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ANNUAL REPORT  
2002



BANQUE CENTRALE DU LUXEMBOURG  
EUROSYSTEM



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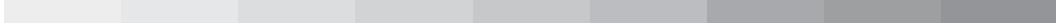
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# FOREWORD

This is the fourth Annual Report to be published by the Banque centrale du Luxembourg (BCL) since its foundation. The year 2002 was marked by the successful cash changeover to the euro in Luxembourg and eleven other European countries. Only one month after the official switch, in Luxembourg, this major change was 98% completed for banknotes and 69% for coins.

Having met, with success, the challenge posed by the integration of the BCL into the operational network constituted by the European System of Central Banks, this logistical operation of historic dimensions in a sense completed the running-in phase of the life of our institution.

2002 was also marked by the integration of the BCL into two important European fields. First, the distribution of the monetary income of the Eurosystem. Second, the institutional reorganisation in view of the projected enlargement of the European Union. Luxembourg's special role in Europe, with respect to financial matters and as a European institutional centre, was reflected in the results of the discussions at European level.

Within the BCL, the past year has been used to prepare the Bank's financial stabilisation. So, during 2003, the Council will be able to confirm the BCL's strategy and objectives. This should guarantee its financial position in the medium-term.

The highly motivated staff, who consistently display initiative, were increased in 2002 to a total of a little more than 200 employees. This number is necessary to carry out the different tasks resulting from the Bank's Eurosystem and domestic missions. It is sufficient for that purpose.

The BCL has improved its capabilities in the fields of analysis and communication. These will be further improved if the requisite statistical instruments, similar to those existing in other European countries, finally become available in Luxembourg.

We wish to contribute to the quality of the economic and financial debate, especially when that is taking place in a difficult and uncertain economic environment regarding public finance as well as the health of the financial place. According to recent estimates, Luxembourg's GDP growth slowed down considerably in 2002 after only 1% growth in 2001. This was, therefore, the second year in a row in which its growth rate has been lower than that of the European Union average (1.5% in 2001 and 0.9% in 2002). Luxembourg's inflation rate (2.1% on average in 2002) remained below the euro zone average (2.2%). Nonetheless Luxembourg's inflation rate exceeded that of its neighbours (1.9% in France, 1.6% in Belgium and 1.3% in Germany).

Moreover, net aggregated results of the banking sector deteriorated by 6.1% compared to 2001, although this development differed as between individual actors. The aggregated balance sheet of the banking sector, the level of employment and the number of institutions followed this downward trend. Weakened by the deterioration of credit quality and by the decline of stock markets, the banking sector saw its commission revenue and its margin on interests decrease by 6.3% and 6.9% respectively in 2002.

With regard to public finance, tax cuts have been implemented during recent years without being accompanied by a slowing-down of the growth of structural expenses. The evolution of public finance remains worrying. According to recent estimates, the surplus of public administrations amounted to 6.4% of GDP in 2001. It amounted to only 2.6% in 2002. A worse deterioration was only avoided by the accelerated collection of direct corporate tax. Piloting at sight, which leads to administrative waste, is out of place. An immediate adjustment would be far less painful than deferred budgetary stabilisation.

After an initial phase of the BCL which was principally concerned with the Bank's integration into the Eurosystem and the successful cash changeover to the euro, a second phase focused on the stabilisation, consolidation and lasting development of human resource and capital factors. A third phase in the development of the BCL will emphasise the importance of communication and the implantation of a stability culture in our country.

Yves Mersch





# I

ANNUAL REPORT 2002





# ECONOMIC AND FINANCIAL SITUATION

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## I

# 1 ECONOMIC AND FINANCIAL SITUATION

## 1.1 Economic situation at the international level

### 1.1.1 Short term interest rates

After one year of unchanged rates, the ECB decided on 5 December 2002 to reduce the minimum bid rate on the main refinancing operations of the Eurosystem by 50 basis points. This decision was followed by another rate cut of 25 basis points to 2.50% on 6 March 2003. Interest rates on the marginal lending facility and the deposit facility were also reduced by 25 basis points, to 3.50% and 1.50% respectively.

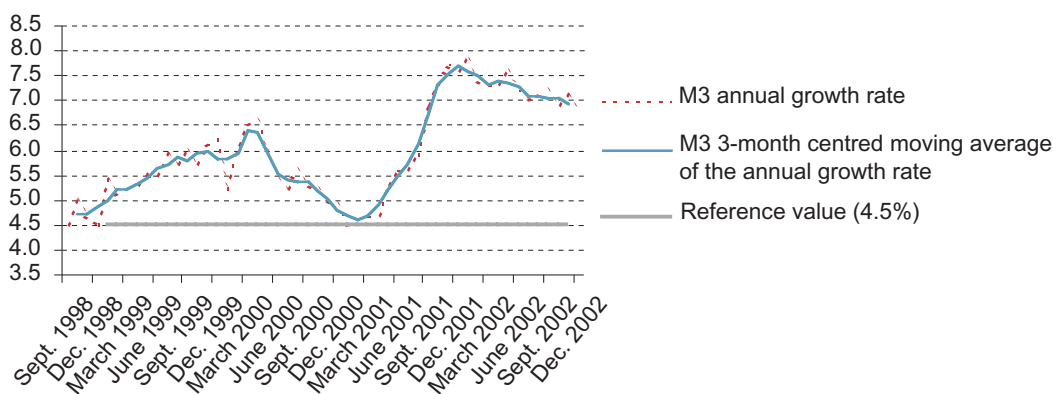
TABLE 1 INTEREST RATE DECISIONS OF THE EUROSISTEM

	Marginal lending rate		Main refinancing operations		Deposit rate	
	Level	Change	Level	Change	Level	Change
10/05/2001	3.50%	-0.25	4.50%	-0.25	5.50%	-0.25
30/08/2001	3.25%	-0.25	4.25%	-0.25	5.25%	-0.25
17/09/2001	2.75%	-0.50	3.75%	-0.50	4.75%	-0.50
08/11/2001	2.25%	-0.50	3.25%	-0.50	4.25%	-0.50
05/12/2002	1.75%	-0.50	2.75%	-0.50	3.75%	-0.50
06/03/2003	1.50%	-0.25	2.50%	-0.25	3.50%	-0.25

Source : BCE

With regard to the analysis under the first pillar, the annual growth rate of M3 remained high over the whole year. Although the rhythm of M3 growth slowed somewhat during the last months of the year, it still remains far above its reference value. Indeed, the three-month average of the annual growth rate of M3 was 6.9% from October to December 2002. This strong growth has been favoured by the preference for liquidity in an environment of financial, economic and geopolitical uncertainty, as well as by low interest rates.

GRAPH 1 EURO AREA M3 GROWTH (IN %)



Source : ECB

Turning to the analysis under the second pillar, data indicate that economic activity remained sluggish and expectations for economic growth in the euro area have been revised downwards. The outlook is particularly uncertain due to developments in financial markets, geopolitical tensions and oil price developments.

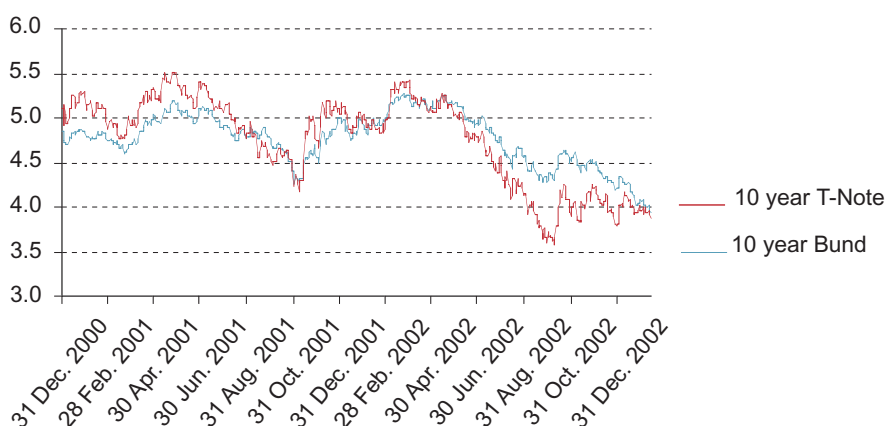
Concerning price developments, annual HICP inflation remained above 2% during most of the year. The main factors behind this were base effects related to food and to oil prices.

### 1.1.2 Long-term interest rates

Long-term interest rates, as measured by the 10-year T-Note and the 10-year Bund, remained broadly unchanged during the first months of 2002. In March, rates rose on more optimistic sentiment regarding the future economic outlook. New tensions, however, emerged as a result of uncertainties regarding accounting standards and the reliability of US company results.

Long-term interest rates have declined continuously since spring as investors revised downwards their expectations regarding general economic activity. Pessimism regarding economic growth increased at the end of the year with the intensification of the geopolitical tensions in the Middle East.

GRAPH 2 LONG-TERM GOVERNMENT BOND YIELDS



Source : Bloomberg

### 1.1.3 Stock markets

European and American stock markets declined for the third year in a row: -23% in 2002 for the S&P500 (after declining by 13% in 2001 and by 8% in 2000) and -35% for the European markets according to the Dow Jones Eurostoxx Broad Index (after a decline of 21% in 2001 and 6% in 2000).

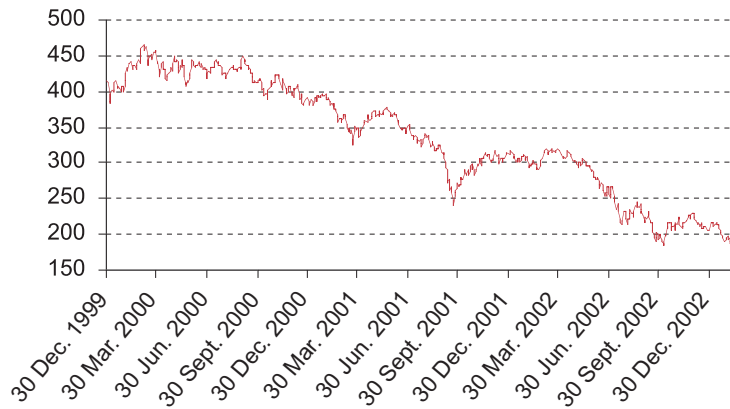
Stock prices declined continuously since the second quarter of 2002. This general pessimism reflected uncertainties concerning accounting standards and the reliability of company results, the publication of micro and macroeconomic data below expectations, geopolitical tensions in the Middle East and uncertainties regarding oil prices.

GRAPH 3 S&P500



Source : Bloomberg

GRAPH 4 EUROSTOXX BROAD



Source : Bloomberg

#### 1.1.4 Exchange rates

The year 2002 was the first year the euro appreciated against the dollar. The euro rose by 16 cents i.e. 18% between the end of 2001 and the end of 2002.

During the first months of 2002, the euro fluctuated in a narrow band below 90 cents. Subsequently, the dollar weakened in a context of uncertainties regarding the results of US companies, a high US commercial deficit and doubts regarding perspectives for potential economic growth. The pressure on the dollar intensified with the continuous decline in stock markets. The dollar weakened further in autumn, with the decline in consumer confidence and the rise in geopolitical tensions.

During the first months of 2003, the weakening of the dollar was driven by the looming conflict in the Middle East.

GRAPH 5 USD/EUR



Source : Bloomberg

## 1.1.5 Price and cost evolution

### 1.1.5.1 Consumer prices

On average, the Harmonised Index of Consumer Prices (HICP) of the euro area increased by 2.2% in 2002, 0.2% less than in 2001. This decline reflected a more favourable outcome for the more volatile components of the HICP, which are unprocessed food and energy. In contrast, the average growth rate of the HICP excluding unprocessed food and energy increased from 2% in 2001 to 2.5% in 2002, suggesting an increase in internal inflationary pressures.

TABLE 2 DEVELOPMENTS IN THE HICP AND ITS COMPONENTS IN THE EURO AREA

(annual percentage changes, unless otherwise indicated)

	1999	2000	2001	2002	2001	2001	2001	2002	2002	2002	2002	2002	2002	2002	2002	2002	2002	2002	2002	2003
					Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.
<b>Overall HICP</b>	<b>1.1</b>	<b>2.1</b>	<b>2.4</b>	<b>2.2</b>	<b>2.4</b>	<b>2.2</b>	<b>2.0</b>	<b>2.6</b>	<b>2.5</b>	<b>2.5</b>	<b>2.3</b>	<b>2.0</b>	<b>1.8</b>	<b>2.0</b>	<b>2.1</b>	<b>2.1</b>	<b>2.2</b>	<b>2.3</b>	<b>2.3</b>	<b>2.2</b>
of which																				
<b>Goods</b>	<b>0.9</b>	<b>2.7</b>	<b>2.5</b>	<b>1.7</b>	<b>2.0</b>	<b>1.5</b>	<b>1.6</b>	<b>2.4</b>	<b>2.1</b>	<b>2.0</b>	<b>1.9</b>	<b>1.2</b>	<b>1.0</b>	<b>1.1</b>	<b>1.3</b>	<b>1.4</b>	<b>1.7</b>	<b>1.8</b>	<b>1.9</b>	<b>1.6</b>
Food	0.6	1.4	4.5	3.1	5.0	4.5	4.5	5.6	4.8	4.2	3.6	2.7	2.3	2.2	2.4	2.4	2.3	2.4	2.2	1.4
- Unprocessed food	0.0	1.8	7.0	3.1	7.5	6.2	6.2	8.3	7.1	5.5	4.2	2.0	1.2	0.9	1.4	1.8	1.6	1.9	1.4	-0.6
- Processed food	0.9	1.2	2.8	3.1	3.4	3.4	3.4	3.8	3.4	3.4	3.3	3.2	3.1	3.0	3.0	2.9	2.7	2.6	2.7	2.8
Industrial goods	1.0	3.1	1.2	0.9	0.4	0.0	0.1	0.8	0.7	0.9	1.1	0.5	0.3	0.6	0.8	0.9	1.5	1.5	1.7	1.8
- Non-energy industrial goods	0.7	0.5	0.9	1.4	1.4	1.5	1.5	1.6	1.8	1.6	1.6	1.5	1.5	1.3	1.2	1.3	1.2	1.2	1.2	0.6
- Energy	2.4	13.1	2.5	-0.6	-2.9	-5.2	-4.8	-1.9	-2.9	-1.6	-0.6	-2.8	-3.6	-1.6	-0.4	-0.2	2.5	2.3	3.8	6.0
<b>Services</b>	<b>1.5</b>	<b>1.5</b>	<b>2.7</b>	<b>3.1</b>	<b>3.1</b>	<b>3.2</b>	<b>2.8</b>	<b>3.0</b>	<b>3.1</b>	<b>3.2</b>	<b>2.9</b>	<b>3.2</b>	<b>3.2</b>	<b>3.2</b>	<b>3.3</b>	<b>3.2</b>	<b>3.2</b>	<b>3.1</b>	<b>3.0</b>	<b>2.8</b>
HICP excluding unprocessed food and energy	1.1	1.1	2.0	2.5	2.5	2.6	2.4	2.6	2.6	2.6	2.5	2.6	2.5	2.5	2.5	2.4	2.4	2.3	2.2	2.0

Source : EUROSTAT

Developments in the overall index were erratic, reflecting the short-term movements of the more volatile items. Indeed, global consumer price inflation decreased until June, reaching 1.8%, when it changed to an upward trend, climbing to 2.3% in December. Unprocessed food prices were the main contributors to the decline of the overall inflation in the first half of 2002 as the effects of unfavourable weather conditions dissipated, as did the upward pressures on meat prices stemming from various animal diseases. Energy prices also contributed somewhat to the decline in the consumer price inflation in the first half of 2003. However, the downward impact of the energy prices was reversed in the second half of the year, reflecting both unfavourable base effects and upward pressures on oil prices.

## 1.1.6 Output, demand and labour market developments

### Economic growth

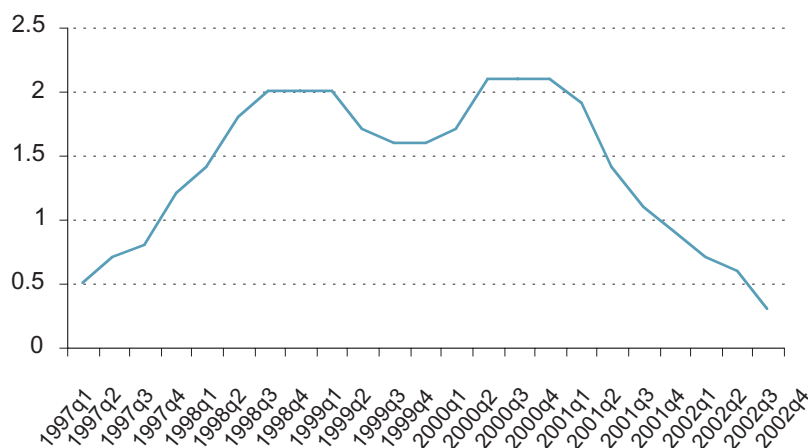
Available information indicates that economic activity remained sluggish during the first three quarters of 2002. Real GDP is estimated to have increased by 0.3% quarter-on-quarter in the third quarter of 2002, following growth of 0.4% in each of the two first quarters. This corresponds to an annual growth of only 0.9% compared with 1.3% in 2001. The lower GDP growth in the third quarter of 2002 mainly reflected a smaller contribution of net exports, as the strong increase in imports neutralised export growth. Consumption growth remained relatively robust, while investment remained weak.

### Labour market

Employment growth was affected by sluggish economic activity, decelerating during the first three quarters (respectively from 0.7% and 0.5% to 0.3% according to available information). This evolution partly reflected the usual lags in cyclical developments in employment compared with economic growth. The unemployment rate increased gradually in 2002 to eventually reach 8.3% on average (8.0% in 2001).

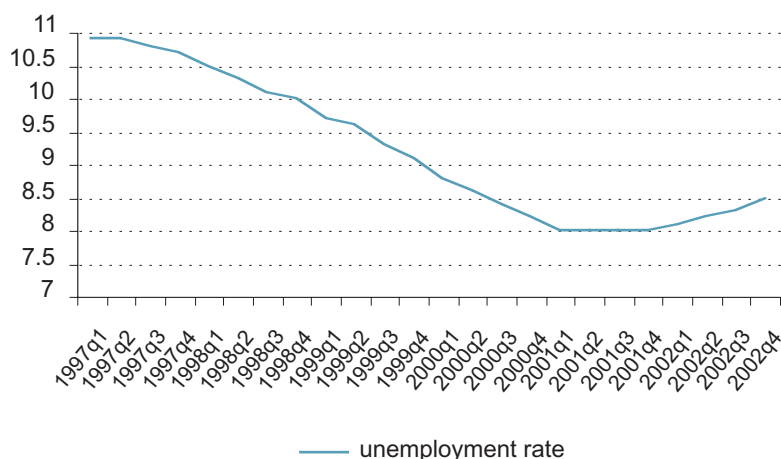


GRAPH 6 EMPLOYMENT (QUARTERLY GROWTH RATES)



Source : Eurostat

GRAPH 7 UNEMPLOYMENT RATE (ANNUAL AVERAGE; AS PERCENTAGE OF THE LABOUR FORCE)



Source : Eurostat

### 1.1.7 External trade

The external trade surplus reached 95.2 billion euros in the first eleven months of 2002 compared with a surplus of 40.7 billion euros in the same period of 2001. This improvement resulted from a 5% decline of imports and a small increase of exports. Main developments were a rise in trade in chemical products and a decrease in trade in machines and transport vehicles. Net external trade improved with all partners except Switzerland and Latin America.

### 1.1.8 Balance of payments

#### 1.1.8.1 Current account

In the first eleven months of 2002, the current account reported a surplus of 53.8 billion euros, while the deficit was 16 billion euros in the same period of 2001. This progress mainly results from an improvement of the surplus in goods and net services. This reflected the appreciation of the euro and the weakness of internal demand.

#### 1.1.8.2 Financial account

Net direct investment outflows reached 30.7 billion euros in the first eleven months of 2002, compared

with net outflows of 102.3 billion euros in the same period of the previous year. This development is the result of a decrease of direct investments in equity capital abroad and in the euro area, combined with a substantial decline of net outflows in inter-company loans abroad and a small increase of net inflows in inter-company loans in the euro area.

Net portfolio investment inflows reached 64.4 billion euros in the first eleven months of 2002 compared with 54 billion euros for the same period of 2001. There was, however, a shift in the composition of euro area portfolio investment. Investors preferred investing in debt instruments, which are less risky than equities, because of economic and geopolitical uncertainties.

## 1.2 Economic situation in Luxembourg

### 1.2.1 Prices and costs

#### 1.2.1.1 Consumer prices

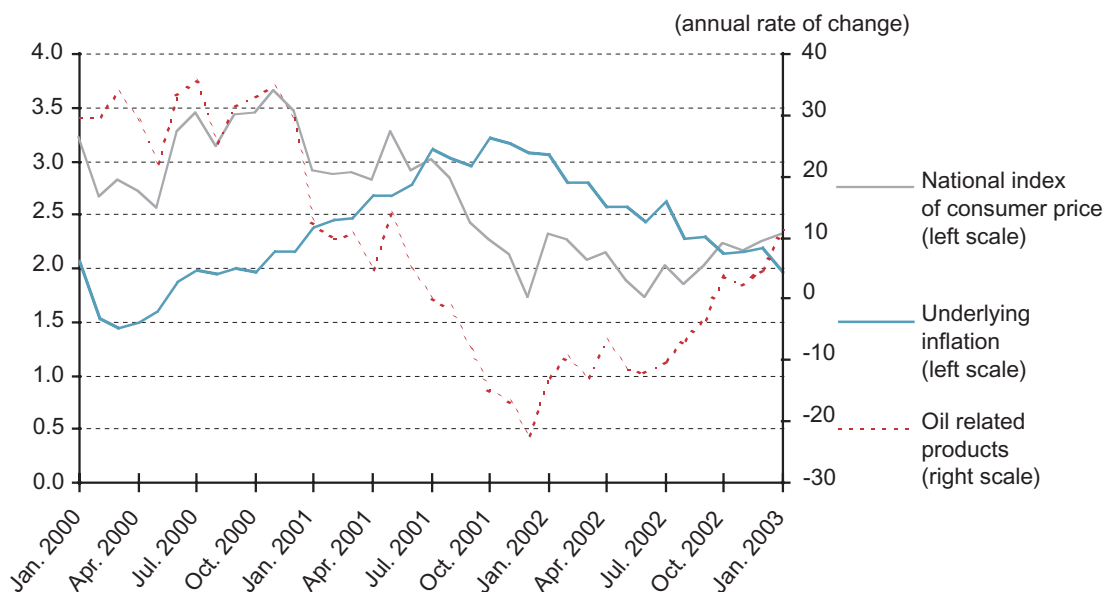
Luxembourg's National Index of Consumer Prices (NICP) increased on average by 2.1% in 2002, after 2.7% in 2001. The annual NICP growth rate decreased over the first half of the year to reach 1.7% in June. The NICP trend then reversed in the course of the second semester to reach a 2.2% yearly growth rate in December.

