 the EMI also started to establish relationships 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 1996

ECU

Assets

		1996	*1995*
I	**EMS-related assets**		
	Holdings of gold	27,816,645,173	*27,204,932,117*
	Holdings of US dollars	31,710,534,867	*27,015,081,233*
		59,527,180,040	*54,220,013,350*
II	**Other assets**		
(1)	Cash and bank sight accounts	11,013,442	*490,709*
(2)	Time deposits	628,044,375	*597,168,977*
(3)	Securities	0	*31,326,075*
(4)	Tangible assets	7,815,279	*8,809,555*
(5)	Other assets	841,986	*1,243,530*
		647,715,082	*639,038,846*
Total assets (I and II)		**60,174,895,122**	*54,859,052,196*

Memorandum item:

	1996	*1995*
Forward claims in ECUs (from revolving quarterly swaps)	59,527,180,040	*54,220,013,350*

Liabilities

ECU

		1996	*1995*
I EMS-related liabilities			
	ECUs issued to EU central banks	59,527,180,040	*54,220,013,350*
		59,527,180,040	*54,220,013,350*
II Other liabilities			
(1)	Creditors and other liabilities	4,200,209	*3,469,106*
(2)	Provision for pensions and similar obligations	3,742,631	*1,958,363*
(3)	Other provisions	7,074,292	*5,258,218*
(4)	Contributions from EU central banks (pursuant to Article 16.2 of the Statute)	615,573,495	*615,573,495*
(5)	Revaluation account	0	*243,514*
(6)	General reserve fund	12,536,150	*0*
(7)	Surplus for the year	4,588,305	*12,536,150*
		647,715,082	*639,038,846*
Total liabilities (I and II)		**60,174,895,122**	*54,859,052,196*
Memorandum item: Forward liabilities in gold and US dollars (from revolving quarterly swaps)		59,527,180,040	*54,220,013,350*

Profit and Loss Account for the year 1996

ECU

	1996	*1995*
Income		
Interest income	44,532,696	*45,439,252*
Total income	**44,532,696**	*45,439,252*
Expenses		
Staff costs	18,157,530	*15,039,033*
Other administrative expenses	18,936,144	*15,775,583*
Depreciation of tangible assets	2,084,941	*2,449,521*
Total expenses	**39,178,615**	*33,264,137*
Extraordinary income	96,523	*361,035*
Less: valuation loss	(862,299)	*0*
Surplus/deficit for the year	**4,588,305**	*12,536,150*

Frankfurt am Main,
12 February 1997

EUROPEAN MONETARY INSTITUTE

A. Lamfalussy
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. Notwithstanding the limited life of the EMI, the accounts have been prepared on a "going concern" basis.

1.3 EMS-related assets and liabilities are shown at cost. Short-term discount securities are shown at cost plus accrued interest. Securities, other than short-term discount securities 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.

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

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

1.5 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 1996, 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 1996. Translation of financial fixed assets denominated in foreign currencies is at the spot rates of exchange ruling on the dates of their acquisition.

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

1.7 In accordance with Article 17.4 of the Statute, the Council has appointed C & L Treuarbeit 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. 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 uninvested cash balances were held on a one-day notice interest-bearing account in Deutsche Mark.

II (2) *Time deposits:* As stated in the Annual Report for 1995, 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 constitute a financial fixed asset of the EMI. As at 31 December 1996, short-term deposits of a further ECU 30.8 million of the EMI's cash balances were held.

II (3) *Securities:* Other cash balances were invested from time to time in Treasury Bills of the Federal Republic of Germany or in discount securities issued by the Bank for International Settlements. No such securities were held at 31 December 1996.

II (4) *Tangible assets:* Net of cumulative depreciation of ECU 4.8 million these comprised, at year-end:

	ECU	
	1996	*1995*
Special installations	3,632,708	*4,717,153*
Other equipment	1,858,180	*2,037,679*
Computers and software	2,231,547	*1,922,277*
Other	92,844	*132,446*
Total	7,815,279	*8,809,555*

"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.

II (5) *Other assets:* This item 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 restoration of the EMI's premises at the end of its lease, office rental and service charge payments outstanding in respect of 1996, final settlement of costs of work on establishing the premises, and the production of the Annual Report and the accounts for 1996.

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) *Revaluation account:* The depreciation of the Deutsche Mark against the ECU during 1996 resulted in an unrealised loss in the net value of assets held in, or denominated in, Deutsche Mark, which has been partly charged against the previous gains taken into this account. The balance has been charged against profit (see Note 1.6 under "Accounting Policies" and Note 3.4 below).

II (6) *General reserve fund:* This represents accumulated undistributed profits from previous years. See also Note 3.5 below.

II (7) *Surplus for the year:* See Note 3.5 below.

3. Notes on the Profit and Loss Account

3.1 Income

Interest income: This item represents interest of ECU 43.5 million earned on the time deposits and of ECU 1.0 million from investment of cash balances (see Notes under "Other assets").

3.2 Expenses

Staff costs: This item relates to salaries and general allowances (ECU 15.6 million), and to employer's contributions to pensions and health and accident insurance (ECU 2.6 million), in respect of permanent staff employed by the EMI. Salaries and allowances of staff, including emoluments of holders of senior management positions, are modelled in essence on, and comparable to, the remuneration scheme of the European Communities.

Numbers of permanent staff (as at 31 December)	1996	1995
Senior management	6	6
Managerial	36	26
Professional	90	81
Support	85	80
Total	217	193

The average number of permanent staff employed during 1996 was 202, compared with 166 for 1995. During 1996 33 permanent staff were recruited and 9 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 recruitment, relocation and installation of staff.

3.3 Extraordinary income

This item represents extraordinary income arising mainly from the release of provisions made at end-1995 in respect of anticipated expenditure arising in that year that are no longer required.

3.4 Valuation loss

Unrealised losses in the net value of assets held or denominated in Deutsche Mark that were not covered by the revaluation account balance have been charged against profit (see Note II (5) under "Other liabilities").

3.5 Allocation of surplus

Pursuant to Article 17.5 of the Statute of the EMI, any surplus of the EMI shall be transferred in the following order:

(a) an amount to be determined by the Council of the EMI shall be transferred to the general reserve fund of the EMI;

(b) any remaining surplus shall be distributed to the national central banks in accordance with the key referred to in Article 16.2.[1]

[1] *At its meeting on 4 March 1997, the Council determined that the entire surplus for the year 1996 should be transferred to the general reserve fund.*

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 I 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 1996 and the results of its operations for the year then ended.

Frankfurt am Main, 12 February 1997

C&L TREUARBEIT
DEUTSCHE REVISION
Aktiengesellschaft

(Wagener) (Kern)

Auditor Auditor

Annexes

Glossary

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 and with which the Community intends to begin accession negotiations after the completion of the Intergovernmental Conference. These associated CEECs currently comprise Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.

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.

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.

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 usually referred to as the *ECOFIN Council*. In special circumstances, in particular in the case of Article 109j of the *Treaty*, the Council meets in the composition of the Heads of State or of Government. See also *European Council.*

EBA (ECU Banking Association): 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.

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. According to the *Treaty* the ECB shall have recourse to the national central banks to carry out operations which form part of the ESCB to the extent deemed possible and appropriate.

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 the 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.

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, as well as for 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 will be laid down in Article 2 of the Council Regulation on some provisions relating to the introduction of the euro, which was endorsed by the *European Council* in Dublin on 13 and 14 December 1996.

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

Electronic purse: a reloadable *multi-purpose prepaid card* which may be used for small retail or other payments instead of coins.

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 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.

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 and the related legal texts which will form the basis of the mechanism (a European Council Resolution and an agreement between the *ECB* and non-euro area NCBs) are currently under preparation.

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 will be 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 will also 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.

euro: the name of the European currency adopted by the *European Council* at its meeting in Madrid on 15 and 16 December 1995. It will be 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 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.

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.

IFTS (Interbank Funds Transfer System): *funds transfer systems* in which most of (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.

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: 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* whose settlement operations are completed on a bilateral or multilateral net basis.

Quick tenders: tender procedure used by the *ESCB* mainly 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.

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).

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. 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: 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: the term 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*.