The decline in global inflation in the course of the first half of 2002 is mainly explained by a negative contribution from oil products. This sub-index, however, increased in the second half of 2002.

Underlying inflation, which tracks economic processes more closely by excluding goods, which have more volatile prices, decreased throughout 2002. On this measure, the annual percentage change in prices declined from 3.1% in January to 2.2% in December. The relative stickiness of this sub-index, which does not reflect the subdued economic conditions, is explained by the developments in the prices of services. Indeed, the limited decline in the year-on-year rate of change of services prices is partly due to the wage indexation of June 2002 and the impact of the introduction of euro coins and banknotes in the beginning of the year. Furthermore, increases in certain food products, like tobacco and several other unprocessed foods, have prevented a faster decline of underlying inflation.

Turning to consumer price developments in the beginning of 2003, it should be noted that the NICP year-on-year growth rate increased by 0.1% in January, from 2.2% in December. The monthly rate was -0.75% in January due to seasonal sales, which had a slightly larger impact than in 2002. Oil prices increased by 5% with respect to the previous month, with an important impact on inflation. January is also traditionally marked by increases in the prices of public utilities including retirement home services, sewage disposal and public transport.

GRAPH 8 INFLATION AND OIL RELATED PRODUCTS (ANNUAL RATE OF CHANGE)



Source : STATEC

## I

## Inflation projections

Since oil prices increased with respect to the previous exercise, and since the HICP excluding energy inflation is decelerating more slowly than previously expected, the outlook for headline inflation has deteriorated recently. Due to the geopolitical tensions in the Middle East, it goes without saying that the uncertainty surrounding the central scenario is currently particularly high.

## Assumptions

The underlying assumptions for the HICP energy projection follow the traditional scheme, i.e. a euro/dollar exchange rate kept constant over the forecast horizon and a pattern of oil prices as observed on the futures markets. In mid-February, the quote for one euro against the dollar stood at 1.08, which corresponds to an appreciation with respect to both 2002 and the previous exercise. The price of oil fluctuated around the 30\$/bl level and the markets were anticipating a gradual fall to a level close to 25\$/bl in December 2003, overall an upward revision linked to fears of a possible war against Iraq. All in all, the euro's appreciation could not totally compensate for the increase in oil prices, implying a worsening of the outlook for the HICP energy component. Detailed assumptions are given in the following table.

TABLE 3 ASSUMPTIONS UNDERLYING THE INFLATION PROJECTIONS

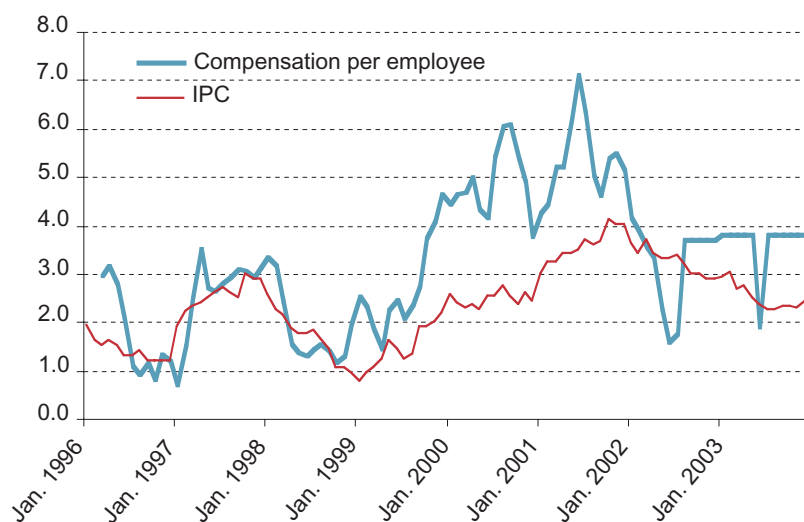
	2001	2002	2003	02-Q4	03-Q1	03-Q2	03-Q3	03-Q4
Price of oil in \$/bl	24.4	24.9	28.0	26.5	30.2	29.1	27.1	25.7
Exchange rate \$/€	0.90	0.94	1.08	1.00	1.07	1.08	1.08	1.08
Price of oil in euros (in annual percentage changes)	-11.5	-3.5	-1.0	22.5	16.6	-1.0	-8.1	-9.8

Source : BCL

HICP excluding energy is usually driven by imported inflation and wage developments. On top of that, specific measures such as indirect tax adjustments, public tariffs and administered prices may also influence inflation developments.

The increase in tobacco prices by the end of 2002 should have a non-negligible impact on consumer prices. A change in excise duties as announced in the 2002 central government budget may further enhance this upward effect. Imported inflation, however, should remain muted as a consequence of the weak economic activity in the neighbouring countries. In addition, the euro's recent appreciation against the dollar should also have a downward impact in the long run. Nevertheless, domestic inflation may decelerate only very slowly. The increase in administered prices and public tariffs at the beginning of the year should affect inflation throughout 2003 through the persistence of price changes. The size of this impact is partially reflected in the relatively high monthly change in the prices of services in January 2003. Furthermore, wage developments may not allow for a more rapid easing of inflationary pressures. The increase in the statutory minimum wage at the start of the year is likely to maintain pressure on prices. According to the projections, the timing of the next automatic wage indexation has also been advanced by a couple of months.

GRAPH 9 COMPENSATION PER EMPLOYEE AND SERVICES INFLATION (IN ANNUAL PERCENTAGE CHANGES)



Source : STATEC, BCL



## Results

Inflation should slow in 2003 after a brief flare up in the first quarter of the year due to an increasing in oil prices in euros and an unfavourable base effect. NICP inflation is expected to fall below the 2% mark by mid-2003 and should remain at this level until the end of the year. Favourable developments in the second half of the year are conditional on a negative contribution from energy prices while the NICP excluding energy would only decelerate relatively slowly. This might be surprising in the context of the weak economic situation, but it actually reflects expected developments in labour costs. The automatic wage indexation would be triggered by mid-2003, somewhat earlier than previously projected, reflecting the deteriorating outlook for inflation with respect to the previous exercise.

TABLE 4 INFLATION PROJECTIONS (IN ANNUAL PERCENTAGE CHANGES)

	2001	2002	2003	2 <sup>nd</sup> half 2002	1 <sup>st</sup> half 2003	2 <sup>nd</sup> half 2003
NICP	2.7	2.1	1.9	2.1	2.3	1.5
HICP	2.4	2.1	2.1	2.4	2.7	1.6
HICP energy	-2.6	-3.7	0.8	0.3	4.2	-2.4
HICP ex energy	3.1	2.9	2.3	2.7	2.5	2.0

Source : BCL

The major risk factor for the inflation projections is of course the oil price itself, which is linked to developments in the Middle East. A peaceful outcome will probably imply a significant decrease in the price of Brent, whereas war could entail an even more unfavourable scenario.

Recently the euro appreciated against the dollar and this favourable development, if sustained, would imply decelerating inflation.

### 1.2.1.2 Producer prices in industry

The cyclical downturn of industrial producer prices that started in the second quarter of 2001 ended in early 2002. Prices increased again in the second and third quarters of 2002 by respectively 0.3% and 1.3%. Average prices, however, were still lower in 2002 than in 2001. The annual fall of 1.4% remains moderate when with 1996 or 1999, when prices fell by more than 4%.

TABLE 5 INDUSTRIAL PRODUCER PRICES (CHANGES WITH RESPECT TO THE PREVIOUS PERIOD)

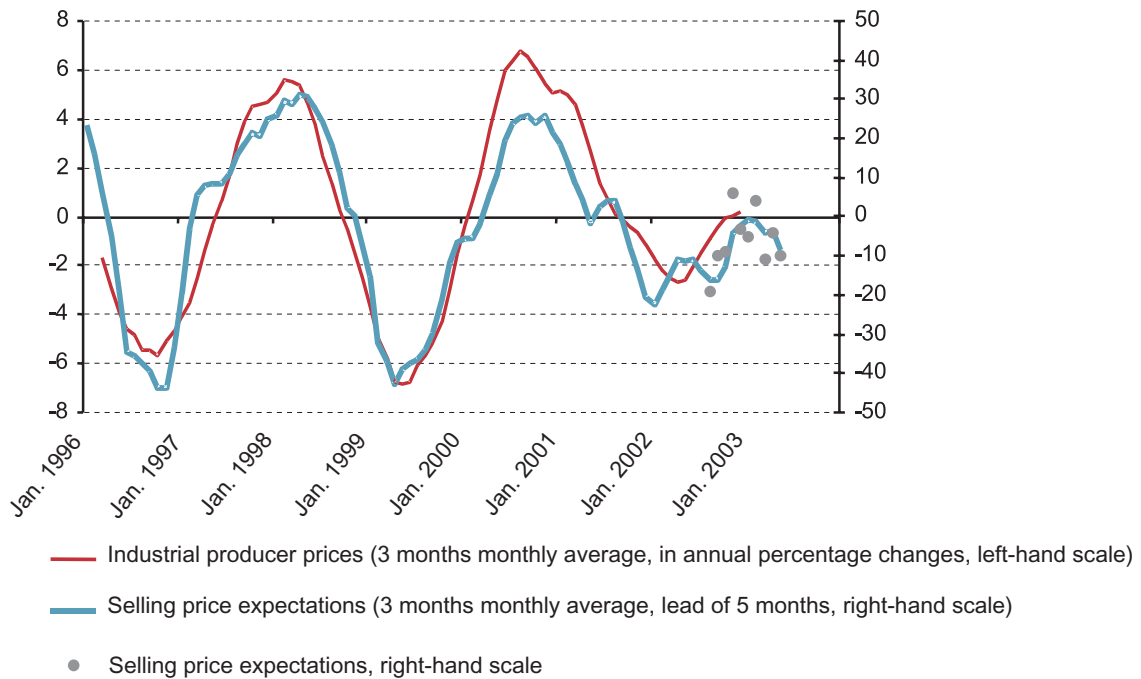
	2000	2001	2002	2001-Q4	2002-Q1	2002-Q2	2002-Q3
Total	4.8	1.1	-1.4	-0.8	-1.1	0.3	1.3
Intermediate goods	5.5	0.4	-2.4	-1.2	-1.7	0.3	1.5
Capital goods	3.3	1.8	1.2	0.3	-0.1	0.3	0.5
Consumer goods	3.2	3.6	1.3	-0.1	0.3	0.5	0.9

Source : STATEC, BCL

Industrial producer prices are usually pro-cyclical and accordingly the major reason for the decrease in 2002 was the unfavourable economic developments at both the international and the national levels. Weak demand often entails simultaneous drops in prices and production. Furthermore, the price decreases were largely concentrated in the intermediate goods industry, which is more exposed to cyclical changes than the consumer or capital goods industries.

The outlook for industrial producer prices hardly remains favourable at the beginning of 2003. Unless demand accelerates, prices are likely to stabilise, or even fall further (in annual percentage changes) according to the results of the harmonised business surveys (see graph).

GRAPH 10 INDUSTRIAL PRODUCER PRICES, PAST AND EXPECTED DEVELOPMENTS

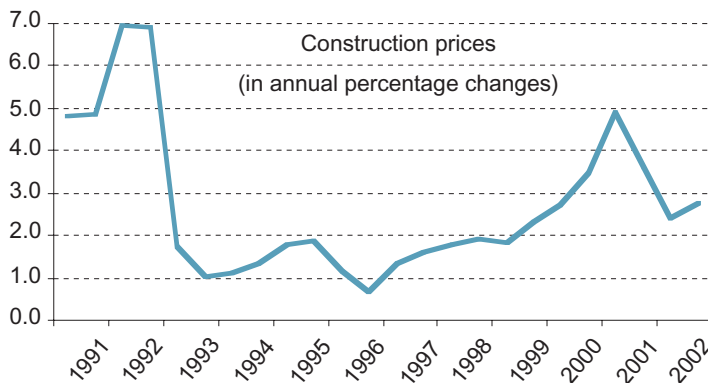


Source : EUROSTAT, BCL

### 1.2.1.3 Construction prices

Prices of construction services increased by 2.6% in 2002, a significant deceleration compared with the rise of 4.2% in 2001. On the one hand, in light of the high labour content of several construction services, the moderate developments are probably due to a lower impact on labour costs of the automatic wage indexation mechanism. Weak economic activity probably also entailed more moderate price increases.

GRAPH 11 CONSTRUCTION PRICES (IN ANNUAL PERCENTAGE CHANGES)



Source : STATEC, BCL

## 1.2.2 Sector-based activity

### Industry

Industrial production in Luxembourg fell by a seasonally adjusted 1.7% in the first quarter, only to rebound by 5.2% in the second quarter and to relapse by 2.6% in the third quarter. This erratic quarterly profile resulted in unchanged production on average in 2002 when compared with 2001. All in all, Luxembourg's industry outpaced its counterparts in the euro area and, taking into account the geopolitical situation and oil price developments, the outcome was probably above expectations. Indeed, the deceleration remains largely concentrated in the steel industry, a sector much more exposed to cyclical changes, whereas the remainder of the industry increased its production on average by 1%.

TABLE 6 ECONOMIC INDICATORS FOR THE INDUSTRIAL SECTOR (IN ANNUAL PERCENTAGE CHANGES)

	2000	2001	11m-2002	Q1-02	Q2-02	Q3-02
Number of employees	1.4	0.6	-1.6	-0.9	-1.9	-1.8
Wage cost	5.4	4.5	0.5	1.3	-0.2	-0.6
Hours worked	-0.6	-1.0	-3.3	-4.8	-2.8	-3.4
Turnover	10.5	3.4	-1.3	-7.2	-0.9	2.4
New orders	9.2	-2.2	-3.0	-11.5	-1.5	3.5
Production per working day (total industry)	5.1	3.1	0.0	-3.8	4.3	-1.0
Production per working day (total industry excluding steel industry)	5.2	3.6	1.0	-2.4	5.6	-0.7

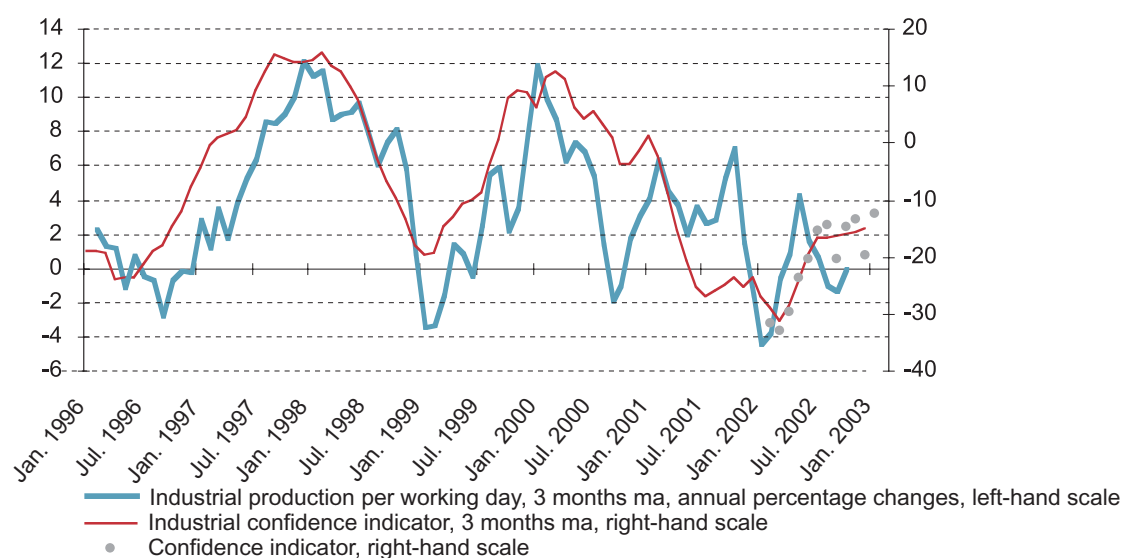
Source : STATEC

An unchanged overall level of production, combined with a fall in prices implied a decrease in turnover in 2002 with respect to 2001. Facing weak demand, companies turned to lay-offs and reductions in hours worked to contain the increase in costs.

The outlook for 2003 remains bleak. A sustained cyclical upturn, both in the US and the euro area, remains uncertain. In addition, the risk of a possible war against Iraq has been weighing on the international environment since August 2002 and has been accompanied by a sharp rise in the oil price. This period of uncertainty has stretched into 2003 without an unfolding of the events in sight.

Uncertainty has affected the results of business surveys, with a horizontal movement of the industrial confidence indicator since July 2002. Although the indicator has improved recently, a significant upturn cannot be detected. The capacity utilisation rate has declined again, as has the number of months of assured production. Insufficient demand remains the major impediment to production.

GRAPH 12 CONFIDENCE INDICATORS AND INDUSTRIAL PRODUCTION



Source: BCL calculations



## Construction

The construction sector, somewhat shielded from the international business cycle, saw an acceleration of its economic activity in 2002. Production per working day increased by an annual 6.1% over the period January to November compared with an annual average change of 4.4% in 2001. The acceleration of activity was, however, largely due to the good performance of the civil engineering branch whereas activity was less buoyant in the building branch.

**TABLE 7** ECONOMIC INDICATORS FOR THE CONSTRUCTION SECTOR (IN ANNUAL PERCENTAGE CHANGES)

	2000	2001	11m-2002	Q1-02	Q2-02	Q3-02
Number of employees	1.5	3.2	2.6	3.8	2.6	2.0
Wages and salaries	3.7	8.5	6.3	5.1	7.8	4.2
Hours worked	3.6	4.8	5.0	6.0	10.6	-1.3
Production per working day -Total	4.4	4.4	6.1	9.6	10.7	-3.7
Production per working day - Building	5.6	13.0	5.7	6.7	11.0	-1.5
Production per working day - Civil engineering	3.2	-4.0	6.4	13.3	10.4	-6.1

Source: STATEC

It is likely that the overall economic slowdown will also affect the construction sector in 2003. Although statistics do not yet suggest a slowdown, business surveys seem to confirm a deterioration of activity by the end of 2002. The share of companies citing a lack of demand has indeed gradually increased since October 2002 and the number of months of assured production has continuously fallen since mid-2002. Weaker employment growth may dampen demand for the sector and the number of new building permits has been falling for the first three quarters of 2002. Only loans to households for house purchases, which have risen on average by 21% in 2002, seem to offer some support for activity in the short term.

## Trade and other sectors

Statistics on the turnover in the retail and wholesale trade branches have been revised downwards, painting a less favourable picture of the past. Both branches also experienced a deceleration in 2002 when compared with 2001. New car registrations posted an increase of 1.2%, the seventh consecutive annual rise.

**TABLE 8** TURNOVER AND NEW CAR REGISTRATIONS (IN ANNUAL PERCENTAGE CHANGES)

	2000	2001	2002 <sup>1</sup>	Q4-01	Q1-02	Q2-02	Q3-02
Total trade	8.3	0.1	-1.1	-3.7	-0.9	-0.8	-1.5
Retail trade	1.2	2.9	2.4	5.1	3.8	3.7	-0.3
Trade and repair of motor vehicles	6.3	2.8	3.7	0.8	2.4	4.7	4.1
Wholesale trade	11.6	-1.6	-3.9	-8.2	-3.7	-4.3	-3.6
Hotels and restaurants	1.9	0.9	8.3	2.0	6.4	7.3	10.9
New car registrations	3.2	2.0	1.2	8.3	1.8	12.8	-3.1

Source: STATEC

Overall, future developments in the trade sector will depend, on the one hand, on the international demand for wholesale trade and on the other hand, on consumer spending, for the retail trade. The latter might be adversely affected by more restrained household spending on durable consumer goods. Indeed, the current cyclical downturn combined with the slowdown in employment growth and the general increase in uncertainty is likely to outweigh the positive impulses on private consumption stemming from the personal income tax reform and wage developments.

The statistical coverage of the other sectors of the Luxembourg economy is scarce and consequently it

<sup>1</sup> The data refer to the first nine months of the year, except data for new car registrations which refer to the whole year.

is more difficult to ascertain the pace of economic activity. Since both the industrial and the banking sectors are experiencing cyclical downturns, however, second-round effects on the dependent sectors are highly likely. According to official VAT statistics, turnover decreased in the first nine months of 2002 in all the other private sectors except transport services. The bleak conditions are confirmed by the chamber of commerce business survey which indicates that business conditions in 2002 were worse than in 2001. Furthermore, they confirm that the downturn was relatively more important in the services industry than in the manufacturing sector.

### 1.2.3 Economic activity

According to current estimates, real GDP growth in Luxembourg slowed in 2001 to 1.0% from 8.9% the year before. Preliminary forecasted figures released by STATEC indicate that real GDP growth is expected to have decelerated further in 2002 to around 0.5% (between 0.5% and 2.0%) on the back of weak international demand and of a protracted fall in stock markets.

Private consumption expenditure, the most important component of GDP, is forecasted to have decelerated from 3.6% growth in 2001 to 2.0% in 2002. Despite the reduced tax burden following the fiscal reform package, households are expected to reduce the share of income consumed in order to increase their savings as a precautionary measure.

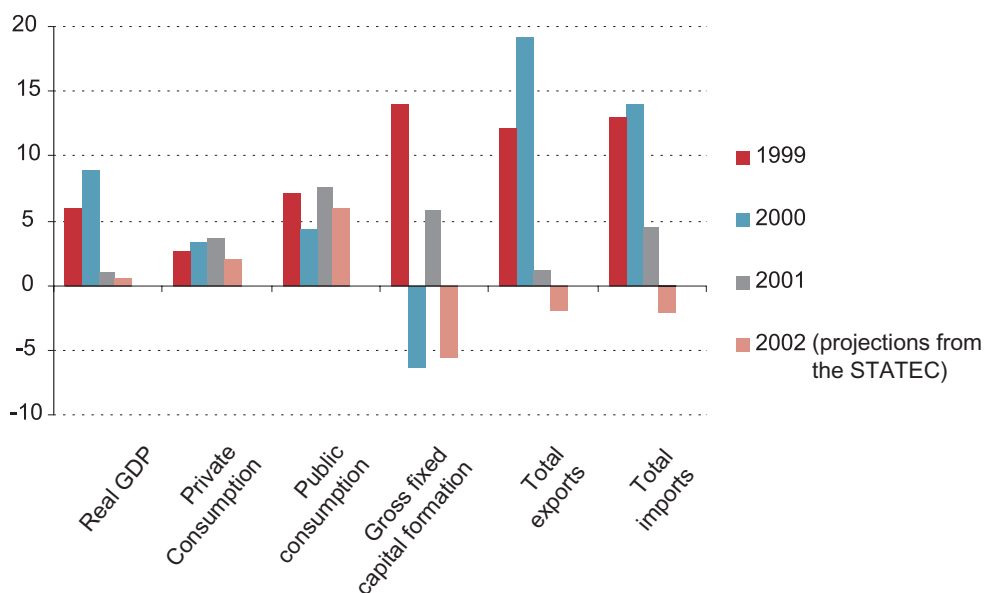
The growth of public consumption expenditure is expected to have slightly decelerated from 7.5% in 2001 to 6.0% in 2002.

The preliminary forecast concerning the gross fixed capital formation expects a strong drop in its average growth in 2002 (-5.6% in 2002 after 5.9% in 2001). This development might be attributed to the slowdown in domestic and international demand, which negatively affected investments.

As sluggishness is expected to have prevailed throughout 2002, the preliminary outlook concerning foreign trade is grim. Both real export and import growth are expected to have fallen respectively by 2.0% and 2.1% in 2002. More precisely, the preliminary forecasts released by the STATEC stress that export growth in financial services is expected to have been sharply affected by the protracted fall in stock markets.

It should be noted that STATEC might release official National Accounts figures for 2002 at the end of April 2003.

GRAPH 13 REAL GDP GROWTH AND ITS COMPONENTS (ANNUAL PERCENTAGE CHANGE)



Source: STATEC

## Outlook for the Luxembourg economy

In the beginning of 2003, the macro-economic outlook for Luxembourg has not changed much compared with the end of 2002. It remains affected by the climate of uncertainty that prevailed since mid-2002. Geopolitical tensions associated with the risk of a war against Iraq have entailed an increase in the oil price, which is likely to weigh on economic activity. Although one might assume or hope for this period of uncertainty to end, a bet on a quick cyclical rebound, either in Luxembourg or in the major economic regions, might be erroneous.

In the euro area, the absence of major macro-economic disequilibria and the recent easing of monetary policy should pave the way for the revival of economic activity. The rebound, however, also depends to a large extent on the US economy which is still suffering from the consequences of the stock market bubble as well as over-investment in some sectors.

A more significant depreciation of the US dollar against the euro is often cited as a possible scenario as it might help to correct the US current account deficit which has persisted for several years. This scenario, however, would likely result in weaker foreign demand for the euro area, whose economic growth would then be more dependent on domestic demand.

In the wake of lower euro area growth, Luxembourg would also become accustomed to more "normal" GDP growth rates. Weak US and euro area growth would weigh on Luxembourg exports, the main driving force of the economy. Although public consumption is unlikely to falter in a low growth environment, it will not be sufficient to boost growth either. In a small open economy like Luxembourg, largely dependent on developments in neighbouring countries, it is important to avoid the emergence of domestic disequilibria which would reinforce the weak international environment. Since corporate profitability has probably deteriorated for the second consecutive year in 2002, one key issue is wage developments. A certain degree of wage moderation might indeed both help companies to remain competitive in a weak international environment and contain domestic inflationary pressures which have contributed to the unfavourable inflation gap with the neighbouring countries.

### 1.2.4 The financial sector

#### 1.2.4.1 Monetary financial institutions

On 31 December 2002, the Luxembourg financial centre included 554 monetary financial institutions (MFIs), 64 less than a year earlier. The number of credit institutions decreased by 12 units and the number of money market funds by 52 units.

The aggregate balance sheet of Luxembourg's MFIs decreased by 4.3% during the year under review to reach a total of 781 344 million euros as of 31 December 2002.

#### 1.2.4.2 Credit institutions

The concentration process continued throughout 2002, with several mergers among Luxembourg branches and subsidiaries of foreign banks. In comparison with the end of 2001, the number of banks officially registered in Luxembourg went down from 189 to 177.

#### 1.2.4.3 Mergers and Acquisitions

The year 2002 was marked by three liquidations, the creation of 2 new credit institutions, the transformation of 2 credit institutions into other financial intermediaries (OFI) and 9 mergers or acquisitions.

Nevertheless, increasing concentration was not the only factor responsible for the fall in the number of credit institutions. Current developments in financial markets as well as poor economic growth in most developed economies may induce further concentration in the financial sector. Indeed, many international groups have concentrated their private banking activities in Luxembourg. Their Luxembourg branches and subsidiaries therefore suffer from customers' lower interest in trading and may be subject to additional restructuring efforts should the economic slowdown persist in the coming months.

#### 1.2.4.4 Number of institutions

On 31 December 2002 Luxembourg's financial centre counted 177 credit institutions. Among these institutions, 122 were subject to Luxembourg law and the remaining 55 were institutions subject to foreign law.

The degree of internationalisation remained stable during 2002. Luxembourg's credit institutions established 22 branches in foreign countries; 14 branches are established in another EU Member State and 8 branches are established outside the EU.

#### 1.2.4.5 Aggregate balance sheet

After several years of sustained growth within the Luxembourg banking sector, the volume of activities declined during the year 2002.

As at 31 December 2002, the aggregate balance sheet total of credit institutions reached 662 618 million euros, which represents a decrease of 8.1% compared with 31 December 2001. The decrease of the aggregate balance sheet may be explained by unfavourable economic developments in Europe and world-wide, but must also be seen in the light of the reduction of the number of the credit institutions in Luxembourg: 177 at the end of the year 2002 against 189 on 31 December, 2001.

#### 1.2.4.6 Aggregate balance sheet structure

The structure of the aggregate balance sheet emphasises the increasing importance of interbank operations for Luxembourg banks. In this perspective, one should note that the economic slowdown in the euro area is a serious barrier to the development of Luxembourg's banking activities. In addition, the reduction of the number of credit institutions also influences the decrease of the aggregate balance sheet. Furthermore, nine mergers implied the elimination of overlapping activities. Considering that the Luxembourg financial market is characterised by strong volumes of interbank activities, any merger between two banks necessarily generates a certain reduction in activity.

Although interbank credits have decreased moderately by 20 271 million euros (-5.5%) to reach 52.2% of the aggregate balance sheet, they account for 34.7% of the aggregate balance sheet decrease. Credits granted to the non-banking private sector also decreased significantly by 11.9%. The share portfolio was reduced by 4.6% to 168 605 million at 31 December 2002. Their fraction of total assets decreased only marginally from the year-end 2001 by one tenth of a percent towards 25.4% at the end of 2002. Considering the unfavourable economic outlook, one could expect a drop of applications for credits on behalf of non-financial companies as well as Luxembourg households. In fact, Luxembourg non-financial companies' demand for credits slowed during the last quarter of 2002. The average growth rate reached almost 15% at the beginning of 2002 and in March 2002 it was only 9.5%. After a short peak in June 2002 annual growth rates went down to a level of 2.1% in September 2002 and even decelerated to 0.1% at the end of December 2002 to amount to 6 879 million euros.

New mortgage contracts for buildings in Luxembourg continued growing strongly (+14.5%) throughout the year 2002 to reach 3 131 million euros. Almost all new contracts were granted to residents (3 025 million out of 3 131 million). The demand for mortgages has accelerated significantly towards the end of 2002 to reach 893 million in the last quarter. This rise can be explained by the announcement by Luxembourg banks that as from January 2003 they will pass on to their customers a reduction in the ECB's main refinancing interest rate (0.5%) in early December 2002. Moreover, the last quarter of the year is traditionally characterised by a high level of requests for mortgage loans. Customers submit their applications for credits at this time with the aim of starting their construction project in spring. The total volume of mortgage lending for Luxembourg households has risen by 4.3% during 2002 and amounts to 6 594 million euros at 31 December 2002.

Consumer credits granted to Luxembourg households also continued to rise with an annual growth rate of 6% to reach a level of 705 million euros. These consumer credits are primarily intended to finance consumer expenditure in the short and medium term. It seems that Luxembourg households do not feel overly affected by the business slowdown at present.

On the liability side, interbank deposits still played the most important role accounting for 47.4% of the aggregate balance sheet on 31 December 2002. They diminished by 9.3% whereas debts towards



customers dropped by 7.4 %. Luxembourg banks preferred to raise finance by issuing debt securities rather than by money market instruments. Debt securities (+5.0%) reached a total of 54 900 million euros (8.3% of the aggregate balance sheet). Money market instruments were less favoured and diminished by 10.7% to reach a level of 24 631 million euros. Both instruments weakened by 0.6% which added to a total of 79 531 million euros or 12.0% of the aggregate balance sheet. The analysis of these data shows quite clearly that Luxembourg households are returning to traditional, less risky savings products. In fact, many small investors who had invested in shares have suffered important losses and reoriented their portfolios during the last six months when stock indices continued falling. This movement is evident in net redemption rates for Luxembourg mutual funds between June and December 2002.

#### 1.2.4.7 Financial derivatives

After a year marked by a considerable increase in the volume of derivative financial instruments held by Luxembourg banks, 2002 was characterised by a sharp decrease of -15.1% (a decrease of 112 688 million euros) to reach 633 704 million euros on 31 December 2002 (excluding branches of banks originating in other EU member states).

This amount represented 114.4% of the total balance sheet of these institutions, compared with 126.7% the previous year.

Interest rate derivatives remain the main category of instruments, with a continued predominance of interest rate swaps (574 164 million euros on 31 December 2002). The volume of options contracts showed an important decrease of 132 059 million euros (-92.5%) during the year to reach 10 708 million euros on 31 December 2002.

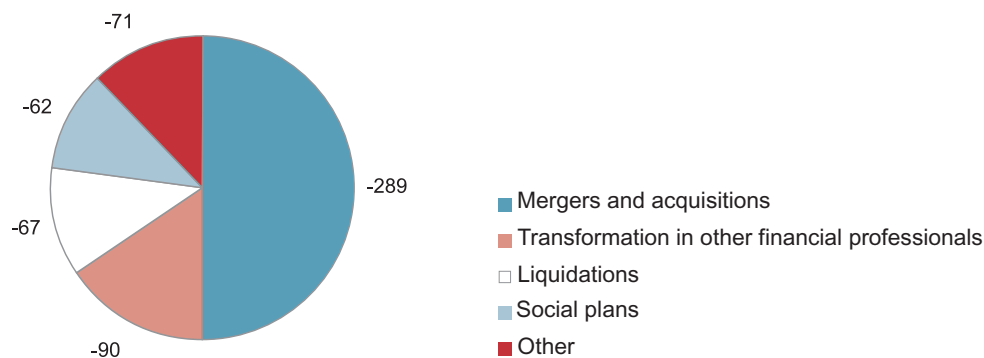
Finally, the share of contracts traded on an organised market fell to 3.3%. Thus more than 96% of transactions are in OTC contracts.

#### 1.2.4.8 Employment in the financial sector

On 31 December 2002, the financial sector (including OFIs as well as those in credit institutions) employed 27 693 individuals, a decrease of 400 (-1.4%) from the previous year-end. The number of individuals employed in banks was 23 300 on 31 December 2002, a decrease of 579 (-2.5%) compared with the previous year-end. This accentuates the slowdown in employment growth rate observed the previous year. In 2000 the increase was 10,65% and in 2001 the increase was only 5.9%. OFIs employed 4 393 individuals against 4 199 in 2001.

As mentioned in the previous paragraph, the banking sector lost 579 jobs. A rapid analysis showed that banks having merged in 2002 diminished their staff by 289 units. The remaining losses can be easily explained by restructurings, movements from the banking sector to the OFI sector and the liquidation of 3 banks. There are also other reasons such as cost reduction, which can be interpreted as a non-employment policy, pre-pension plans, unpaid leave etc.

GRAPH 14 VARIATION OF THE EMPLOYMENT GROWTH IN THE BANKING SECTOR





In the OFI sector there was a slight increase of 194 units. This increase, however, can be explained by the transformation of two credit institutions in OFIs (90 employees). There was no significant job creation during the last two quarters of 2002.

Employment in the financial sector represents 9.7% of total employment in Luxembourg. Only 29.2% of the employees in the financial sector are Luxembourg nationals against 29.8% the year before. This proportion was 34.4% end-1999.

#### 1.2.4.9 Investment funds

The investment fund industry in Luxembourg had a difficult year in 2002, as it did in most other European countries. The net asset value (NAV) of Luxembourg undertakings for collective investment (UCIs) experienced a series of rises and falls, mainly due to adverse financial market trends. Overall NAV, however, decreased during 2002 due to the problems faced in financial markets.

On 31 December 2002, the number of UCIs had increased by 33 and totalled 1 941 (1 908 a year earlier). The number of fund compartments continued to grow and reached 7 806 at the end of 2002.

The total NAV of Luxembourg UCIs was marked by financial market instability throughout 2002. It started strongly in 2002 with a net capital inflow of 20 050 million euros in January. This promising start, however, shifted to a net capital outflow in June, September and December 2002. On 31 December 2002, the total NAV of Luxembourg investment funds reached a high of 844 508 million euros against 928 447 million euros on 31 December 2001. This represents a decrease of 9% in comparison with net increases in previous years.

Net capital investment amounted to 57 314 million euros compared with 121 700 million euros in 2001 and 168 200 million euros in 2000.

Money market funds are part of the MFI sector and therefore are subject to the statistical reporting of the BCL. Their number remained relatively stable last year, reaching 377 units at the end of December 2002 against 426 units the year before (a reduction of 49 units). The NAV of money market funds experienced a sharp increase over the period under review, growing from 95 634 million euros on 31 December 2001 to 118 728 million euros on 31 December 2002, a rise of 23 094 million euros (+24.1%).

#### 1.2.4.10 Profit and losses in credit institutions

Despite the ongoing weakness of global financial markets and the world-wide economic slowdown, aggregated gross revenue before taxes and provisions for Luxembourg's credit institutions remained stable at 4 575 million euros as at 31 December 2002. This represents an increase of 5.3%, compared with the level on 31 December 2001.

This appreciation in gross revenue before taxes and provisions, however, has to be considered in the context of the acquisition by Deutsche Börse of remaining shares in Cedel International held by Luxembourg's credit institutions. This generated exceptional revenues for the shareholding institutions involved.

Gross income amounted to 8 218 million euros as at 31 December 2002, increasing by 0.8 % (67 million) since 31 December 2001. Net interest income (4 151 million euros) declined by 6.9 % compared with the level on 31 December 2001. This decrease can be explained by a lower volume of activity as well as a drop in interest rates which occurred too late to have an impact in 2002.

Global expenses (staff costs and other costs) fell by 1.0% during 2002. This is mainly due to a decrease in other costs as institutions attempted to contain costs in order to maintain net results at a high level.

Provisions, mainly set up to cover risks, have increased considerably compared with 2001 growing 82.1% to reach 1 309 million euros. As a result, the aggregate net result after provisions and taxes decreased by 6.1% to reach 2 621 million euros as at 31 December 2002.

## I

## 1.2.5 The labour market

## 1.2.5.1 Employment

Despite the lower forecasted GDP growth in 2002, total employment (employees and self-employed) grew by 3.1% in 2002. This positive growth rate could seem high compared with the GDP growth forecast, but in fact this evolution could be partly explained by the usual lags of employment relative to changes in economic activity (total employment growth fell from 4.3% at the start of the year to 2.3% by year end). The inflow of non-residents continued to account for the largest part of employment growth. Most newly created jobs were still taken up by non-residents (65%) in 2002. Average growth in cross-border employment reached 5.8% in 2002 after 11.5% in 2001. Among cross-border commuters, 53.0% come from France, 27.5% come from Belgium, and 19.5% from Germany.

Residents' participation rate continued to increase, reaching 63.0% in 2001 (after 62.7% in 2000). This rate is still below the EU15 average (64.0%), mostly because of significantly lower participation of women (50.8% in Luxembourg compared with 54.9% in the European Union).

GRAPH 15 EMPLOYMENT DEVELOPMENTS (AVERAGE OF ANNUAL GROWTH RATE)

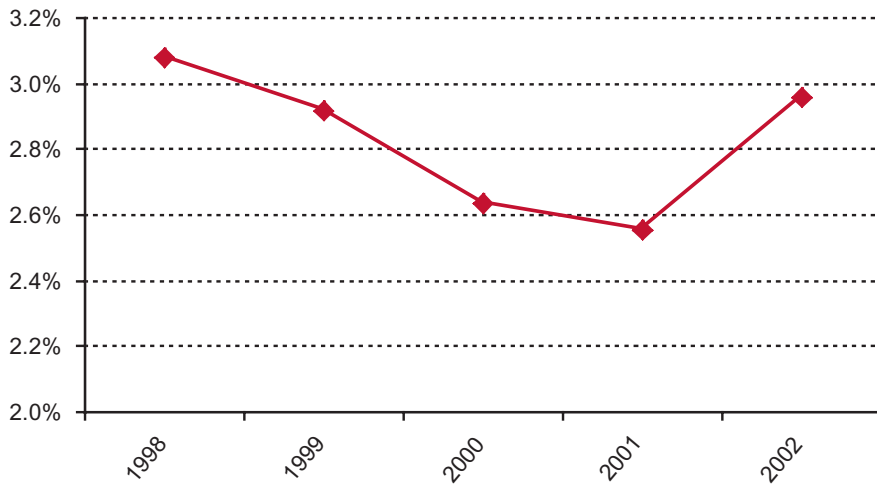


Source : IGSS, STATEC

## 1.2.5.2 Unemployment

The unemployment rate was 3.0% on average in 2002, compared with 2.6% in 2001. The number of registered unemployed increased substantially by 896 persons on average (+18.2% after -0.7% in 2001). This can be explained mostly by the cyclical downturn and is in line with the observed deceleration in employment growth.

GRAPH 16 UNEMPLOYMENT RATE (ANNUAL AVERAGE; AS PERCENTAGE OF THE LABOUR FORCE)



Source : IGSS

Preliminary figures released by STATEC suggest that average labour costs decelerated drastically during the first two quarters of 2002 and accelerated during the third quarter. This acceleration could be attributed to one major factor: nominal wages and social benefits were increased by 2.5% in June 2002 by the indexation mechanism. Nevertheless, yearly increase in average labour costs, which was high throughout 2001 (+5.5%), could have experienced a severe slowdown in 2002 because the cyclical slowdown could have had a negative impact on bonuses and constrained wage demands during the wage bargaining rounds.

#### 1.2.6 External trade

For the first eleven months of 2002, the trade deficit reduced modestly to 2 885 millions euros, reflecting a 2.9% drop in comparison with the same period of the previous year. Exports and imports of goods recorded a drop of respectively 3.1% and 3.0% in nominal terms. Both decreases were stronger in volumes (-6.7% for exports and -3.7% for imports). The drop of nominal exports was limited to 3.1% under the effect of a strong rise (+3.8%) in export prices. As import prices increased by 0.7%, the terms of trade improved by 3.1% contributing further to the reduction in the trade deficit.

#### 1.2.7 Balance of payments

For the first three quarters of 2002, the current account registered a surplus of 1 943 million euros compared with a surplus of 1 575 million euros during the same period of 2001. This improvement originated mostly from a substantial decrease in the goods deficit (by 29%), due to a drop in goods imports (-5%) combined with an increase in exports (1%). Regarding other items, the services surplus increased by 2% while the deficit of the income balance increased substantially (23%) due to the compensation of cross-border workers.

In the financial account, net outflows amounted to 2 717 million euros during the first three quarters of 2002. Portfolio investment, however, registered substantial net inflows of 66 312 million euros. The money received by mutual funds, and to a lesser extent the money market instruments issued by residents of Luxembourg, largely explain these inflows. The substantial portfolio net inflows have been balanced by net outflows in direct investment (22 007 million euros) and other investment (45 710 million euros). The net outflows in direct investments originated mostly from inter-company loans provided by Luxembourg residents. Other investments net outflows reflected sizeable decrease in the short-term liabilities of the Luxembourg MFIs.



## 1.2.8 Foreign direct investments

During the year 2000, the stock of foreign direct investments was estimated at 24 874 million euros. This figure did not include inter-company loans. The banking sector seemed to attract more investments from abroad. Investments in the banking sector represented 68% of all foreign investments. Industry attracted 14% while the insurance sector accounted for 5.3% of foreign investments.