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): *EMS* credit facility between central banks for financing interventions in *ERM* currencies.

Chronology of monetary measures taken in the EU in 1996[1]

2 January The *Bank of England* launches an open gilt repo market.

9 January *Sveriges Riksbank* reduces its repo rate by 0.25 percentage point to 8.66%.

10 January The *Banque Nationale de Belgique* lowers its central rate and its ordinary end-of-day rate by 0.05 percentage point to 3.7% and 4.95% respectively.
The *Deutsche Bundesbank* allows for a fall in its securities repurchase rate of 0.02 percentage point to 3.73%.
Suomen Pankki announces a reduction of its base rate by 0.25 percentage point to 4.5%, with effect from 1 February 1996.

11 January *Danmarks Nationalbank* reduces its 14-day certificates of deposit rate by 0.1 percentage point to 4.5%.

12 January The *Banco de España* reduces its official 10-day repurchase rate by 0.25 percentage point to 8.75%.
The weighted average repo rate of the *Banco de Portugal* decreases by 0.009 percentage point to 8.491%.

16 January The weighted average repo rate of the *Banco de Portugal* decreases by 0.166 percentage point to 8.325%.

17 January The *Banque Nationale de Belgique* lowers its central rate and its ordinary end-of-day rate by 0.05 percentage point to 3.65% and 4.9% respectively.
The *Deutsche Bundesbank* allows for a fall in its securities repurchase rate of 0.08 percentage point to 3.65%.

18 January The *Banque de France* reduces its money market intervention rate and its 5 to 10-day lending facility rate by 0.25 percentage point to 4.2% and 5.6% respectively.
De Nederlandsche Bank lowers the rate on special advances by 0.1 percentage point to 3.3%.
The *Bank of England* lowers its minimum lending rate by 0.25 percentage point to 6.25%.

22 January The *Oesterreichische Nationalbank* starts offering weekly tenders. The repo rate for the first volume tender is fixed at 3.65%.
The weighted average repo rate of the *Banco de Portugal* decreases by 0.075 percentage point to 8.25%.

24 January The *Banque Nationale de Belgique* lowers its central rate and its ordinary end-of-day rate by 0.1 percentage point to 3.55% and 4.8% respectively.
Danmarks Nationalbank reduces its discount rate by 0.25 percentage point to 4.0% and its 14-day certificates of deposit rate by 0.15 percentage point to 4.35%.

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1 *Dates of announcement of monetary measures.*

	The *Deutsche Bundesbank* allows for a fall in its securities repurchase rate of 0.1 percentage point to 3.55%. *De Nederlandsche Bank* lowers the rate on special advances by 0.1 percentage point to 3.2%.
26 January	The *Oesterreichische Nationalbank* reduces its GOMEX rate by 0.1 percentage point to 3.65%.
29 January	The *Oesterreichische Nationalbank* reduces its repo rate by 0.1 percentage point to 3.55%.
30 January	*Sveriges Riksbank* reduces its repo rate by 0.21 percentage point to 8.45%.
31 January	The *Banque Nationale de Belgique* lowers its central rate and its ordinary end-of-day rate by 0.15 percentage point to 3.4% and 4.65% respectively. The *Deutsche Bundesbank* allows for a fall in its securities repurchase rate of 0.15 percentage point to 3.4%. The *Greek Government* lowers the interest rate on three-month Treasury bills by 0.2 percentage point to 12.9%, the interest rate on six-month Treasury bills by 0.4 percentage point to 13.1% and the interest rate on twelve-month Treasury bills by 0.4 percentage point to 13.8%.
1 February	The *Banque Nationale de Belgique* lowers its central rate and its ordinary end-of-day rate by 0.1 percentage point to 3.3% and 4.55% respectively. The *Deutsche Bundesbank* announces that the next two securities repurchase agreements will be offered at a fixed rate of 3.3% (allowing for a reduction of 0.1 percentage point). The *Banque de France* reduces its money market intervention rate by 0.15 percentage point to 4.05%.
2 February	*De Nederlandsche Bank* lowers the rate on special advances by 0.2 percentage point to 3.0%. The *Oesterreichische Nationalbank* reduces its GOMEX rate by 0.15 percentage point to 3.5%.
5 February	The *Oesterreichische Nationalbank* reduces its repo rate by 0.25 percentage point to 3.3%. The weighted average repo rate of the *Banco de Portugal* increases by 0.009 percentage point to 8.259%.
8 February	*Danmarks Nationalbank* reduces its 14-day certificates of deposit rate by 0.1 percentage point to 4.25%.
9 February	The *Banque de France* reduces its money market intervention rate by 0.15 percentage point to 3.9%.
12 February	The weighted average repo rate of the *Banco de Portugal* decreases by 0.134 percentage point to 8.125%.