In terms of geographical breakdown, 80% of foreign direct investments in Luxembourg came from EU residents, especially from Germany, France and Belgium. Directs investments from the United States represented 13.9% while those from Japan and Switzerland amounted respectively to 2.8% and 2.1%. Direct investment abroad was estimated at 9 160 million euros for the year 2000. Luxembourg's investments abroad were concentrated in industry.

## 1.2.9 Public finance

### 1.2.9.1 Fiscal policy stance in Luxembourg

The central government draft budget was amended by the government in November in line with a significant deceleration of economic activity. Compared with the initial budget, central government expenditure and revenue were adjusted downward by about 2% to 6%. The budget should be roughly in balance.

Although the central government budget is useful to grasp the main features of fiscal policy in Luxembourg, it does not offer a fully comprehensive view of public finance developments. In 2001, the central government represented only about one half of the total general government non-consolidated budget, which includes not only the central government but also the social security system and local government. Moreover, the official presentation of the budget does not comply with the ESA 95 accounting rules. These rules are especially important, because they require the inclusion of the so-called special and investment funds in the central government account, and because they are the reference for monitoring compliance with the requirements of the Maastricht Treaty and the Stability and Growth Pact. For these reasons, the following paragraphs focus on the ESA 95 version of the general government accounts.

TABLE 9 THE 2003 BUDGET (MILLION EUROS, UNLESS STATED OTHERWISE)

Million euros, unless stated otherwise				
	2002 Budget	Draft 2003 budget	2003 amended Budget	Nominal rate of growth <sup>(1)</sup>
<b>Revenue</b>	<b>5,977.2</b>	<b>6,468.7</b>	<b>6,349.7</b>	<b>6.2%</b>
Current revenue	5,935.2	6,424.3	6,305.3	6.2%
Capital revenue	42.0	44.4	44.4	5.7%
<b>Expenditure</b>	<b>5,999.0</b>	<b>6,465.8</b>	<b>6,349.2</b>	<b>5.8%</b>
Current expenditure	5,146.0	5,567.3	5,521.3	7.3%
Capital expenditure	853.0	898.6	827.8	-2.9%
<b>Balance</b>	<b>-21.8</b>	<b>2.9</b>	<b>0.5</b>	

Source : Finance Ministry

(1) Evolution between the 2002 budget and the 2003 amended budget.

### 1.2.9.2 General government revenue in Luxembourg

As a percentage of GDP, total general government revenue was remarkably stable over the period 1997-2001. The decrease observed in 1998 following a first downward adjustment in direct tax rates was offset by an increase of the same magnitude in 2001. This was in spite of the implementation of a generous personal tax reform in 2001, and reflected the resilience of social security contributions. In fact, social contributions depend in a direct and even proportional way on the wage bill in Luxembourg. Since the wage bill traditionally lags GDP growth, the economic slowdown in 2001 mechanically

increased the ratio of social contributions to GDP. This helped somewhat to insulate total revenue – which increased by 5% in nominal terms – from the unfavourable economic context.

TABLE 10 GENERAL GOVERNMENT REVENUE IN LUXEMBOURG (AS A PERCENTAGE OF GDP, UNLESS STATED OTHERWISE)

(as a percentage of GDP, unless stated otherwise)										
	1997	1998	1999	2000	2001	2002	2002	2003	2004	2005
	ESA 1995 data (February 2003)						Stability programme			
<b>Current revenue</b>	<b>47.1</b>	<b>45.6</b>	<b>45.6</b>	<b>46.2</b>	<b>46.9</b>	<b>48.5</b>	<b>46.4</b>	<b>46.8</b>	<b>45.8</b>	<b>45.4</b>
of which direct taxes	17.4	16.4	15.8	15.8	15.9	16.9	--	--	--	--
of which indirect taxes	13.6	13.5	14.4	15.0	14.3	14.3	--	--	--	--
of which social contributions	11.5	11.2	11.4	11.4	12.5	13.1	--	--	--	--
<b>Capital revenue</b>	<b>0.2</b>	<b>0.1</b>	<b>0.2</b>	<b>0.2</b>	<b>0.1</b>	<b>0.2</b>	<b>0.2</b>	<b>0.2</b>	<b>0.2</b>	<b>0.2</b>
<b>Total revenue</b>	<b>47.2</b>	<b>45.8</b>	<b>45.8</b>	<b>46.3</b>	<b>47.0</b>	<b>48.6</b>	<b>46.6</b>	<b>47.0</b>	<b>46.0</b>	<b>45.6</b>
Nominal rate of growth of total revenue (%)	9.0	6.3	9.4	13.3	4.9	4.8	--	4.1	2.7	4.2

Source : STATEC, fourth update of the Luxembourg stability programme, BCL calculations

The data mentioned in the last four columns of the table have been extracted from the fourth update of the stability programme. The breakdown between current and capital revenue, however, results from BCL calculations. Furthermore, the growth rate of total revenue calculated for 2003 has been derived on the basis of total revenues reported for 2002 in the stability programme.

Social contributions exerted the same stabilising effect in 2002, although to a lesser extent. Direct revenue in 2002 has also been particularly strong in spite of an adverse context. First, a new fiscal reform was implemented in 2002. It consisted in an alleviation of tax rates for households as well as for companies. Second, the economic slowdown was even more substantial in 2002 than the previous year. The strong resilience of direct taxes in such an environment is attributable to a significant acceleration in the collection of business tax arrears, which took place especially at the end of 2002.

This reliance on the collection of tax arrears cannot be sustained for long, however, as the stock of tax arrears is decreasing. In the steady state, business tax revenue should converge to a level that is more in line with the underlying economic activity. This could give way to significant tax shortfalls in the future.

### 1.2.9.3 General government expenditure

Disregarding the impact of a one-off transaction related to SES Global, total general government expenditure would have increased by 10% in 2002 and would amount to 46% of GDP. According to the fourth update of the stability programme, this ratio would only slightly decrease from 2003 to 2005 and the nominal growth of general government expenditure would reach 3.9% in 2003, 3.3% in 2004 and 2.7% in 2005. These rates of growth are extremely low by past standards in Luxembourg. In fact, total general government expenditure increased by 8% a year, on average, over the period 1991-2001, and it was up by 10% in 2002. This shows that a significant slowdown in expenditure growth would be required in order to ensure compliance with the objectives set out in the stability programme.

TABLE 11 GENERAL GOVERNMENT EXPENDITURE IN LUXEMBOURG (AS A PERCENTAGE OF GDP, UNLESS STATED OTHERWISE)

(as a percentage of GDP, unless stated otherwise)										
	1997	1998	1999	2000	2001	2002	2002	2003	2004	2005
	ESA 95 data (February 2003)						Stability programme			
Social payments	21.1	19.9	20.4	19.3	20.7	23.1	--	--	--	--
Government investment	4.2	4.5	4.6	4.1	4.3	4.7	--	--	--	--
Compensations of employees	9.2	8.8	8.5	8.0	8.3	9.0	--	--	--	--
Other expenditure	9.5	9.5	8.8	8.8	7.4	9.3	--	--	--	--
<b>Total expenditure</b>	<b>44.0</b>	<b>42.7</b>	<b>42.3</b>	<b>40.2</b>	<b>40.6</b>	<b>46.1</b>	<b>47.0</b>	<b>47.3</b>	<b>46.7</b>	<b>45.6</b>
Nominal rate of growth of total expenditure (%)	5.9	6.5	8.3	6.4	9.4	9.7	--	3.9	3.3	2.7

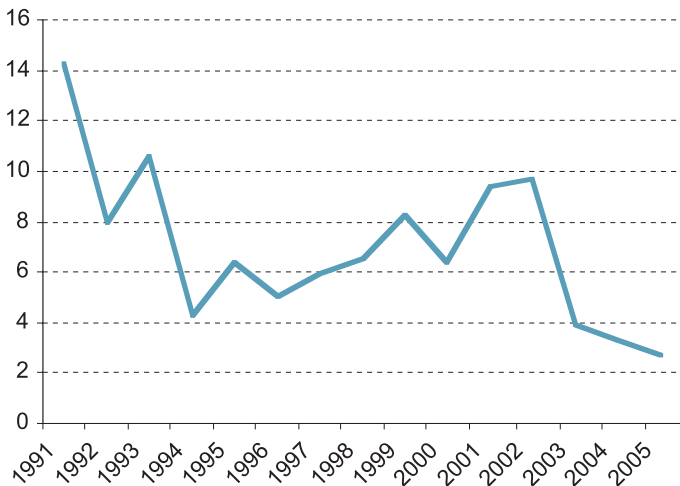
Source : STATEC, fourth update of the Luxembourg stability programme, BCL calculations



The data mentioned in the last four columns of the table have been extracted from the fourth update of the stability programme. The expenditure level recorded in 2001 has been affected by a one-off transaction related to SES Global, which decreased total expenditure by 2% of GDP in 2001. This factor explains the substantial decrease of the item "other expenditure" in 2001 and the offsetting increase recorded in 2002. Furthermore, the rate of growth of total expenditure calculated for 2003 has been derived on the basis of the total amount of expenditure reported for 2002 in the stability programme.

Such a deceleration will be difficult to implement due to the conjunction of four factors. First, public investments should increase by 31% in 2003 according to the stability programme. Second, wages in the public sector should increase by 1.6% in 2003 and 2004. Third, pension expenditure will go up significantly from 2003 to 2005, if only because of the adjustment of pensions to real wage developments. Fourth, health expenditures are likely to increase at a sustained pace due to a growing number of insured persons and the increase in costs. The implementation of structural reforms aimed at decreasing the spontaneous increase in general government expenditure is particularly desirable in such a context. This is all the more so as general government expenditure per capita is much higher in Luxembourg than in the rest of Europe.

GRAPH 17 NOMINAL RATE OF GROWTH OF GENERAL GOVERNMENT EXPENDITURE IN LUXEMBOURG (AS PERCENTAGE OF GDP)



Source : Stability programme, STATEC, BCL calculations

#### 1.2.9.4 Net lending and net borrowing requirements

The general government surplus would record a marked decline in 2002, reaching 2.6% of GDP, compared with 6.4% the year before. This result is more favourable than forecast in the last update of the stability programme, where a deficit equal to 0.3% of GDP was envisaged for 2002. This evolution, however, is primarily the reflection of a non-structural factor, namely the aforementioned acceleration in the collection of business taxes. In addition, the central government would record a substantial deficit, close to 3% of GDP in 2004 and 2005.

TABLE 12 BUDGETARY BALANCES IN LUXEMBOURG (AS A PERCENTAGE OF GDP)

(as a percentage of GDP)											
	1997	1998	1999	2000	2001	2002	2002	2003	2004	2005	
<b>1 Non adjusted balances: net lending (+) or borrowing (-)</b>	<b>ESA 1995 data (February 2003)</b>						<b>Stability programme</b>				
1.1 Central government	1.9	1.4	2.1	3.0	3.1	-0.1	-2.2	-2.1	-2.8	-2.8	
1.2 Local government	0.5	0.3	0.2	0.6	0.2	0.3	-0.4	-0.6	-0.6	-0.1	
1.3 Social security	0.8	1.4	1.3	2.5	3.1	2.4	2.2	2.4	2.7	2.9	
1.4 General government (= 1.1+1.2+1.3)	3.2	3.1	3.5	6.1	6.4	2.6	-0.3	-0.3	-0.7	-0.1	
<b>2 Cyclical component of the general government balance</b>	<b>-0.9</b>	<b>0.0</b>	<b>0.2</b>	<b>1.2</b>	<b>0.8</b>	<b>-0.2</b>	<b>-0.2</b>	<b>-0.5</b>	<b>-0.5</b>	<b>-0.4</b>	
<b>3 Cyclically adjusted general government balance</b>	<b>4.1</b>	<b>3.1</b>	<b>3.3</b>	<b>4.9</b>	<b>5.6</b>	<b>2.8</b>	<b>-0.1</b>	<b>0.2</b>	<b>-0.2</b>	<b>0.3</b>	

Source : STATEC, fourth update of the Luxembourg stability programme, BCL calculations

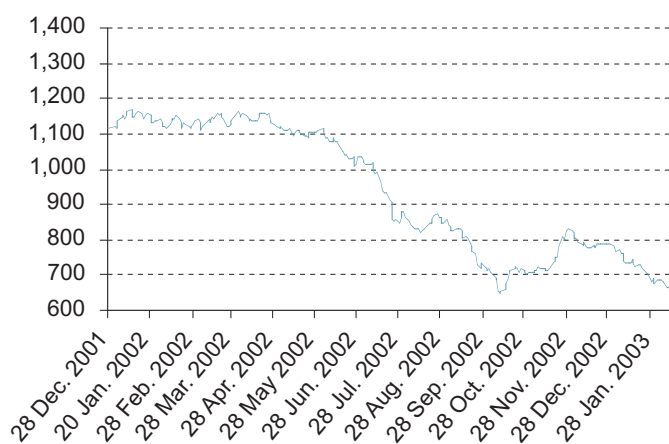
The non-adjusted balances displayed in the last four columns of the table have been extracted from the fourth update of the stability programme. The cyclically adjusted balances are equal to the non-adjusted balances minus the cyclical component. The latter has been calculated by the BCL on the basis of the Hodrick-Prescott filter.

Cyclically adjusted general government balances would be roughly in equilibrium from 2003 to 2005. The current context, however, casts a shadow of uncertainty on these results. First, they presuppose a strict monitoring of expenditure. Second, they could be affected by adverse macroeconomic developments in an unstable geopolitical context. Third, the favourable budgetary situation forecast in the stability programme critically depends on high surpluses in the social security system. These surpluses will probably decline significantly in the future. As illustrated in ad hoc projections made by the BCL, the surpluses recorded in the general pension regime are liable to decrease over the next years due to a marked slowdown in the growth of total employment and to a high spontaneous rate of expenditure growth. The same evolution would also be observed in the health system, which further highlights the need for structural reforms aimed at curbing expenditure drift.

### 1.2.10 The Luxembourg Stock Exchange

In a context of general turmoil in international stock markets, the LuxX index fell by 29% in 2002. A specific national factor, the phasing out of the "Rau" law which offered fiscal advantages to holders of domestic stocks, also contributed to the decline of the LuxX index.

GRAPH 18 LUXX



Source : Bloomberg



In line with the decline of the stock prices, the market capitalisation of listed companies also fell significantly in 2002. Market capitalisation of domestic companies and of foreign companies decreased respectively by 12% and 33% in 2002. This development accompanied a decline in the number of listed companies.

TABLE 13 MARKET CAPITALISATION OF LISTED COMPANIES

	Capitalisation (EUR million)			Change 2001/2002	Listings 2001/2002
	31/12/2000	31/12/2001	31/12/2002		
Domestic	36	26	23	-12%	48/48
Foreign	522	419	281	-33%	209/197
Total	559	446	304	-32%	257/245

Source : Source: Luxembourg Stock Exchange

In 2002, the Luxembourg Stock Exchange admitted an additional 7 531 securities to listing. At the end of the year, the total number of listings mounted to 26 486 securities, of which 18 883 bonds, 5 798 UCIs, 1 537 warrants and 268 stocks. The bond compartment is by far the most important (71% of total listings), followed by UCIs (22% of total listings), warrants (6% of total listings) and stocks (1% of total listings).

TABLE 14 NUMBER OF LISTED SECURITIES

	Total	Bonds	UCIs	Warrants	Stocks
1996	12,870	8,441	2,766	1,350	313
1997	14,478	9,574	3,030	1,557	317
1998	15,386	10,513	3,337	1,228	308
1999	17,051	12,021	3,658	1,060	312
2000	19,690	13,679	4,625	1,089	297
2001	23,438	16,447	5,407	1,306	278
2002	26,486	18,883	5,798	1,537	268

Source : Luxembourg Stock Exchange

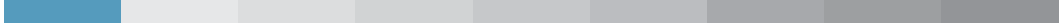
The uncertainties regarding general economic activity and geopolitical issues resulted into a global decline in the volume of trading. As a matter of fact, the volume of trading declined by 28% in 2002 compared with 2001, whereas the number of trades decreased by 30% over the same period.

TABLE 15 TRADING (VOLUME IN EUR MILLION)

	2000		2001		2002		Change (2002/2001)	
	Number	Volume	Number	Volume	Number	Volume	Number	Volume
Bonds	33,561	1,000.6	27,091	1,361.8	15,341	1,223.6	-43%	-25%
Stocks	43,938	1,321.6	27,046	494.2	22,893	291.8	-15%	-41%
UCIs	16,901	496.7	7,769	292.7	5,132	231.4	-34%	-21%
Warrants	52	1.1	152	0.8	36	0.4	-76%	-51%
Total	94,452	2,819.9	62,058	2,419.5	43,402	1,747.2	-30%	-28%

Source : Luxembourg Stock Exchange







# II

ANNUAL REPORT 2002



## OTHER BCL FINANCIAL ACTIVITIES

II	OTHER BCL FINANCIAL ACTIVITIES	
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## 2 OTHER BCL FINANCIAL ACTIVITIES

### 2.1 Monetary policy operations

In the Grand Duchy, the BCL is in charge of the execution of the monetary policy formulated by the ECB for the whole euro area.

To implement monetary policy decisions the BCL carries out a certain number of open market operations with its counterparties -credit institutions- forming the Luxembourg financial centre.

Open market operations are divided into:

- main refinancing operations -MRO- which are conducted through weekly standard tenders and have a maturity of two weeks,
- longer-term refinancing operations -LTRO- which are executed through monthly standard tenders and have a maturity of three months.

In 2002, 86.8% of the banking liquidity was provided through MROs.

The BCL ensures the implementation of the Eurosystem's minimum reserves requirements. This system, introduced on 1st January 1999, day of the official euro launch, is applicable to all the banks of the Luxembourg financial centre, whatever their legal form or geographic origin.

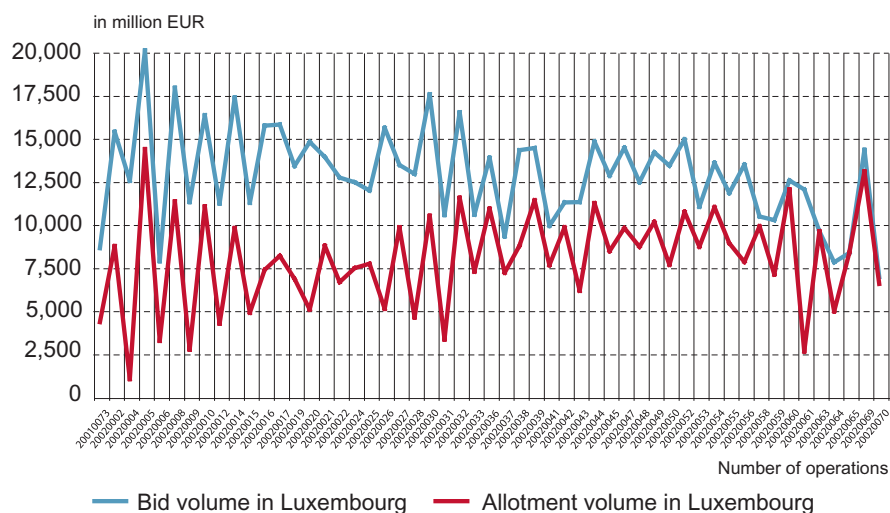
The minimum reserve requirement for banking institutions aims at stabilising interest rates in the money market and, if necessary, may create or increase a structural liquidity deficit.

#### - The main refinancing operations

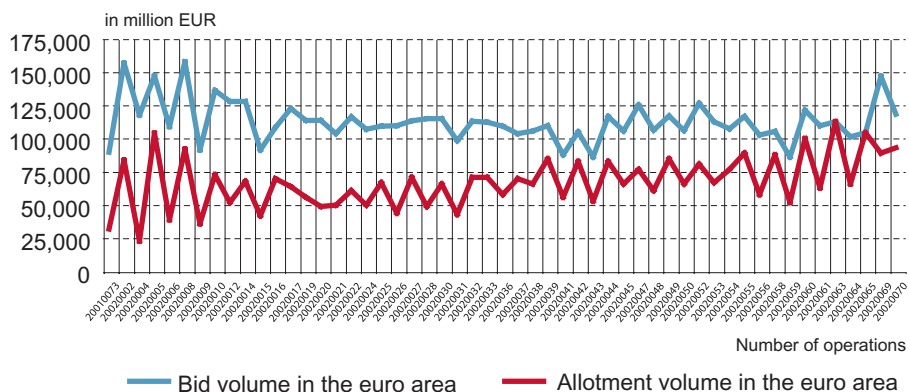
Since 28 June 2000, the MROs of the Eurosystem are conducted as variable rate tenders, using the multiple rate auction technique. The ECB sets the minimum bid rate for these operations, thereby signalling the monetary policy stance.

The background for this decision was the severe overbidding problem which occurred under the fixed rate tender procedure until June 2000. In 2002, the allotment ratio (i.e. the ratio between the amount allotted in the tender and the total amount of bids) averaged 59.3%.

GRAPH 1 MRO 2002 - BID AND ALLOTMENT VOLUME IN LUXEMBOURG

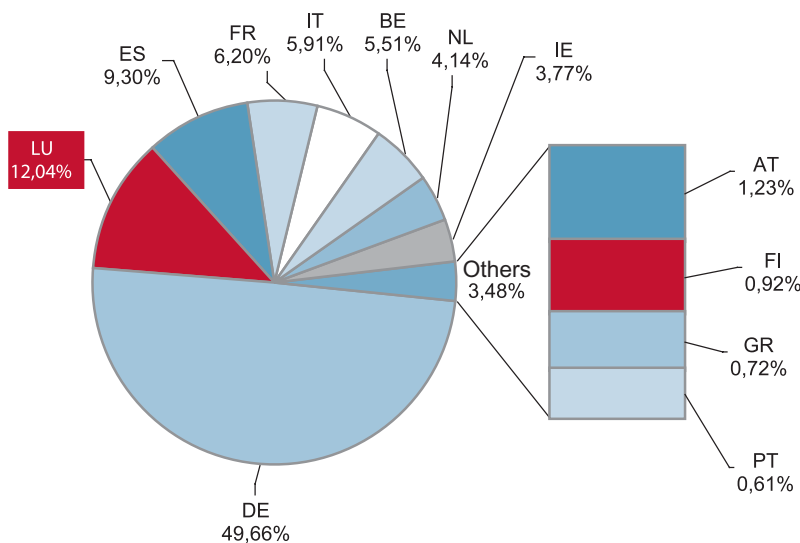


GRAPH 2 MRO 2002 - BID AND ALLOTMENT VOLUME IN THE EURO AREA



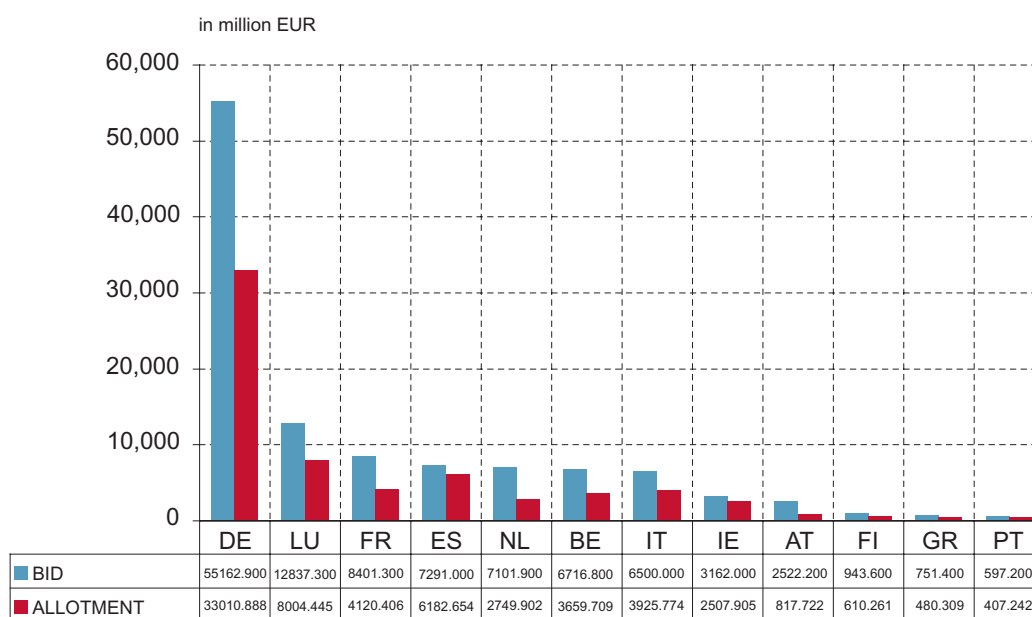
With regards to the allotment volume in the whole euro area, Luxembourg ranked, on average, on the second place. Overall, Luxembourg ranked in the second place in 2002 as it did in 2001 behind Germany, leading to the conclusion that Luxembourg is an important financial place in monetary markets.

GRAPH 3 MRO 2002 - AVERAGE ALLOTMENT VOLUME IN THE EURO AREA



Compared to 2001, the average percentage allotted to Luxembourg in 2002 increased from 9.9% to 12%.

GRAPH 4 MRO 2002 - AVERAGE BID AND ALLOTMENT VOLUME IN THE EURO AREA

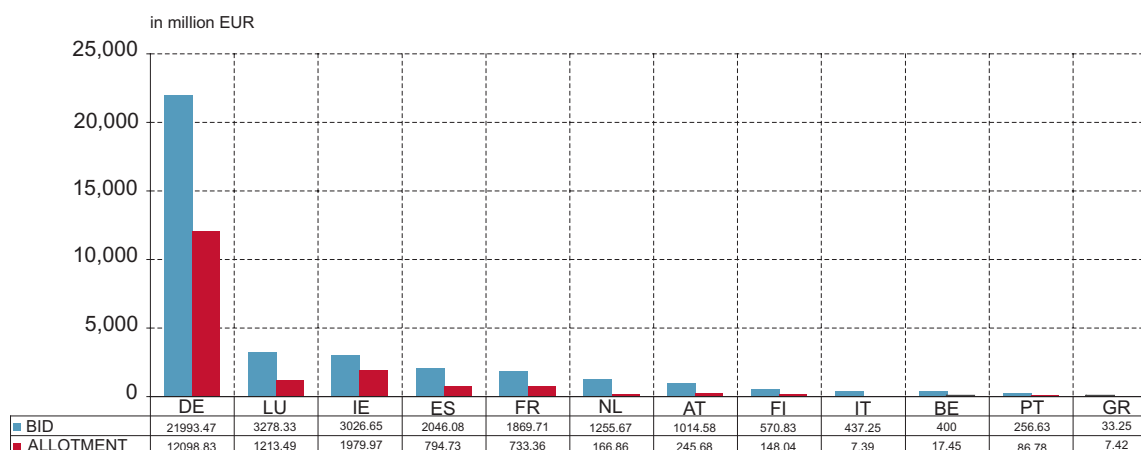


Compared to 2001, the average number of participating counterparties in MROs decreased from 21.4 to 18.2. This situation was also observed in the whole euro area (from 404.4 to 306.8). The decrease of the number of counterparties can be explained by the mergers and acquisition phenomenon in the banking sector.

#### - The longer-term refinancing operations

With regards to the allotment volume in the whole euro area, Luxembourg on average ranked on the second place in 2002. Overall, Luxembourg ranked on the third place for the year 2002. The average number of counterparties remained stable at 10.8.

GRAPH 5 LTRO 2002 - AVERAGE BID AND ALLOTMENT VOLUME IN THE EURO AREA



As in 2001, the Governing Council decided to allot 20 billion euros for each LTRO during the first half

of 2002. In June 2002, the Governing Council decided to shift the allotment volume to 15 billion euros for LTROs of the second half of 2002. This decision was taken regarding the development of autonomous factors, especially the impact of cash changeover. The revised amount took into account the banking need for liquidity for the second half of 2002.

In September 2002, the Governing Council also discussed the possibility of suppressing the LTRO. This measure was proposed in a public consultation held at the ECB on 8 October 2002 with some other technical measures in order to improve the efficiency of the operational framework of monetary policy. These operations meeting Eurosystem counterparties requirements in liquidity management, the Governing Council decided to maintain the LTRO and to keep the allotment volume at 15 billion euros per auction in 2003.

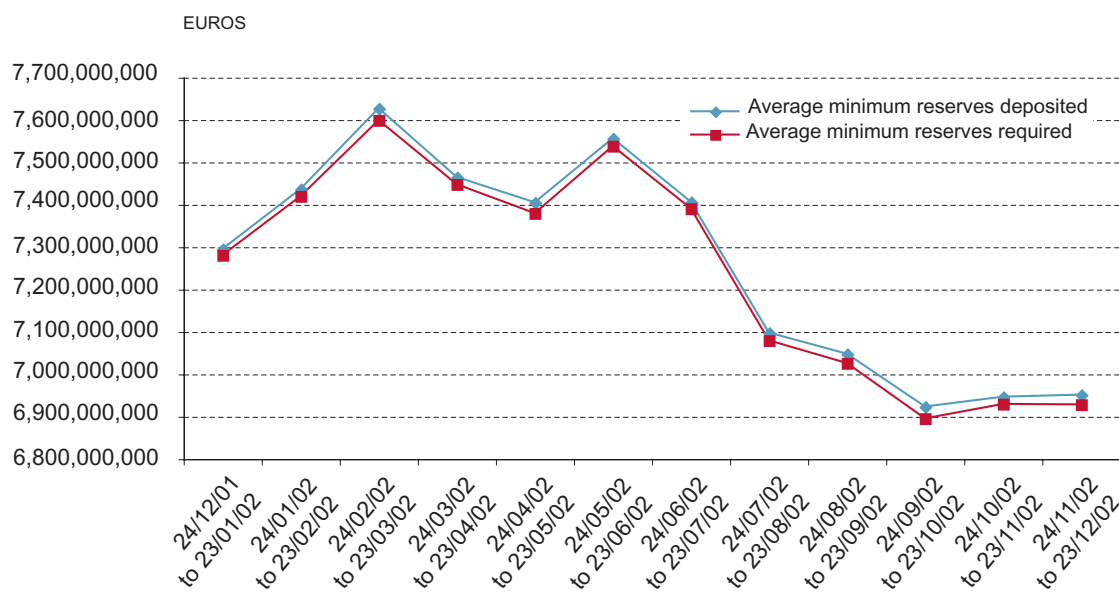
### - Fine-tuning operations

Following the introduction of the fiduciary euro, autonomous factors -especially banknotes- in the euro area showed a high degree of volatility. In order to re-establish the liquidity situation the ECB executed two fine-tuning operations on 4 and 10 January, 2002. On 18 December 2002 the ECB also launched a fine-tuning operation in order to reduce market tensions resulting from the underbidding in the last refinancing operation during the minimum reserves period.

### - The minimum reserves system

In 2002, the average amount of minimum reserves held by credit institutions in Luxembourg was estimated at 7.3 billion euros.

GRAPH 6 DEVELOPMENT OF THE AVERAGE REQUIRED AND DEPOSITED MINIMUM RESERVES



The deposited amounts are remunerated at the average MRO rate of the ECB during the maintenance period.

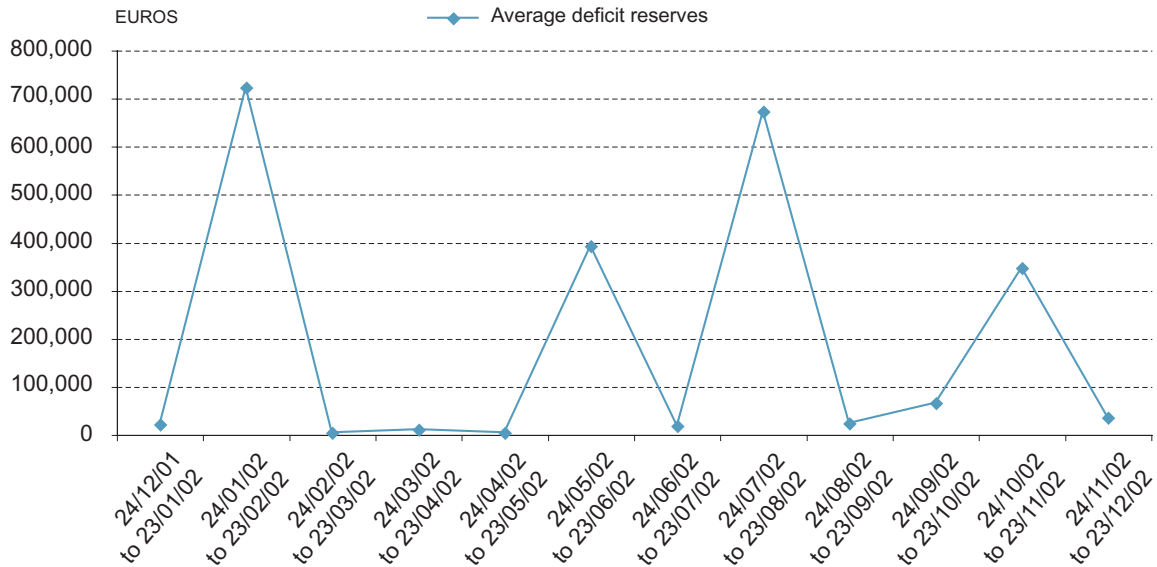
Evolution of the remuneration rate in 2002

Period	1	2	3	4	5	6	7	8	9	10	11	12
Rate (%)	3.34	3.30	3.28	3.30	3.30	3.33	3.32	3.29	3.28	3.28	3.28	3.06

In 2002, the rates at which minimum reserves were remunerated passed from 3.34% to 3.06%.

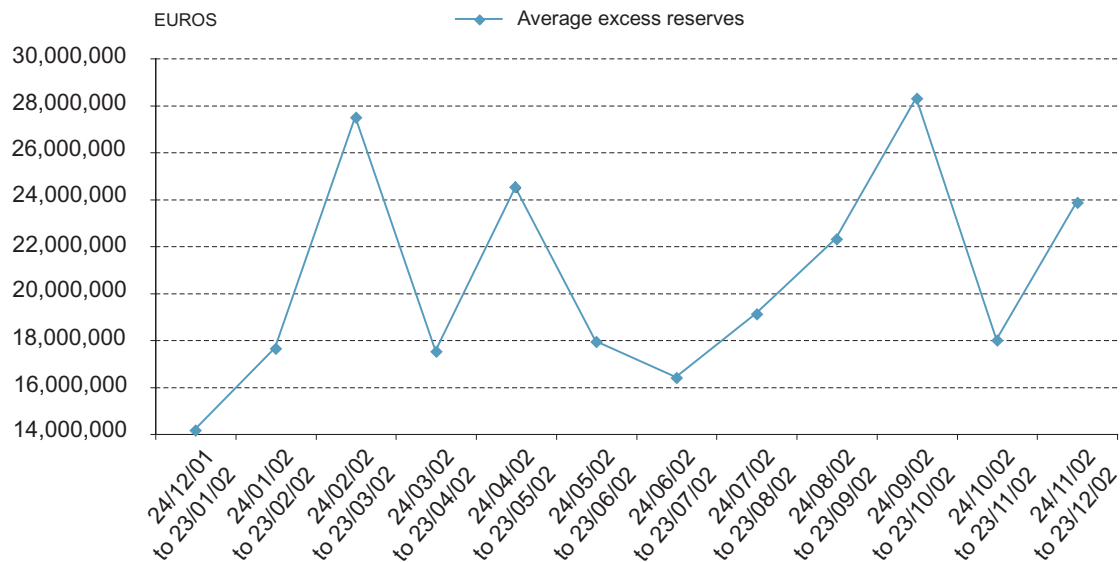
It is noteworthy that 17 sanctions for not respecting minimum reserve requirements have been paid in 2002 in comparison to 16 in 2001.

GRAPH 7 DEVELOPMENT OF AVERAGE DEFICIT RESERVES



Penalties for not respecting minimum reserve requirements remained at a high level during the whole year.

GRAPH 8 DEVELOPMENT OF AVERAGE EXCESS RESERVES



Excess of minimum reserves -that are not remunerated- remained at a high level during the whole year.



## 2.2 Foreign exchange reserves management by the BCL

According to the Statute of ESCB, the BCL, as a full member of the System, had to contribute to the ECB's capital. As a result, it transferred an amount of € 74.6 m in foreign exchange assets, corresponding to 0.1492% of the ECB's capital. The ECB's foreign exchange reserves are managed in a decentralised way by NCB's including the BCL since September 1999. On 31 December 2002, the total market value (accrued interest included) owned by the BCL corresponded to € 78.6 million. One of the objectives of the foreign exchange reserves management of the ECB is to make sure that, if necessary, the ECB has sufficient liquidities available to intervene in the foreign exchange markets.

Security and liquidity are therefore basic requirements for the management of these reserves. The tactical benchmark is set up by taking the strategic benchmark into account for each currency. It reflects the ECB's medium term preference as regards revenue and risk with reference to market conditions.

A modification of the tactical benchmark may affect different risk categories (e.g. modified duration or liquidity risk). The modified maturity of the tactical benchmark may differ from the modified maturity of the strategic benchmark in the context of fluctuation margins announced in advance by the ECB.

In the management of this portfolio, the first task of the BCL is to invest the foreign exchange reserves on behalf of the ECB within the foreseen fluctuation margins and fixed risk limits and to maximise revenue. The amount of gold assets managed actively is set by the ECB, taking into account strategic considerations as well as market conditions.

## 2.3 The management of BCL's assets

The management of the BCL's own assets is performed in accordance with ECB principles. The investment policy underlying the management of the assets is based on the following criteria:

- cautious investment approach;
- fundamental macroeconomic analysis;
- organisation of the portfolio scheme;
- choice of the investment decisions;
- thorough control and well calculated risk-taking.

The BCL's investment policy aims at achieving the following goals: generate regular high incomes and provide in the long term a lasting return on investment by taking into account various considerations such as capital security, stability of the securities and liquidity subject to investment.

For that reason and with respect to the principle of equal risk distribution, the BCL implements a proactive, progressive and matching investment policy based on modern portfolio theory.

The bulk of BCL's own assets is invested in fixed income securities denominated in euro. Yet, the BCL's strategic orientation allows a diversification to other categories of assets.

The investment policy committee has to define the investment policy of the BCL's financial resources. Taking into account goals and constraints on an annual basis, the committee sets a strategic orientation for the portfolio management by defining an appropriate framework for the investment policy and the determination of the strategic benchmark oriented towards revenue collection and performance calculation. The management committee is in charge of the tactical allocation and defines the main thrust of investment. The tactical benchmark is set up according to the strategic benchmark, taking into account fluctuation margins. The attention is put on the tactical investment strategy in the short term.

Given that the portfolios are exclusively invested in euro, investment decisions are made by taking into account:

- the interest rate risks (average portfolio duration, yield curve position);
- the risk degree of markets (chosen sectors, portfolio asset selection according to a given security and, to a lesser extent, to the geographic distribution by country).

Investment decisions are taken on the basis of technical and fundamental analysis, as well as on quantitative assessments. The management committee's role is to define reference factors that guide the management of the bank's assets, to follow the investments up, to review the strategy and the



realised performance. Standard external benchmarks allow a regular comparison of performance.

The cautious investment approach takes into account:

- the analysis of the different (country) economies and international financial markets;
- the allocation decision of the assets under management by appreciating the investment returns on the different international markets;
- the definition of a clear strategy;
- the capital value preservation of the assets under management by a policy of risk diversification and the maintenance of a particular quality demand of investment;
- the applying of strict risk control measures.

#### “Liquidity Portfolio”

The first goal of this operational portfolio is to provide liquidity to face up to cash-flow fluctuations. The instruments used are mainly short-term interbank deposits, CDs, commercial papers, transfer and retrocession operations and the purchase of variable rate bonds.

#### “Investment Portfolios”

The main goal of this investment portfolio is to maximise yield while taking into account particular demand as regards risk, revenue and liquidity. As of 31 December 2002, the total market value (accrued interest included) represented € 1 221.6 million.

TABLE 1 ASSETS ALLOCATION AS OF 31 DECEMBER 2002

Maturity	Portfolio
0-1 year	51%
1-3 years	21%
3-5 years	14%
5-10 years	14%

In 2002, a big part of the BCL's own funds has been invested in long-term bonds, given that market conditions for that kind of investment were favourable. Around the end of the year, however, the underlying duration of the portfolio has been reduced.

It is worth noting that the securities included in this portfolio are largely diversified according to the geographic location and credit risk of the issuer. Counterparties and credit risk limits are regularly set up and checked by the risk management team.

#### “Outright Portfolio”

Several securities of this investment portfolio are used for outright transactions. Outright open market transactions refer to operations where the Eurosystem buys or sells assets outright in the market (spot or forward). Outright open market operations are executed only for structural and fine-tuning purposes, i.e.:

- for these open market operations which the Eurosystem carries out primarily in order to manage the structural liquidity situation in the market;
- for these open market operations which the Eurosystem carries out on a non-regular basis in order to face unexpected liquidity fluctuations.

#### “Pension Fund Portfolio”

The management of this fund is described further under chapter VIII, section 2.4.

### “Institutional Portfolios”

The BCL provides discretionary asset management services to public institutional clients and other central banks.

## 2.4 Banknotes and circulation of fiduciary money

In 2002, the introduction of euro coins and banknotes in Luxembourg was a great success thanks to the excellent cooperation of all those involved and to its acceptance by the public. For the BCL, 2002 also represented a normalisation concerning the management of fiduciary money. Because of the return of the Luxembourg coins and banknotes and of the legacy currencies of the other participating Member States, the first quarter was busy. The level of activity, however, has stabilised to a more sustained rhythm in comparison to the situation prevailing before the introduction of the euro coins and banknotes. This is due to the increased volume of coins and banknotes that have to be processed and the supplementary efforts to be made for the organisation of the production.

As the other NCBs of the Eurosystem, the BCL has assumed its responsibilities for the organisation of the production and the management of the quality of the euro banknotes. In order to facilitate the management of the quality of the banknotes and to reduce the number of specialised printing works, the ECB has put in place a pooled production scheme which is nevertheless implemented in a decentralised manner. According to this scheme, the needs of the participating NCBs are aggregated by the ECB and the production of one denomination is afterwards assigned to at most two NCBs. In 2002, the BCL was responsible for, according to a strict delivery schedule, the production of 30 million 100-euro banknotes, for seven different NCBs, among which was of course the BCL. The production of these banknotes has been entrusted to the specialized printing works of Setec Oy established in Finland near Helsinki.