13 February	*Sveriges Riksbank* reduces its repo rate by 0.15 percentage point to 8.3%.
19 February	The weighted average repo rate of the *Banco de Portugal* decreases by 0.125 percentage point to 8.0%.
22 February	*Sveriges Riksbank* announces a reduction in its lending and deposit rates of 0.5 percentage point to 9.0% and 7.5% respectively, with effect from 28 February 1996. It also reduces its repo rate by 0.25 percentage point to 8.05%.
29 February	The *Greek Government* reduces Treasury bill rates by 0.4 percentage point at three, six and twelve months' maturity to 12.5%, 12.7% and 13.4% respectively.
5 March	*Sveriges Riksbank* reduces its repo rate by 0.2 percentage point to 7.85%.
7 March	*Danmarks Nationalbank* reduces its 14-day certificates of deposit rate by 0.15 percentage point to 4.1% and its discount rate by 0.25 percentage point to 3.75%. The *Banque de France* reduces its money market intervention rate and its 5 to 10-day lending facility rate by 0.1 percentage point to 3.8% and 5.5% respectively.
8 March	The *Bank of England* lowers its minimum lending rate by 0.25 percentage point to 6.0%.
12 March	The *Banco de Portugal* reduces its liquidity absorption rate and the overnight credit rate by 0.25 percentage point to 7.5% and 10.25% respectively. In addition, its weighted average repo rate decreases by 0.1 percentage point to 7.9%.
13 March	The *Banco de España* reduces its official 10-day repurchase rate by 0.5 percentage point to 8.25%. *Suomen Pankki* lowers its tender rate by 0.5 percentage point to 3.75%.
19 March	*Sveriges Riksbank* reduces its repo rate by 0.25 percentage point to 7.6%.
21 March	*Danmarks Nationalbank* reduces its 14-day certificates of deposit rate by 0.1 percentage point to 4.0%. *Sveriges Riksbank* announces a reduction in its lending and deposit rates by 0.75 percentage point to 8.25% and 6.75% respectively, with effect from 27 March 1996.
26 March	The weighted average repo rate of the *Banco de Portugal* decreases by 0.1 percentage point to 7.8%. *Sveriges Riksbank* reduces its repo rate by 0.2 percentage point to 7.4%.
28 March	The *Bank of Greece* announces that, as of May 1996, banks will be allowed to fulfil a fraction (10%) of their required reserves as an average over the maintenance period, rather than on a day-by-day basis as hitherto.

De Nederlandsche Bank reduces the rate on advances by 0.25 percentage point to 2.5% and the rate on special advances by 0.1 percentage point to 2.9%.

1 April	*Danmarks Nationalbank* reduces its 14-day certificates of deposit rate by 0.1 percentage point to 3.9%. The *Greek Government* reduces Treasury bill rates by 0.1 percentage point at three, six and twelve months' maturity to 12.4%, 12.6% and 13.3% respectively.
3 April	The *Banco de España* reduces its official 10-day repurchase rate by 0.5 percentage point to 7.75%.
9 April	*Sveriges Riksbank* reduces its repo rate by 0.25 percentage point to 7.15%.
11 April	The *Banque de France* reduces its money market intervention rate by 0.1 percentage point to 3.7%.
12 April	*De Nederlandsche Bank* reduces the rate on special advances by 0.1 percentage point to 2.8%. The *Banco de Portugal* reduces its liquidity absorption rate by 0.3 percentage point to 7.2% and the overnight credit rate by 0.75 percentage point to 9.5%. In addition, its weighted average repo rate is cut by 0.2 percentage point to 7.6%.
18 April	The *Banque Nationale de Belgique* lowers its discount rate by 0.5 percentage point to 2.5% and the emergency lending rate by 1 percentage point to 6.0%. *Danmarks Nationalbank* reduces its 14-day certificates of deposit rate by 0.1 percentage point to 3.8% and its discount rate by 0.5 percentage point to 3.25%. The *Deutsche Bundesbank* announces a reduction of its discount and lombard rates by 0.5 percentage point to 2.5% and 4.5% respectively. *De Nederlandsche Bank* reduces the rate on advances by 0.5 percentage point to 2.0% and the rate on special advances by 0.1 percentage point to 2.7%.
19 April	The *Bank of Greece* lowers its discount and lombard rates by 0.5 percentage point to 17.5% and 21.0% respectively. The *Central Bank of Ireland* cuts its short-term lending facility rate by 0.25 percentage point to 6.25%. The *Oesterreichische Nationalbank* reduces its discount and lombard rates by 0.5 percentage point to 2.5% and 4.75% respectively. The *Banco de Portugal* reduces its liquidity absorption rate by 0.4 percentage point to 6.8% and the overnight credit rate by 0.5 percentage point to 9.0%. In addition, its weighted average repo rate is cut by 0.1 percentage point to 7.5%.

22 April	The *Oesterreichische Nationalbank* reduces its repo rate by 0.1 percentage point to 3.2%.
23 April	*Sveriges Riksbank* reduces its repo rate by 0.25 percentage point to 6.9%.
25 April	The *Banque de France* reduces its 5 to 10-day lending facility rate by 0.6 percentage point to 4.9%. *Sveriges Riksbank* announces a reduction in its lending and deposit rates of 0.75 percentage point to 7.5% and 6.0% respectively, with effect from 2 May 1996.
3 May	Access to the *Banco de Portugal's* overnight credit facility is no longer subject to quotas related to each credit institution's share in the minimum reserve requirement. In addition, tender operations are henceforth announced on the last day of the previous reserve maintenance period instead of the first day of the new reserve maintenance period.
6 May	*De Nederlandsche Bank* reduces the rate on special advances by 0.1 percentage point to 2.6%.
7 May	The *Banco de España* reduces its official 10-day repurchase rate by 0.25 percentage point to 7.5%. *Sveriges Riksbank* reduces its repo rate by 0.2 percentage point to 6.7%.
14 May	The *Banque Nationale de Belgique* lowers its central rate and its ordinary end-of-day rate by 0.1 percentage point to 3.2% and 4.45% respectively.
21 May	*Sveriges Riksbank* reduces its repo rate by 0.2 percentage point to 6.5%.
31 May	The *Greek Government* reduces Treasury bill rates by 0.2 percentage point at three, six and twelve months' maturity to 12.2%, 12.4% and 13.0% respectively.
4 June	The *Bank of Greece* announces an increase in the minimum reserves ratio for credit institutions from 11% to 12% and an extension of the minimum reserves basis, to be applied as from end-June 1996 balances. The liability basis for calculating the reserve requirement is widened to include banks' net liabilities vis-à-vis non-residents with a maturity exceeding two years. Additionally, compulsory reserves are imposed for the first time on mortgage banks at a ratio of 4%. The *Banco de España* reduces its official 10-day repurchase rate by 0.25 percentage point to 7.25%. *Sveriges Riksbank* reduces its repo rate by 0.2 percentage point to 6.3%.
6 June	*Danmarks Nationalbank* reduces its 14-day certificates of deposit rate by 0.1 percentage point to 3.7%. The *Banque de France* reduces its money market intervention rate by 0.1 percentage point to 3.6%.