### 2.4.1 Evolution of the circulation of currency

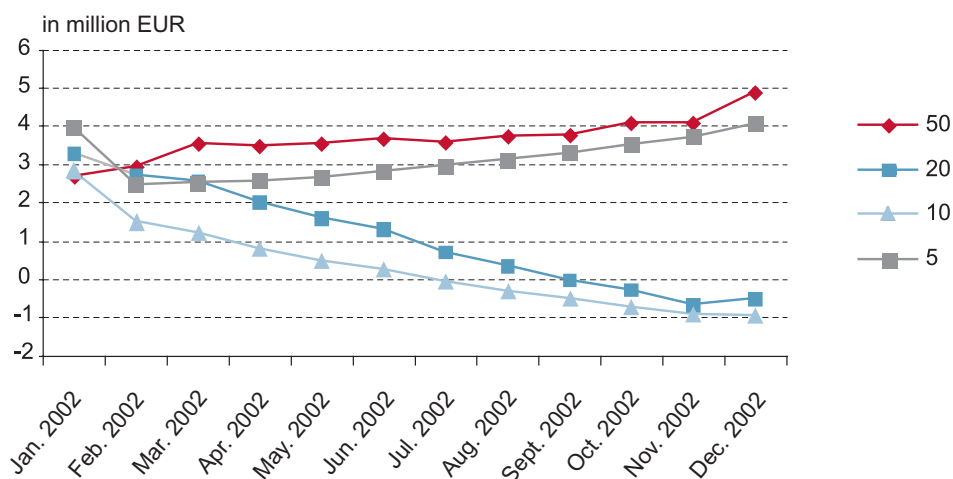
#### 2.4.1.1 Euro coins and banknotes

The volume of euro coins and banknotes put into circulation by the BCL does not necessarily correspond to the volume effectively in circulation in Luxembourg, i.e. those used in the payment systems in Luxembourg. The reason therefore is the migration of euro banknotes and coins inside the euro area.

In 2002, the total volume of euro banknotes put into circulation by the BCL amounts to 23.78 million banknotes (frontloading excluded) and thus increased by 158% in comparison to the volumes frontloaded. At the end of July 2002, the volume of the 10-euro banknotes put into circulation by the BCL became negative, i.e. credit institutions, which are BCL clients, deposited more banknotes than they have withdrawn from the BCL. This phenomenon can be explained by the fact that tourists and cross border workers massively brought this denomination to pay their everyday transactions in Luxembourg. The same situation appeared as from the end of September for the 20-euro denomination.

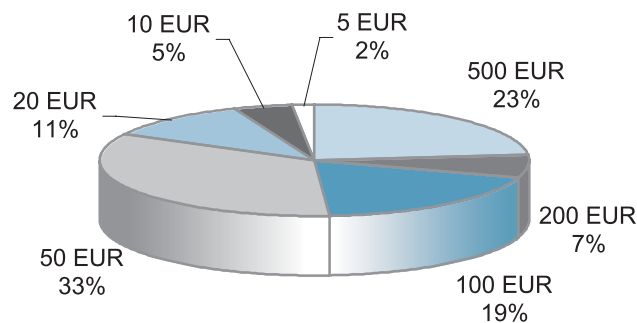
The graph below illustrates the divergent evolution in the volume of the denominations mainly used in everyday transactions:

GRAPH 9 EVOLUTION OF THE NUMBER OF CERTAIN EURO BANKNOTE DENOMINATIONS PUT INTO CIRCULATION BY THE BCL



In comparison with the whole euro area, the BCL has increased its contribution to the total volume of banknotes put into circulation by the Eurosystem, passing from 0.22% in January to 0.47% in December 2002. In Luxembourg and in the euro area, the first months of 2002 have been characterised by a massive demand of lower denominations for settling everyday transactions. Subsequently, a renewed interest for higher denominations, also used for hoarding purposes, became apparent and this development can be seen as a sign of trust in the new currency. The total value of euro banknotes put into circulation by the Eurosystem amounts to 358.54 billion euro at the end of 2002 and the following total value breakdown per denomination was as follows:

GRAPH 10 BREAKDOWN OF THE VALUE OF EURO BANKNOTES PUT INTO CIRCULATION BY THE EUROSYSTEM PER DENOMINATION

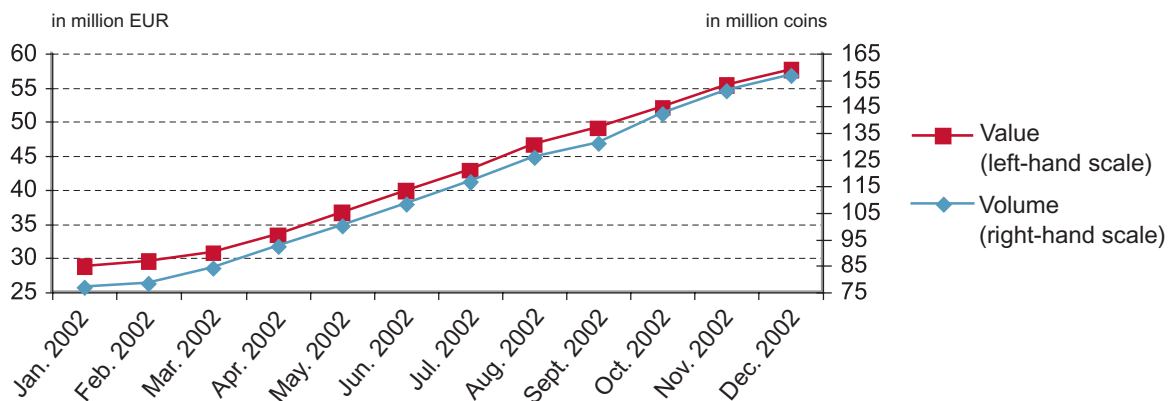


The value of banknotes put into circulation by the Eurosystem during 2002 has increased by 167% in comparison to the situation as of 31 December 2001 (frontloading), that is to say an increase of more than 225 billion euro.

The Luxembourg euro coins have also been subject to an important demand of the Luxembourg and foreign public. After a frontloading of 69.69 million coins at the end of 2001, 157.07 million Luxembourg coins were in circulation at the end of 2002 representing a total value of 57.65 million euro. This volume represents a weight of 764 tons of coins, which statistically represents 356 coins per inhabitant or a weight of 1.73 kg coins per inhabitant. The Luxembourg euro coins have been subject to an important demand coming from collectors from the entire world.

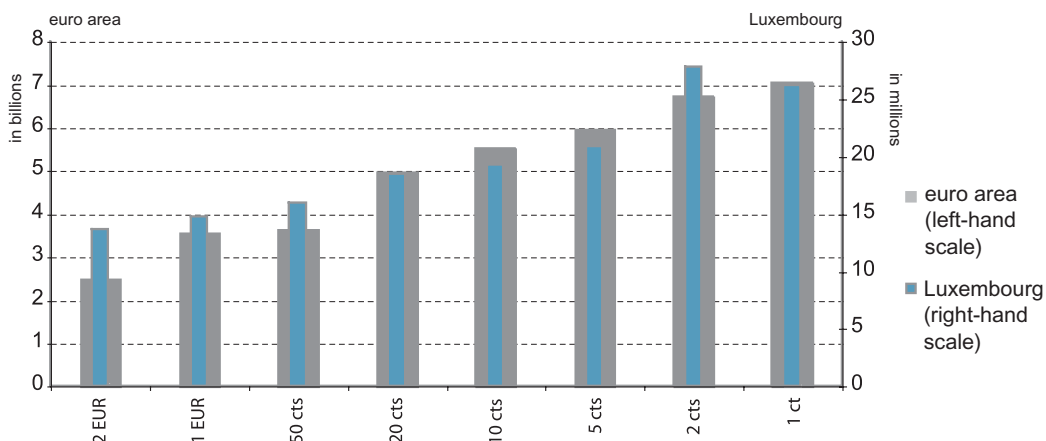
The average monthly volume of coins in circulation amounts to 113.71 million. The following graph shows the evolution of the volume and the value of Luxembourg euro coins in circulation in 2002. The demand for Luxembourg coins has kept increasing, the difference between the volume and the value having slightly increased.

GRAPH 11 VOLUME AND VALUE OF THE LUXEMBOURG EURO COINS IN CIRCULATION



In comparison with the euro area, Luxembourg contributes to 0.39% of the total number of coins put into circulation by the participating Member States, whilst Luxembourg contributes to 0.46% of the total value issued by all the issuing authorities of the euro area. The average value of Luxembourg euro coins put into circulation amounts to 36.7 cent in comparison to an average of 31.1 cent for the euro area coins. The following graph shows the comparison of the volume of the different coin denominations put into circulation by Luxembourg to the corresponding volume in the euro area.

GRAPH 12 COMPARISON OF THE VOLUME OF CIRCULATION OF THE DIFFERENT EURO COIN DENOMINATIONS IN LUXEMBOURG TO THAT OF THE EURO AREA

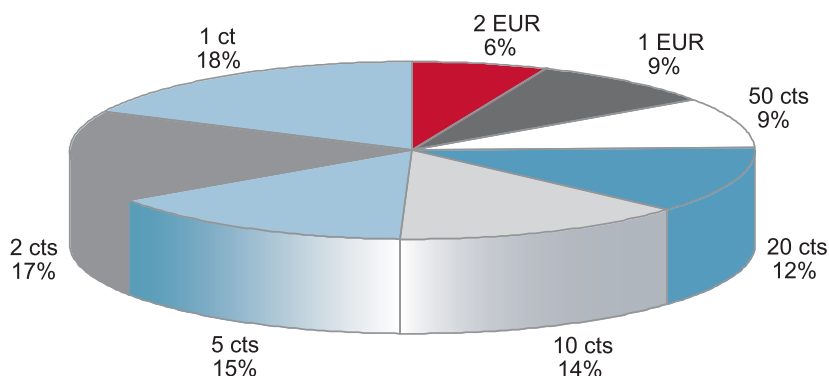


Concerning the Luxembourg coins, the 2-cent denomination is the most widespread. The classification according to the volume in descending order is as follows: 2 cent, 1 cent, 5 cent, 10 cent, 20 cent, 50 cent, 1 euro, 2 euro.

The demand for Luxembourg coins for the three higher denominations is higher than that of the euro area. The other denominations are slightly underneath the European average.

The total value of euro coins put into circulation by the Eurosystem has reached 12.43 billion euro at the end of 2002 and the total volume of coins amounts to 39.953 billion. The following graph shows the breakdown of this volume of the euro area according to following denominations:

GRAPH 13 BREAKDOWN PER DENOMINATION OF THE VOLUME OF COINS OF THE EURO AREA IN CIRCULATION



### 2.4.1.2 Luxembourg coins and banknotes

The withdrawal of the legacy currencies has been initiated a long time before the introduction of the euro coins and banknotes and has been completed systematically by the end of March 2002 due to the good cooperation of all people involved in Luxembourg. In 2002, the total value of Luxembourg currency (coins and banknotes altogether, numismatic and commemorative coins included) still in circulation and not yet exchanged moved from 3.48 billion to 505.77 million Luxembourg francs, i.e. a decrease by 85%. The average monthly value for last year amounts to 702.03 million Luxembourg francs, against 4.09 billion in 2001. The circulation of the 5 000-Luxembourg-franc-banknote has the most strongly decreased, that is to say by 96.1% and that of the 1 000-franc-banknote has decreased by 80%. The denomination of 100 Luxembourg francs has only decreased by 40.7%. These figures show that collectors prefer the lower denominations. The following table shows the evolution of the outstanding Luxembourg banknotes for the five last years:

TABLE 2 EVOLUTION OF THE OUTSTANDING LUXEMBOURG BANKNOTES FOR THE FIVE LAST YEARS

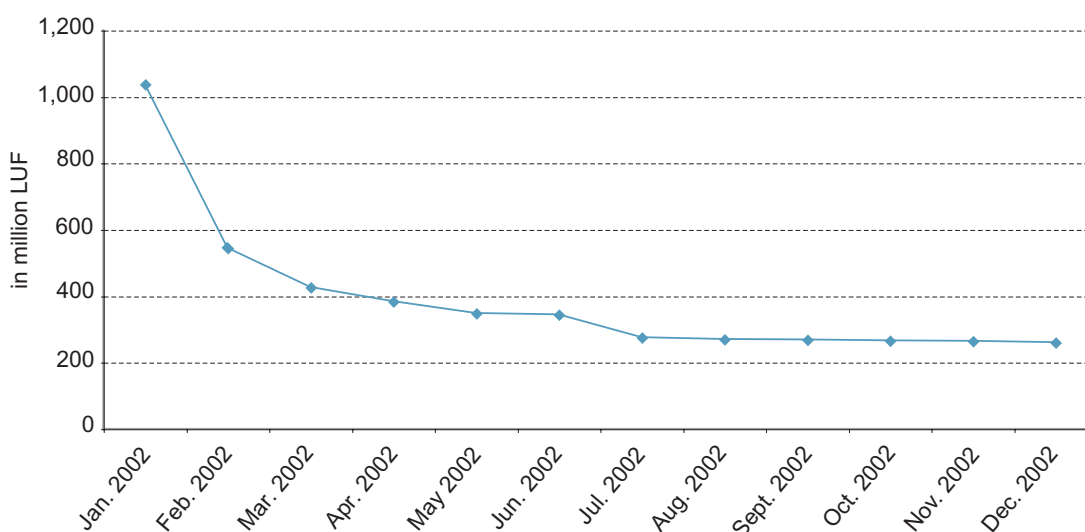
end of period	5,000 LUF	1,000 LUF	100 LUF	withdrawn LUF banknotes abroad	total
1998	3,194,890,000	1,090,562,000	185,821,900		4,471,273,900
variation*	-8.7%	-15.1%	-4.3%		-10.1%
1999	3,190,680,000	853,482,000	168,913,800	-159,980,000	4,053,095,800
variation*	-0.1%	-21.7%	-9.1%		-9.4%
2000	3,054,750,000	676,114,000	153,731,500	-168,910,000	3,715,685,500
variation*	-4.3%	-20.8%	-9%		-8.3%
2001	2,398,720,000	435,327,000	141,357,900	-198,966,000	2,776,438,900
variation*	-21.5%	-35.6%	-8.1%		-25.3%
2002	93,855,000	83,749,000	83,781,100	0	261,385,100
variation*	-96.1%	-80.8%	-40.7%		-90.6%

\* in comparison to the precedent year

- in LUF

It can be noted that the global circulation volume of Luxembourg notes has decreased by 94.2% between the end of 1998 and the end of 2002. The flow back of the notes takes the form of an asymptotic curve. The monthly evolution is shown in the following graph:

GRAPH 14 EVOLUTION OF THE CIRCULATION OF THE LUXEMBOURG NOTES IN 2002



As to the circulation of Luxembourg notes in the other countries of the euro area, it can be seen that the article 52 mechanism (free of charge exchange in other euro area countries and repatriation to the issuing central bank) has extensively been used until end of March 2002, official deadline for this mechanism. The monthly average value of Luxembourg notes repatriated by the other central banks of the euro area amounts to approximately 47.5 million Luxembourg francs.

As to the value of coins in circulation, there has been a decrease of not yet exchanged coins of 68.4% in 2002 and the amount still in circulation was 2 of 10.08 million Luxembourg francs at the end of December 2002. The withdrawal scenario of Luxembourg coins was jointly put in place by the Belgian and Luxembourg authorities and was operational in October 2001 in order to perform a common withdrawal, which avoided the obligation to separate Luxembourg and Belgian coins.

At the end of 2002, a total volume of 940 331 Luxembourg notes and 65 865 183 coins was still not presented for exchange and represented a global value of 471.46 million Luxembourg francs.

#### 2.4.2 Management of fiduciary money

The first three months of the year were characterised by the flow back of the legacy currency which was either to be repatriated to the issuing central bank or to be sorted.

On the basis of article 52 of the ESCB statutes, the BCL exchanged the notes of the other euro area countries free of charge until end of March. In this context, the cash department received and repatriated some 3.8 million notes representing a total value of 225 314 million euro.

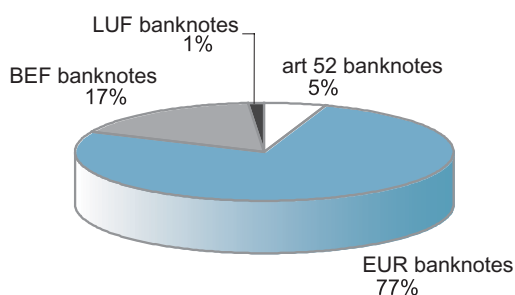
In 2002, the BCL exchanged more than 12 million Belgian notes for a counter-value of 468.41 million Belgian francs, which was below the amount of 579 million euro estimated to be in circulation in Luxembourg ahead of the cash changeover, according to the theoretical key. In these operations, the BCL acted as an agent of the BNB. The BCL has been authorised by the BNB to entirely destroy the 12 million Belgian legacy notes withdrawn in Luxembourg.

The number of Luxembourg notes returned to the BCL by the financial institutions came close to 885 000. As to the euro notes returned to the BCL, their number was approximately 54 million so that the circulation volume was in average 2.1 times at transit in the counters of the bank.

These volumes represented more or less 2 000 different lodging operations managed and registered by the cash department.

GRAPH 15

LODGING OPERATIONS BY TYPE OF NOTE



Three quarters of the lodged notes in 2002 were euro notes, 17% were Belgian notes and only a small amount were Luxembourg notes because of their highly reduced volume before the cash changeover.

As to the withdrawal operations of euro notes, they exceeded the number of 4 200 in 2002. The public also took advantage of the services offered by the BCL through its public counter for the exchange of notes and coins. More than 12 600 operations were handled at the public counter.

After the technical switch of the sorting machines for processing the euro notes, more than 39 million notes have been treated. The sorting machines do not only operate authenticity tests, but also soiling



tests. Considering denominations altogether, nearly 750 000 notes were destroyed for unfitness for circulation. The reject/destruction rate is of course low in this first year of the circulation of the euro.

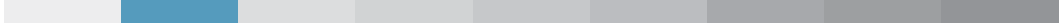
In the field of counterfeit monitoring, the BCL has cooperated with the ECB and the national authorities in the analysis of the discovered counterfeits.

### 2.4.3 Numismatic issues

The euro has generated a great interest for numismatic collections of the legacy currencies as well as of the new euro notes and coins. In Luxembourg, the following numismatic products have been put into circulation in 2002:

- the "12 countries cube": produced by the BCL, was in CD-format and contained the first euro coin issues of the 12 participating countries
- the "12 countries album", was a luxurious edition of the first euro coins of the 12 participating countries
- the "2002 yearly set" displayed the first Luxembourg euro coins with the year 2002
- the silver coin "Court of Justice", issued in December 2002, was the first Luxembourg commemorative coin in euro and commemorated the 50th anniversary of the Court of Justice of the European Communities. This coin has a face value of 25 euro and is minted in sterling silver. Its diameter is 37 mm and its weight 22,85 g. It has legal tender only in Luxembourg.







# III

ANNUAL REPORT 2002



# DEVELOPMENTS IN THE AREA OF STATISTICS

## III DEVELOPMENTS IN THE AREA OF STATISTICS

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## 3 DEVELOPMENTS IN THE AREA OF STATISTICS

### 3.1 Monetary and financial statistics

#### 3.1.1 The consolidated balance sheet of the MFI sector

The data collection on financial markets as well as money and banking statistics proceeded smoothly during 2002. Money and banking statistics have been compiled within the set timeframe and the quality standards announced by the Eurosystem.

Harmonised money and banking statistics for the euro area, collected according to the requirements of ECB regulation 1998/16, have been published since December 1998. The BCL publishes statistics relating to the aggregated balance sheet of the Luxembourg MFI sector on its website as well as in its bulletin.

In 2002, the ECB, assisted by the National Central Banks (NCBs), revised the harmonised data requirements concerning the consolidated balance sheet of the MFI sector as laid down in regulation ECB/1998/16 and adopted in regulation ECB/2001/13. The first data collection according to the new regulation took place in February 2003 and contributed to the improvement in the detail and quality of money and banking statistics.

In November 2002, the ECB adopted a new regulation regarding the identification of the final holders of money market fund shares/units issued. This information will also help to increase the quality of monetary statistics in general and especially the compilation of M3.

#### 3.1.2 Interest rate statistics

In November 2002, the Governing Council of the ECB adopted regulation ECB 2001/18 concerning statistics on interest rates applied by MFIs to deposits with and loans from households and non-financial corporations. The information on interest rates collected on the basis of this new regulation ensures the publication of harmonised interest rate statistics in the euro area and allows more in-depth research in the area of the monetary transmission process.

The first data collection according to the new regulation took place in February 2003 and contributed to improving the tools for monetary policy analysis.

#### 3.1.3 Bank lending survey

In November 2002 the Governing Council decided to introduce a bank lending survey for the euro area. The main objective of the survey, which the BCL conducts for Luxembourg, is to enhance the Eurosystem's knowledge of financing conditions in the euro area. The first data collection took place in December 2002 and the ECB as well as the BCL will soon start publishing the first results of this survey.

#### 3.1.4 Securities issues statistics

The ECB, assisted by the NCBs, continued the data collection with regard to securities issues in the euro area in order to gain a better understanding of the importance of this activity at the euro area level. The short-term approach, consisting of the collection of existing data, will in the long term be replaced by the introduction of new harmonised reporting requirements in this area. Long-term developments will imply the revision of the securities issues collection system in Luxembourg as well as in some other euro area Member States.

#### 3.1.5 Other financial intermediaries statistics

The ECB, assisted by NCBs, has already undertaken various efforts to identify those entities that belong

to the Other Financial Intermediaries (OFI) sector which, in Luxembourg, essentially comprises collective investment institutions as well as other professionals of the financial sector falling beneath the prudential supervision of the *Commission de Surveillance du Secteur Financier*.

The ECB, assisted by the NCBs, currently continues to collect data with regard to OFI statistics in the euro area in order to gain better understanding of the importance of this sector and its activity at the euro area level. As mentioned for the securities issues under 3.1.4, the short-term approach will in the future be replaced by the introduction of a set of new harmonised reporting requirements in this area. Again, long-term developments will imply a revised OFI statistics collection system in Luxembourg as well as in some other euro area Member States.

## **3.2 Balance of payments and international investment position**

### **3.2.1 Compilation of the balance of payments and of the international investment position**

The year 2002 has seen the completion of the necessary requirements to compile a comprehensive balance of payments for Luxembourg. This achievement is the fruit of a joint effort by the BCL and the STATEC. The main focus in 2002 concerned the consolidation of the undertaken efforts and the publication of quarterly balance of payments data. Consequently, Luxembourg complied with obligations imposed by international organisations, such as the European Commission (EUROSTAT) and the ECB.

During the course of 2003, the BCL will, for the first time, compile the international investment position of Luxembourg. Until today, this statistic was only available for the BLEU<sup>1</sup> as a whole. The international investment position is a statistical statement of the external financial assets and liabilities of an economy for a given date. It differentiates between foreign direct investment, portfolio investment and reserve assets. The international investment position will be published annually. The first publication is foreseen for the end of 2003.

### **3.2.2 Harmonisation of the Portfolio investment collection systems**

During the course of 2002, a technical group, under the umbrella of the ECB Statistical Committee, has finalised a report defining which type of collection systems Member States should be using to gather data on portfolio investment operations. The Governing Council subsequently decided that, from 2004 onwards, compilations of national balance of payments are based on one of the proposed systems. In Luxembourg, the systems currently in place in the area of balance of payments and money and banking statistics are to a large extent already in line with this new requirement.

The efforts to harmonise the collection systems have been pursued during 2002. The ECB Statistics Committee has mandated a working group with the objective of analysing the feasibility of introducing a harmonised collection system for portfolio investment based on the transmission of data on portfolio investment flows and stocks in the long term. The BCL takes an active part in this project and has consulted a representative sample of respondents. The final results of this feasibility study are expected to be available in July 2003.

## **3.3 The IMF special data dissemination standard**

In 1996, the IMF introduced the Special Data Dissemination Standard (SDDS) which is aimed at improving the production and publication of a large set of macroeconomic statistics.

The ultimate objective is to increase the number of macroeconomic statistics provided to the political decision makers and the financial markets. Currently 51 countries are SDDS subscribers among which 11 are Member States of the euro zone.

The Luxembourg authorities have made substantial efforts in 2002 to develop the necessary statistical framework consistent with the SDDS reporting requirements. The BCL is, among others, in charge of the analytical accounts of the central bank and of the MFI sector, the balance of payments (jointly with STATEC), the international investment and the reserve assets positions.

1 Belgian Luxembourg Economic Union



# IV

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# PAYMENT AND SECURITIES SETTLEMENT SYSTEMS

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## 4 PAYMENT AND SECURITIES SETTLEMENT SYSTEMS

### 4.1 LIPS-Gross

#### 4.1.1 Membership of RTGS-L Gie

The real time gross settlement system, LIPS-Gross, Luxembourg's interbank gross payment system, started operations on 4 January 1999. In 2002, a new bank joined the system and the RTGS-L Gie, operator of the system, now has 31 members.

#### 4.1.2 Operations in 2002

##### 4.1.2.1 Domestic payments

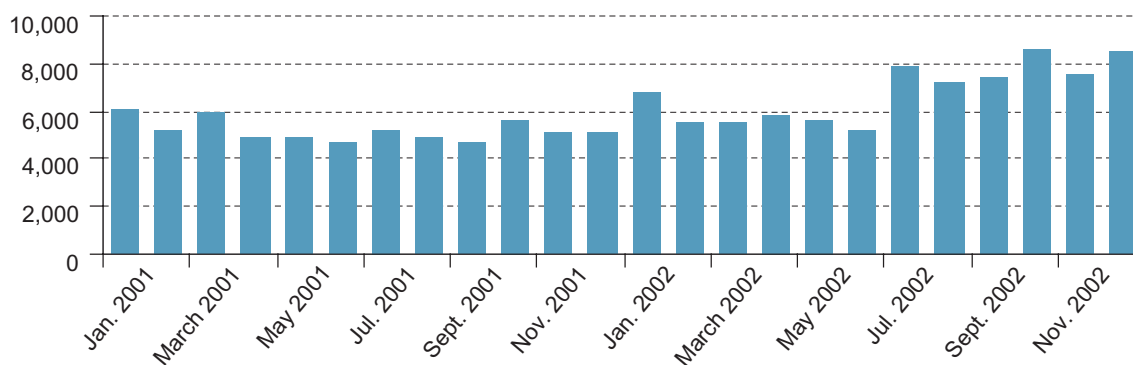
In 2002 and on a domestic level, LIPS-Gross participants sent a total of 81 749 payments (62 336 in 2001) for a total value of 1 231 billion euros (1 208 billion in 2001). In comparison with 2001, the volume increased by 31% and the value exchanged by 2%.

Average value per payment was 15.1 million euros against 19.4 million in 2001, the decrease reflecting the strong increase in volume and the rather stable value exchanged. A monthly average of 6 812 domestic payments for a total value of 102.6 billion euros passed through LIPS-Gross.

On a daily basis, an average of 320 domestic payments for a total of 4.83 billion euros were processed.

The following graphic shows the evolution of domestic payment volumes on a monthly basis.

GRAPH 1 DOMESTIC PAYMENTS: MONTHLY VOLUMES IN 2001 AND 2002

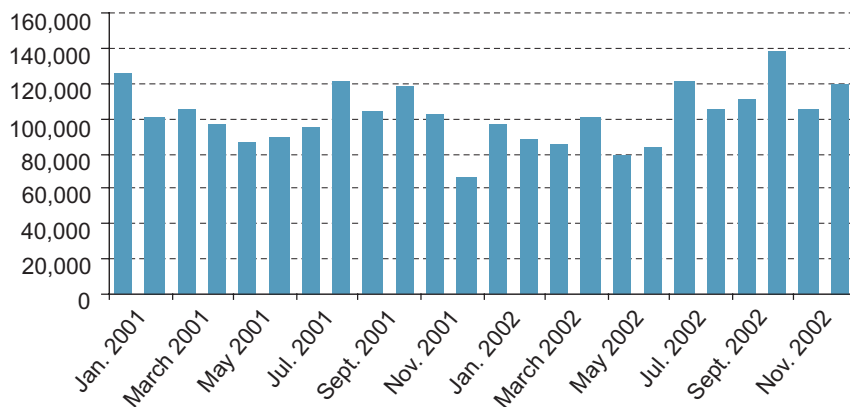


From February to June, lower volumes followed the strong increase of volumes of January 2002; the last months of the years showed again much higher volumes. On a global scale volumes increased strongly. Concerning the value of domestic payments, the BCL first noted a downward trend until June 2002 followed by increases starting in July. Globally, the value exchanged remained rather stable.

One reason for the increase of domestic volumes results from the fact that the depository Clearstream used LIPS-Gross from 1st July 2002 on as an interface for the cash accounts which Clearstream manages on behalf of its Luxembourg-based customers. This, however, had no effects on total value exchanged.



GRAPH 2 DOMESTIC PAYMENTS: MONTHLY VALUE IN MIO EURO IN 2001 AND 2002



#### 4.1.2.2 Cross-border payments

In 2002, LIPS-Gross participants sent 265 757 payments to other RTGS systems related to TARGET (231 852 payments in 2001) for a global value of 3 197 billion euros (3 221 billion euros in 2001). They received 297 862 cross-border payments (267 751 payments in 2001) for a total value of 3 199 billion euros (3 224 billion euros in 2001).

As for domestic payments, volumes of cross-border payments increased strongly, by 14.6% and 11.2% respectively. The value of payments, however, remained stable and as a consequence the average value per payment decreased.

Due to the stronger increase of domestic payments, the part of cross-border payments (in and out) in all the payments treated by LIPS-Gross declined slightly in comparison with 2001 and made up 87.3% (88.9% in 2001) of the volume and 83.9% (84.2%) of the value of all payments exchanged.

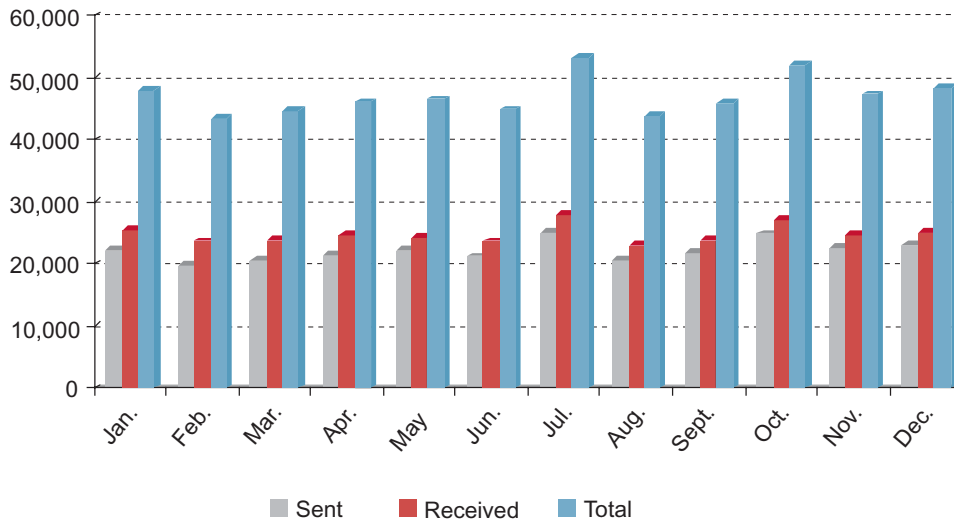
Average values for 2002 and annual variation rates in comparison with 2001 are indicated in the following table:

TABLE 1 CROSS-BORDER PAYMENTS

	Payments sent	Payments received	Value sent (EUR m)	Value received (EUR m)
Daily average	1 053	1 159	12 539	12 569
Monthly average	22 146	24 822	266 445	266 550
Variation	+14.6%	+11.2%	-0.7%	-0.7%

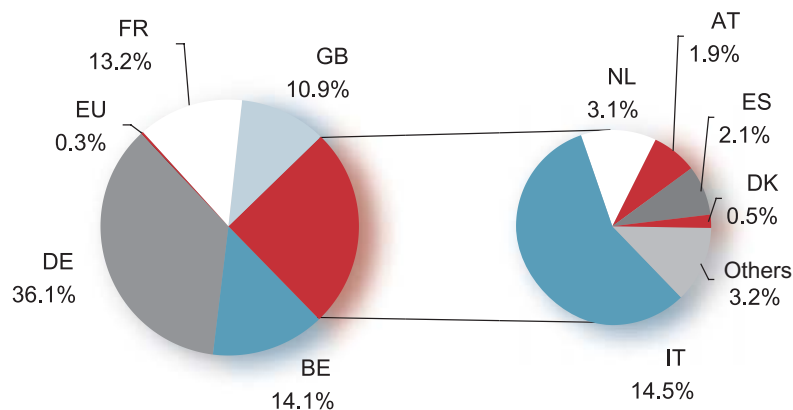
The following graphic shows the evolution of cross-border payments in volume. It confirms the traditional trend of RTGS-L members receiving more payments than they sent. After strong volumes in January, the further evolution turned out rather erratic, nevertheless showing a clear global upward trend.

GRAPH 3 LIPS-GROSS: CROSS-BORDER PAYMENTS



As in 2001, a majority in value of cross-border payments was exchanged with Germany (47.5% against 47.1% in 2001), Belgium (12.3% against 12.9% in 2001) and France (10.5% against 11.7% in 2001). The total part of the value exchanged with our neighbouring countries showed a decrease: 70.3% against 71.7% in 2001. Payments with the United Kingdom represented 10.8% of the total and those with Italy 5.2%. These percentages show some variations per volume and the most significant variations concern Germany and Italy.

GRAPH 4 LIPS-GROSS: CROSS-BORDER PAYMENTS PER VOLUME PER COUNTRY



In 2002, the Luxembourg banks achieved a positive balance of 1.3 billion euros with foreign banks. In 2001, this figure reached 2.1 billion euros. As in 2001, the ECB in Frankfurt as the clearing bank for EURO1, a multinational compensation system in euros, was an important supplier of liquidities – Luxembourg participants in this system have structural credit balances – whereas exchanges with Germany showed an important net transfer of funds in favour of our neighbour.

#### 4.1.2.3 Aggregated figures of domestic and cross-border payments

The following table gives a global overview of daily average volumes and values exchanged per year. Volumes continue to increase whereas values exchanged remain stable at a high level.

TABLE 2 DAILY AVERAGES OF VOLUMES AND VALUES OF PAYMENTS EXCHANGED IN THE DIFFERENT YEARS

	Volume of payments			Total	Value of payments (EUR m)			Total
	Domestic	Cross-border sent	Cross-border received		Domestic	Cross-border sent	Cross-border received	
1999	206	624	702	1 532	2 805	8 675	8 657	20 137
2000	240	809	973	2 022	3 937	11 069	11 044	26 050
2001	246	915	1 056	2 216	4 750	12 717	12 726	30 193
2002	320	1 053	1 159	2 532	4 830	12 539	12 569	29 938

#### 4.1.2.4 LIPS-Gross in comparison to other systems connected to TARGET

In 2002, all national RTGS systems together processed a total of 50.8 million of domestic payments (42.2 million in 2001) for a total value of 271 916 billion euros (201 428 billion euros in 2001). With 81 749 domestic payments for a total of 1 231 billion euros, Luxembourg represented 0.16 % of the volume and 0.45 % of the value.

In addition TARGET treated 13.7 million cross-border payments (11.5 million payments in 2001) for a total of 123 722 billion euros (128 481 billion in 2001). Luxembourg contributed by 1.94% to this volume and by 2.58% to the value exchanged.

#### 4.1.2.5 Availability of TARGET

The global availability of TARGET reached 99.77 % in 2002 after 99.75% in 2001. The average figure for the 4 years of existence of TARGET is 99.60%.

After 99.98% in 2001, the availability of LIPS-Gross averaged 99.92% in 2002, reaching 100% during nine months out of twelve. In August, October and December minor incidents on the SWIFT network reduced the availability to 99.69%, 99.76% and 99.54%. The average availability for the 4 years of existence of LIPS-Gross is 99.55%.

## 4.2 Evolution of the Interbank netting system LIPS-Net

As 2001, 2002 may be considered as a year of consolidation for the electronic interbank netting system LIPS-Net, which has continued to offer to the Luxembourg banking community a fast and efficient tool for channelling domestic credit transfers and cheques. The European regulation on the harmonisation of fees for domestic and cross-border credit transfers will come into force in July 2003. This regulation will gradually change the European payments infrastructure landscape. Therefore, the consolidation process in the European retail infrastructure will require close monitoring and appropriate decisions will need to be taken with regard to the future evolution of the system in order to avoid isolation within the euro zone.

### 4.2.1 Operations in 2002

In 2002, the number of transactions exchanged through LIPS-Net has increased by 4.3% and reached a total of 13.69 million operations. The total value of operations has amounted to 48.16 billion euros (+ 0.88% compared with 2001). The daily average volume of transactions was of 54 541 operations. The highest volume has been recorded on 3rd of April with 112 472 operations.

Since October 2000, CETREL has introduced transactions related to the settlement of balances of debit and credit cards into LIPS-Net. Originally, these data were integrated with credit transfers and cheques figures and it was impossible to separate these statistics from the others. It is now possible, however, to distinguish figures related to the settlement of balances of credit and debit cards. This is why figures presented in the present annual report may differ slightly from the figures presented in the 2001 annual report.

Henceforth, operations of settlement of balances of debit and credit cards will be presented separately.

TABLE 3 OPERATIONS EXCHANGED IN THE INTER-BANK NETTING SYSTEM

	2001	2002	Variation
Number of <b>credit transfers</b>	12 556 252	13 292 580	5.86%
Value of credit transfers (1)	40 145	40 026	-0.30%
Average value per credit transfer	3 197	3 011	-5.82%
Number of <b>cheques</b>	544 699	379 373	-30.35%
Value of cheques (1)	3 639	3 334	-8.39%
Average value per cheque	6 681	8 788	31.53%
Number of transactions related to the <b>settlement of balances of debit and credit cards</b>	20 311	17 938	-11.68%
Value of transactions related to the settlement of balances of debit and credit cards (1)	3 958	4 803	21.34%
Average value per transaction related to the settlement of balances of debit and credit cards	194 893	267 775	37.40%
<b>Total number of operations</b>	<b>13 121 262</b>	<b>13 689 891</b>	<b>4.33%</b>
<b>Total value of operations (1)</b>	<b>47 743</b>	<b>48 163</b>	<b>0.88%</b>
<b>Average value per operation</b>	<b>3 639</b>	<b>3 518</b>	<b>-3.31%</b>

(1) millions of euro

#### 4.2.1.1 Credit transfers

The total volume growth is exclusively due to credit transfers, which have increased by 5.9% to reach 13.29 million operations. The value of credit transfers, however, remained stable (-0.30%) to reach a total value of 40.03 billion euros. Concerning volume, credit transfers represented 97.1% of transactions exchanged in 2002 (95.7% in 2001). On the other hand, the value of credit transfers represented only 83.1% of the total value (84.1% in 2001).

#### 4.2.1.2 Cheques

Concerning cheques, the withdrawal of the Eurocheque guarantee at the end of 2001 explains the strong decrease in volume (-30.4% compared with 2001). The decrease was smaller in value terms (-8.4% compared with 2001) and the average value of cheques increased from 6.681 to 8.788 euros.

#### 4.2.1.3 Operations related to the settlement of debit and credit cards

Insofar as these operations are not retail operations but settlement operations between cards issuing institutions, it is important to mention them separately.

The total value of these operations was very high as it represented 10% of the value of total operations exchanged through LIPS-Net.

#### 4.2.2 Technical changes

From a technical point of view, the new security infrastructure installed at the end of 2001 has been upgraded in order to meet the security level initially foreseen. This last step closed the security architecture replacement project.

#### 4.2.3 Membership

On 31 December 2002, the number of direct participants connected to LIPS-Net amounted to 13, the same figure as at end-2001.

### 4.3. Eligible assets and their use for monetary policy operations

#### 4.3.1. Categories of collateral

All Eurosystem credit operations are based on adequate collateral provided by the counterparties. In order to protect the Eurosystem from incurring losses in its monetary policy operations, and in order to ensure an equal treatment of counterparties throughout the euro area, collateral has to fulfil precise and common criteria.

Owing to existing disparities in Member States' financial structures, a distinction has been made between two categories of assets eligible for ESCB monetary policy operations. These two categories are referred to as "tier 1" and "tier 2".

Tier 1 consists of marketable debt instruments fulfilling uniform euro area wide eligibility criteria specified by the ESCB. Tier 2 consists of additional assets, marketable and non-marketable, which are of particular importance to national financial markets and banking systems. Eligibility criteria are established by the NCBs, which become thereby guarantors. The specific eligibility criteria for tier 2 applied by the respective NCBs are subject to approval by the ECB.

#### 4.3.2. Collateral in Luxembourg and in the euro zone

At the end of December 2002, the domestic counterparties deposited eligible assets for a value estimated at 42.7 billion euros at the BCL. They were essentially made up of tier 1 assets (98.3%). 57.8% have been issued by credit institutions, 29.7% by central governments or local communities, 9.7% by corporations and 1.2% by supranational issuers.

Luxembourg counterparties significantly use eligible cross-border collateral. In 2002, 37.9% of all eligible collateral deposited by Luxembourg counterparties were used via the Correspondent Central Banking Model (CCBM) and 31% via the eligible links between national custodians. The proportion of domestic securities has increased in 2002 (31%) following a significant increase in eurobond issues, which reflect the considerable international activity of banks established in Luxembourg.

In December 2002, the average usage of CCBM in the euro zone was of 26.7% whereas domestic securities held with the national custodians represent 68% and securities held through links between securities settlement systems represent 5.3%.

### 4.4. Securities settlement systems

Article 18 of the statutes of the ESCB and the ECB provides that "In order to achieve the objectives of the ESCB and to carry out its tasks, the ECB and the national central banks may conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral".

In order to ensure "adequate collateral", the ESCB ensures that the securities settlement systems are of a high standard. These standards include technical, legal and operational safety. They maintain the safety of domestic securities but also the safety of the cross-border use of collateral.

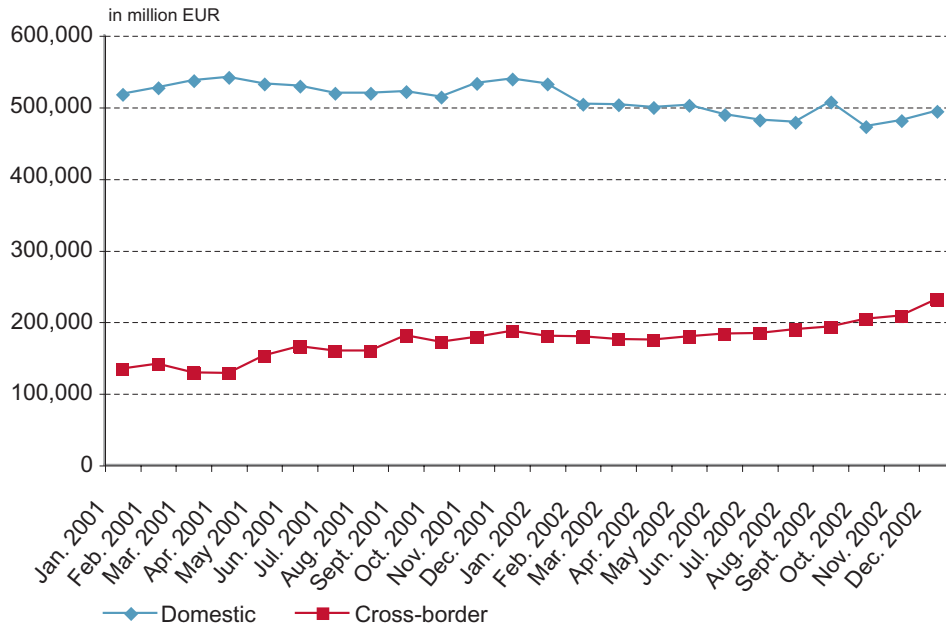
Besides using eligible domestic securities settled via the national Central Securities Depository (Clearstream Banking Luxembourg for the Luxembourg counterparties, CBL), the ESCB counterparties may receive credit from their local NCB by using collateral located in another Member State of the ESCB. Cross-border collateral can be mobilised by using either the CCBM, or links as described in 4.3.2.