	The *Bank of England* cuts its minimum lending rate by 0.25 percentage point to 5.75%.
14 June	*Suomen Pankki* lowers its tender rate by 0.15 percentage point to 3.6%.
18 June	*Sveriges Riksbank* reduces its repo rate by 0.2 percentage point to 6.1%.
20 June	*Sveriges Riksbank* announces a reduction in its lending and deposit rates by 0.75 percentage point to 6.75% and 5.25% respectively, with effect from 26 June 1996.
2 July	*Sveriges Riksbank* lowers its repo rate by 0.2 percentage point to 5.9%. The maturity of its repo operations is reduced from two weeks to one week.
4 July	The *Banque de France* reduces its money market intervention rate by 0.05 percentage point to 3.55%.
5 July	*Suomen Pankki* lowers its tender rate by 0.1 percentage point to 3.5%.
12 July	*De Nederlandsche Bank* raises the rate on special advances by 0.1 percentage point to 2.7%.
16 July	*Sveriges Riksbank* reduces its repo rate by 0.2 percentage point to 5.7%.
23 July	The *Banca d'Italia* reduces its discount and fixed term advances (or lombard) rates by 0.75 percentage point to 8.25% and 9.75% respectively.
30 July	The *Greek Government* reduces Treasury bill rates by 0.2 percentage point at three, six and twelve months' maturity to 12.0%, 12.2% and 12.8% respectively. *Sveriges Riksbank* reduces its repo rate by 0.15 percentage point to 5.55%.
1 August	The *Banque de France* reduces its 5 to 10-day lending facility rate by 0.15 percentage point to 4.75%.
13 August	*Sveriges Riksbank* reduces its repo rate by 0.15 percentage point to 5.4%.
15 August	*Sveriges Riksbank* reduces its lending and deposit rates by 0.5 percentage point to 6.25% and 4.75% respectively, with effect from 21 August 1996.
22 August	The *Banque Nationale de Belgique* lowers its central rate and its ordinary end-of-day rate by 0.2 percentage point to 3.0% and 4.25% respectively. The *Deutsche Bundesbank* announces that the next two securities repurchase agreements will be offered at a fixed rate of 3.0% (allowing for a reduction of 0.3 percentage point). The *Banque de France* reduces its money market intervention rate by 0.2 percentage point to 3.35%. *De Nederlandsche Bank* reduces the rate on special advances by 0.2 percentage point to 2.5%.

The *Oesterreichische Nationalbank* announces a reduction of its repo rate by 0.2 percentage point to 3.0% and of its GOMEX rate by 0.1 percentage point to 3.4%, with effect from 2 September 1996.

23 August

Danmarks Nationalbank reduces its 14-day certificates of deposit rate by 0.2 percentage point to 3.5%.
The *Banco de Portugal* reduces its repo rate by 0.25 percentage point to 7.25%.
Suomen Pankki lowers its tender rate by 0.25 percentage point to 3.25%.

27 August

Sveriges Riksbank reduces its repo rate by 0.15 percentage point to 5.25%.

2 September

The *Greek Government* reduces Treasury bill rates by 0.1 percentage point at three, six and twelve months' maturity to 11.9%, 12.1% and 12.7% respectively.

10 September

Sveriges Riksbank reduces its repo rate by 0.1 percentage point to 5.15%.

16 September

Suomen Pankki reduces its base rate by 0.5 percentage point to 4.0%.

18 September

Suomen Pankki lowers its tender rate by 0.15 percentage point to 3.1%.

19 September

The *Banque de France* reduces its money market intervention rate by 0.1 percentage point to 3.25%.

24 September

Sveriges Riksbank reduces its repo rate by 0.1 percentage point to 5.05%.

3 October

The *Banco de España* reduces its official 10-day repurchase rate by 0.5 percentage point to 6.75%.
The *Banco de Portugal* reduces its repo rate by 0.15 percentage point to 7.1%.

8 October

Sveriges Riksbank reduces its repo rate by 0.1 percentage point to 4.95%.

9 October

Suomen Pankki lowers its tender rate by 0.1 percentage point to 3.0%.

12 October

The Ministers and central bank governors of the *Member States of the European Union*, following a decision by the Finnish Government to join the ERM of the EMS, decide by mutual agreement, in a common procedure involving the European Commission and the EMI and after consultation with the Monetary Committee, on the terms on which the Finnish markka will participate as of 14 October 1996. In this context, the Finnish authorities express their intention to press on with their successful policies aimed at convergence with the most stable EU economies.

18 October

The *Banca d'Italia* raises the portion of the banks' minimum reserve requirement that can be mobilised in the interbank market from 10% to 12.5% of the total requirement, with effect from 21 October 1996.

21 October	The *Banco de Portugal* reduces its repo rate by 0.1 percentage point to 7.0%.
22 October	*Sveriges Riksbank* reduces its repo rate by 0.1 percentage point to 4.85%.
23 October	The *Banca d'Italia* reduces its discount and fixed term advances (or lombard) rates by 0.75 percentage point to 7.5% and 9% respectively.
24 October	*Sveriges Riksbank* announces a reduction in its lending and deposit rates of 0.5 percentage point to 5.75% and 4.25% respectively, effective from 30 October 1996. It also announces a reduction in its repo rate of 0.25 percentage point to 4.6%, effective from 30 October 1996.
30 October	The *Bank of England* raises its minimum lending rate by 0.25 percentage point to 6%.
31 October	The *Greek Government* reduces Treasury bill rates by 0.4 percentage point at three, six and twelve months' maturity to 11.5%, 11.7% and 12.3% respectively. The *Banque de France* reduces its money market intervention rate by 0.05 percentage point to 3.2%, effective from 5 November.
18 November	The *Banco de Portugal* reduces the liquidity absorption rate by 0.4 percentage point to 6.4% and the overnight credit rate by 0.5 percentage point to 8.5%. In addition, the repo rate is lowered by 0.1 percentage point to 6.9%.
25 November	The Ministers and central bank governors of the *Member States of the European Union*, following a decision by the Italian Government to resume the intervention obligations of the ERM of the EMS, decide by mutual agreement, in a common procedure involving the European Commission and the EMI and after consultation with the Monetary Committee, on the terms on which the intervention obligations of the system relating to the Italian lira, which were suspended on 17 September 1992, will again apply as of 25 November 1996. In this context, the Italian authorities commit themselves to intensifying their efforts to complete the adjustment of the Italian economy.
26 November	*Sveriges Riksbank* reduces its repo rate by 0.25 percentage point to 4.35%.
2 December	The *Greek Government* lowers the interest rate on twelve-month Treasury bills by 0.8 percentage point to 11.5%.
5 December	The *Deutsche Bundesbank* announces that it will exempt from its minimum reserve requirements all liabilities vis-à-vis non-banks as well as banks abroad related to securities repurchase agreements with a maturity up to one year. The measure takes effect from January 1997. *Sveriges Riksbank* announces a reduction in its lending and deposit rates of 0.5 percentage point to 5.25% and 3.75% respectively, with effect from 11 December 1996.

13 December The *Banco de España* reduces its official 10-day repurchase rate by 0.5 percentage point to 6.25%.

17 December The *Banque de France* lowers its money market intervention rate by 0.05 percentage point to 3.15% (effective from 20 December) and its 5 to 10-day lending facility rate by 0.15 percentage point to 4.6%.
Sveriges Riksbank cuts its repo rate by 0.25 percentage point to 4.1%.

18 December The *Bank of Greece* reduces its discount rate by 1 percentage point to 16.5%.
The *Oesterreichische Nationalbank* announces that it will exempt from its minimum reserve requirement all deposits of resident non-banks related to securities repurchase deals. The measure takes effect from January 1997.

19 December The *Deutsche Bundesbank* sets the target for M3 growth in 1997 and 1998 at around 5% and the target range for 1997 at 3.5-6.5%, compared with the 1996 target range of 4-7%.
The *Banco de Portugal* lowers its overnight credit, liquidity absorption and repo rates by 0.2 percentage point to 8.3%, 6.2% and 6.7% respectively.

Other EMI publications[1]

"Role and functions of the European Monetary Institute", February 1996.

"Payment systems in the European Union" (the "Blue Book"), April 1996.

"The statistical requirements for Monetary Union", July 1996.

"First progress report on the TARGET project", August 1996.

"Progress towards convergence 1996", November 1996.

"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), January1997.

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

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

"Developments in EU payment systems in 1996", due to be released April 1997.[2]

"Recent developments in the use of the private ECU: statistical survey", due to be released April 1997.[3]

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1 *Since the beginning of 1996.*

2 *A report relating to developments in 1995 was released in March 1996.*

3 *The first edition of this annual review was published in February 1991.*