Since 1999, following regular in-depth assessments, the Governing Council of the ECB has approved the use of some unilateral and / or bilateral links between different Securities Settlement Systems (SSS). These links enable counterparties to use securities held in one SSS of the EU but issued in another European country as collateral in credit operations in the ESCB. Thus, a Luxembourg bank can pledge to the BCL German securities, which were issued in Clearstream Banking Frankfurt (CBF), since the link CBL – CBF has been formally authorised by the ESCB.

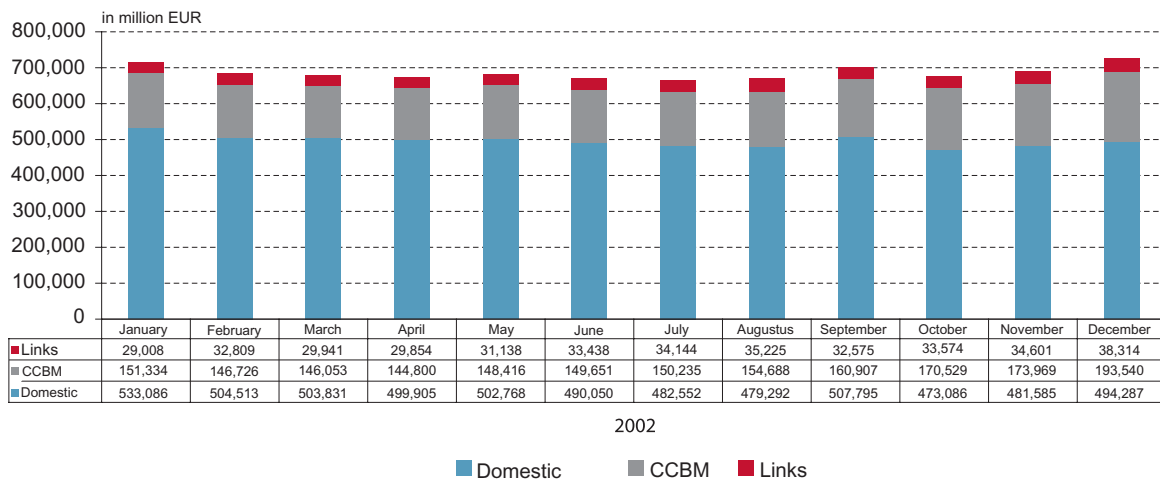
CBL has approved links with Euroclear, the National Bank of Belgium, Monte Titoli (Italy), VP (Denmark), OeKB (Austria), Euroclear Netherlands and CBF. The approval of these links enables Luxembourg counterparties to use securities issued in these systems as collateral.

There is an increase in the use of cross-border securities (securities held in a country different from the issuance country) as collateral within the euro area. This increase, although gradual, indicates the development of a single capital market (see graphic below).

GRAPH 5 VALUE OF DOMESTIC SECURITIES COMPARED TO CROSS-BORDER SECURITIES



GRAPH 6 TOTAL VALUE OF SECURITIES DEPOSITED WITH THE EUROSISTEM



#### 4.5 Correspondent Central Bank Model (CCBM)

In the framework of the CCBM each NCB acts on behalf of the other central banks as a custodian for securities accepted by its national Central Securities Depository or by its SSS. The correspondent central bank (CCB) receives the securities in custody and the home central bank (HCB) grants the credit.

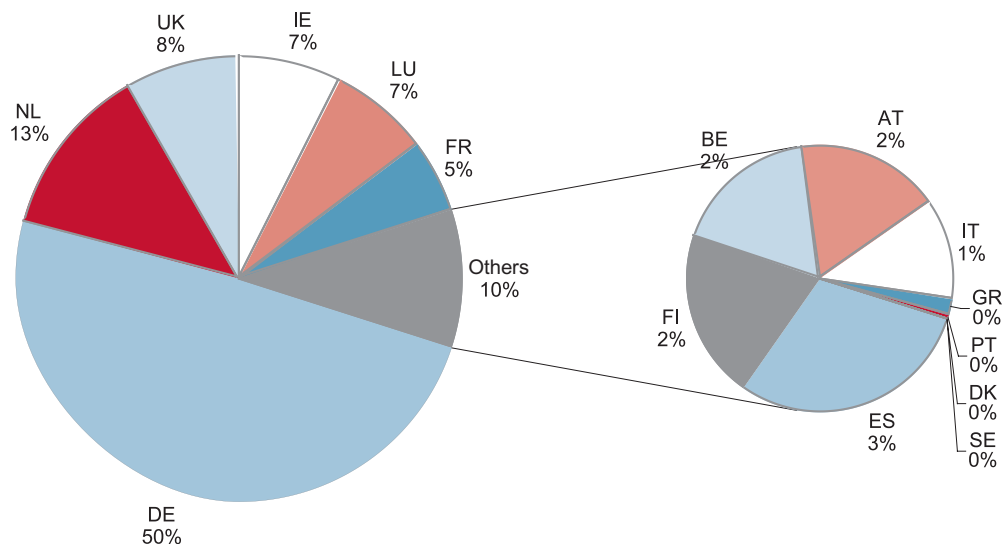
The model has been operational since the start of EMU. Experience acquired during the first years has shown that the CCBM is successful with the counterparties. Indeed, the value of securities in deposit has been steadily growing to 193.54 billion euros at the end of 2002. 26.7% of all eligible assets in the Eurosystem are held via the CCBM.

In 2002, the use of the CCBM has been very asymmetrical. The most active correspondent central banks have been Italy (26%), Luxembourg (21%), Belgium (15%) and Germany (14%).

Among the biggest users of the CCBM appeared the counterparties from Germany (50%), the Netherlands (13%), Great Britain (8%), Ireland (7%), Luxembourg (7%) and France (5%).

The cross-border use of tier 2 assets remains marginal.

GRAPH 7 HCB-2002



#### 4.6 Night Time Link with Clearstream Banking Luxembourg

During the second half of 2002, BCL and CBL have introduced a new procedure enabling Luxembourg Banks to improve the use of their assets deposited with BCL while increasing the financial safety of their security settlements with CBL during the night processing.

This procedure called Night Time Link (NTL) consists of 2 parts:

1. CBL's client can use the assets available at BCL (securities and cash) to guarantee intraday credit which CBL grants in order to settle its securities transactions carried out during the night processing.
2. At the end of CBL's night processing, the reimbursement of overnight credit is carried out automatically through a book entry on the client's account with BCL.

BCL considers that NTL, while offering new collateralisation possibilities to the banking community, contributes to the improvement of the security of transactions. This procedure also allows the banks to centralise their treasury management.



# V

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# FINANCIAL STABILITY

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## 5 FINANCIAL STABILITY

In the field of financial stability, the BCL reinforced its framework in 2002. This pertains, on the one hand, to the analysis of the financial sector from a macro-prudential point of view and, on the other hand, in accordance with the law, to the oversight of payment and securities settlement systems in which the BCL participates. This reinforcement extends the efforts undertaken within the ESCB, where the links between monetary and financial stability are well established.

### 5.1 Macro-prudential surveillance

#### 5.1.1 Regular monitoring activities

The macro-prudential surveillance of the financial sector is based on the regular reporting of credit institutions as well as on specific information complemented by direct contacts with market players. More specifically, the surveillance relies on a follow-up of the activities and results of the financial sector as a whole and of systemically important credit institutions in particular.

In order to monitor the soundness of the Luxembourg banking sector and to detect its potential vulnerabilities, the BCL has set up a system of macro-prudential indicators. The BCL has thus reinforced its macro-prudential surveillance; its efforts are embedded in those carried out at the international and especially at the European level in the prevention of systemic risk.

The BCL indicators cover Luxembourg law credit institutions, including their foreign branches. The indicators basically follow the so-called CAMELS approach. They highlight developments in the banking sector in the fields of capital adequacy, asset quality, management soundness, earnings, liquidity and sensitivity to market risk, and are complemented by indicators pertaining to competitive conditions. The assessment generally takes into account the simple average, the weighted average and the standard deviation of the respective indicators.

Two publications were made in relation to the indicators in 2002. The first text, published in BCL Bulletin 2002/2, provides a description of the methodology and the results for the years 1999 to 2001. The second text, published in December 2002 in BCL Bulletin 2002/4, comments the evolution of a sample of the more important indicators until September 2002. Further publications are planned on a regular basis.

The unfavourable international economic and financial environment in 2002 has affected the Luxembourg financial sector. Because of its high economic opening degree, it has been confronted to pressures that have affected its financial results. Thus, both the return on assets and the return on equity have decreased; the return on assets has fallen back to its 1999 level. Large exposures as well as the volume of credit outstanding have declined, both in nominal and in real terms. Exposures towards related entities have intensified. Nevertheless, Luxembourg banks are well capitalised and their liquidity ratio stands comfortably above the prudential threshold. Credit risk remains limited. Although the results do not lead to the conclusion of an apparent systemic risk, the evolution of some ratios and the uncertain economic and financial context call for heightened vigilance of the authorities. Market players have initiated measures aimed at structural adjustment and cost reduction.

Institutionalising cooperation with the supervisory authority, following the example of the other Monetary Union members, could strengthen work in the fields of financial stability, systemic risk and crisis prevention.

#### 5.1.2 Specific analyses and studies

In 2002, the BCL analysed the cyclicity of the Luxembourg banking sector from 1993 to 2001. The study highlights the interaction between the real economy, measured by the GDP growth rate, and various activity and performance variables of the banking sector. The results show a cyclical pattern for a large number of banking variables, in particular for credit activity, securities, provisions and own funds. A distinct relationship with the business cycle, however, is less pronounced for most of the revenues variables. These variables generally show a higher correlation with the national rather than with the

European economy. The result underlines the importance of the banking industry for the national economy.

The BCL has also contributed to the elaboration of several specific studies, notably within the framework of the Banking Supervision Committee of the ESCB. The BCL has continued its work regarding the geographical distribution of the activities of the major European banking groups and markets as well as the instruments for credit risk transfer.

The first study shows strong differences in the degree of “Europeanisation” as well as in the configuration of assets and the relative importance of assets held abroad. The main activities developed abroad relate to commercial banking and retail banking, but regional specialisations do exist, as for example in Luxembourg. Nearly all large European banking groups are active in the United States and in the United Kingdom. Overall, the banking groups are fairly evenly split in their preference for developing activities through branches or subsidiaries.

The second study observes the rapid recent emergence of a global credit risk transfer market, not only between banks themselves, but also between banks and other financial institutions like insurance companies and investment funds. This phenomenon is accompanied by the emergence of new financial instruments such as asset backed securities, collateralised debt obligations or credit default swaps. In General, these instruments can be distinguished according to the structure of their underlying credit (simple or portfolio) and to their fungibility. Credit risk transfer activities can increase market efficiency and allow for a better diversification and improved risk management. They are thus beneficial from a systemic stability point of view. Additional work concerning data availability, the changing relationships between creditors and debtors, imperfect contracts and the influential role of rating agencies in the evaluation of credit risk transfer products is deemed necessary. In Luxembourg, interviews conducted with a limited number of banks have revealed that they are principally buyers of investment grade credit risk transfer products. In light of the continuous growth and evolution of the market, a follow-up of these activities seems appropriate.

### 5.1.3 European cooperation

At the European level, the BCL contributes to the macro-prudential and structural analyses of the financial sector of the Banking Supervision Committee (BSC) of the ESCB. This committee produces, among others, a semi-annual stability report and an annual structural developments report on the EU financial sector. A Memorandum of Understanding between banking supervisors and central banks on co-operation in crisis situation has been endorsed by the Governing Council of the ECB. This document aims at contributing to an enhanced cooperation between the authorities, without prejudice to their actual competences. The practical arrangements for implementation in Luxembourg are not yet specified.

The analysis at the European level shows that credit conditions have tightened and that profitability has fallen back to its average of the 1995-99 period. The banks have, however, been resilient and remain well capitalised. Potential risk sources for the sector are namely:

- geopolitical risk;
- further decline of the stock markets;
- increased vulnerability of firms in the present economic context; and
- the possibility of an emerging markets crisis.

The structural analysis reveals in particular that European banks have developed alternative investment strategies. The advanced consolidation has eliminated some of the less efficient actors. The biggest banks are in a wait and see position concerning further domestic or cross-border consolidation. They are making resolute efforts to cut costs, restructure their organisation, concentrate on their core businesses and develop a multi-channel distribution for their products. Work on a new Basle capital accord has spurred improvements in risk management techniques. Possible procyclicality effects of the new accord are being discussed.

The BCL hosted the 17th meeting of the BSC on 15 April 2002. This committee is composed of representatives of NCBs, of supervisory authorities and of the ECB.



#### 5.1.4 International cooperation

The IMF published its first report on the stability of the Luxembourg financial sector within the framework of its Financial Sector Assessment Program (FSAP) in June 2002. The BCL has contributed to this IMF mission. The IMF concluded that the Luxembourg financial sector is sound, efficient and well supervised. According to its assessment, the principal source of vulnerability of the Luxembourg financial place resides in its outward openness and its sensitiveness towards reputational risk. The sector could suffer from the impact of shocks arising from interbank activities. The BCL intends to deepen its analysis in this field in 2003.

The BCL contributes on a best effort basis to the necessary strengthening of the international financial architecture.

### 5.2 Oversight of payment and securities settlement systems

#### 5.2.1 General activities

The operators of the payment and securities settlement systems that have been notified by the BCL to the European Commission on 12 February 2001 are subject to the BCL's oversight. These operators are the following: RTGS-L Gie (LIPS-Gross), SYPAL Gie (LIPS-Net) and Clearstream Banking Luxembourg. Moreover, the following technical agents are currently subject to oversight: the BCL for LIPS-Gross, CETREL for LIPS-Net and Clearstream Services for operational and IT services.

The oversight is based on a system of regular and *ad-hoc* reportings being for instance general information, business statistics, financial reporting, reportings from units in charge of compliance, internal audit and risk management, as well as direct contacts with the operators. In addition, operators have been invited, in the context of a self-assessment exercise requested by the BCL oversight policy and procedures, to give a detailed assessment of their compliance with criteria related to access to the system, governance, products and services, IT, risk analysis and risk mitigation techniques, business continuity solutions, relations between operators / technical agents / participants / suppliers, the use of contracts and by-laws, the legal framework and standards of the industry and of capital market bodies.

Moreover, the modification in the shareholder structure of Clearstream and the projects of integration of Deutsche Börse Group required a specific follow-up and an analysis of potential consequences, in particular as regards new risks for the operator, the smooth functioning of the system and the impact on the oversight mission of the BCL.

Finally, the BCL defined LIPS-Net, the national net interbank payment system, as systemically important notably because of its importance in the Luxembourg economy.

In accordance with a principle pointed out in the "Core principles for systemically important payment systems" and a recommendation of the IMF, the BCL has put in place a strict separation of oversight and operational activities.

#### 5.2.2 Specific analysis and studies

The BCL Bulletin 2002/2 presents the role of the BCL in the field of oversight of systems. This analysis describes the objectives and the legal framework of the oversight mission, as well as its detailed practice. Other subjects presented in the analysis are: the potential risks within payment and securities settlement systems, the main studies under way as regards oversight and the relations with other authorities and with the operators.

In addition, the BCL made a specific analysis of the risks run by payment and securities settlement systems, (nature and probability of materialisation) and of the mitigation techniques. This analysis also measures the impact of these risks on the oversight mission of central banks. Subsequently, it describes an oversight framework suitable for both payment and securities settlement systems, including the development of tools for the evaluation and mitigation of risks. The aim is to allow for a comprehension of existing and future risks, an evaluation of the availability and efficiency of the mitigation techniques currently used by the market, as well as a prompt reaction of the overseers in case of crisis. This study has been published on February 2003.

### 5.2.3 Protection of payment and securities settlement systems against crime and terrorism

The prevention of systemic risk is notably based on the compliance with the rules applicable in the field of money laundering, of financial sanctions and of fight against terrorism. In this context, the BCL issued, on 28 June 2002, the circular BCL 2002/172 "Protection of payment and securities settlement systems against crime and terrorism". The operators are required to report to the BCL the procedures put in place in order to comply with the legal framework. This circular also requests from the addressees to keep track (traçabilité) of the transactions performed by the systems. This means that operators have to enable, if necessary, the identification of the participants who introduce an order into the system and the participants who benefit from this transfer. Moreover, the addressees are required to call their participants attention to the need to fill up the messages used for the transfer orders completely and correctly.

### 5.2.4 European cooperation

Following a decision made by the ECB Governing council and the CESR (Committee of European Securities Regulators) in 2001, a working group, in which the BCL is a participant, has been put in place. The working group's objective is the development of standards for the activities of securities clearing and settlement. The work is based on the CPSS/IOSCO (Committee on Payment and Settlement Systems/International Organization of Securities Commission) recommendations in this field.

In the field of oversight, the BCL is also represented in the ESCB's Payment and Settlement Systems Committee (PSSC) and its subgroups. The objective of this committee is to assist the ESCB in the promotion of the smooth operation of payment systems, in particular by advising on the operation and maintenance of TARGET and of the CCBM (Correspondent Central Banking Model), on the general payment systems policy and oversight issues and on issues of interest for central banks in the field of securities clearing and settlement systems.

The ECB Governing council approved a general framework for the oversight of TARGET to ensure, among others, the respect of the Core Principles for Systemically Important Payment Systems. The decision has been taken of a separation of the oversight and operational functions within the PSSC, entrusting the oversight function to the Payment Systems Policy Working Group subgroup and recommending a separation within the central banks. An assessment of a potential conflict of interests between the operational and oversight functions of payment systems, operated both at the PSSC level, will be done within the next two years.

### 5.2.5 International cooperation

In the context of the FSAP, mentioned above (5.1.4), the IMF has welcomed the Bank's implementation of its oversight mission concerning payment and securities settlement systems. Moreover, the IMF pointed out the observance of various standards and codes approved by international organisations and the payment systems' efficiency and soundness.



# VI

ANNUAL REPORT 2002



# EXTERNAL COOPERATION

## VI EXTERNAL COOPERATION

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## 6 EXTERNAL COOPERATION

### 6.1 Activities with the International Monetary Fund (IMF) and other international organisations

The BCL handles Luxembourg's financial transactions with the IMF. For this purpose, it manages Luxembourg's assets and liabilities *vis-à-vis* the IMF in both the general account and the Special Drawing Rights (SDR) account. On 31 December 2002, Luxembourg's quota, entirely recorded in the BCL balance sheet, amounted to SDR 279.1 million, whereas the reserve position (the difference between Luxembourg's total quota at the IMF and the euro-denominated assets held by the IMF at the BCL) represented 37.5% of the Luxembourg quota.

The IMF's operational budget defines the currencies to be made available to its members on a quarterly basis. During 2002, the BCL contributed for € 55.4 million to IMF operations

At the end of 2002, Luxembourg held 39.6% of its SDR allocation (29.5% in 2001) following the accumulation of net interest received on the SDR account and on the reserve position. On 31 December 2002, the amount recorded on the SDR account was SDR 6 720 571.

The BCL also participated in several OECD and BIS working groups, such as the OECD Financial Markets Committee (FMC) and the BIS Committee on the Global Financial System (CGFS). The latter Committee continued monitoring international capital markets and the developments in the global financial system.

### 6.2 European activities

#### 6.2.1 Governing Council

The President of the BCL is a member of the Governing Council of the ECB, which further includes six Executive Board members and the 11 other NCB Governors of the euro area. In 2002, the Governing Council held 22 meetings.

At its meeting on 19 December 2002, the Governing Council of the ECB unanimously decided on the contents of its proposal on the future adjustment of its voting modalities. This proposal is made in accordance with the ECB "enabling clause" contained in the Nice Treaty (article 10.6).

According to the current institutional arrangements, the Governing Council consists of 6 Executive Board members and up to 15 NCB Governors. In order to maintain the Governing Council's capacity for efficient and timely decision-making as its membership increases substantially, the Governing Council agreed that the number of NCB Governors exercising a voting right should not exceed 15.

When the number of NCB Governors exceeds 15, or possibly 18, they will exercise a voting right on the basis of a rotation system. Each member of the Executive Board will maintain a permanent voting right. The rotation system is designed to ensure that the NCB Governors with the right to vote are from Member States which, taken together, are representative of the euro area economy as a whole. Consequently, the NCB Governors will exercise a voting right with different frequencies depending on an indicator of the relative size of the economies of their Member States within the euro area. The first criterion, GDP at market price, represents the relative size of the economy. The second criterion, aggregated balance sheet amount of monetary financial institutions (MFIs), represents the importance of the financial sector. As a matter of fact, it is important that the financial sector is significantly represented for central bank decisions. Based on these indicators, NCB Governors will be allocated to different groups. This allocation determines how often they can exercise a voting right. Initially, there will be two groups. Once there are 22 euro area Member States, there will be three groups. The first group will be composed of 5 governors, the second group of half of the total number of governors rounded up, the third group of the remaining governors. According to current projections, the Luxembourg governor will be a member of the second group. This is also likely to be the case in the final configuration, together with the majority of the current governors of the Governing Council.

All NCB Governors will continue to participate in the discussions of the Governing Council and attend the meetings in a personal and independent capacity. All members of the Governing Council exercising a voting right will do so on the basis of the "one member, one vote" principle.



The final decision of the Governing Council will be formally adopted in the form of an ECB Recommendation as soon as the Treaty of Nice enters into force and will be submitted to the EU Council. The EU Council, meeting in the composition of Heads of State or Government, shall then decide unanimously on an adjustment of the voting modalities in the Governing Council, on the basis of the ECB Recommendation and after taking account of the opinions of the European Commission and the European Parliament. The agreed amendment will then be recommended to the Member States for ratification in accordance with their respective constitutional requirements. It does not change the weighted voting procedure for those issues on which all NCB Governors vote as shareholders of the ECB.

### 6.2.2 ESCB Committees

ESCB Committees are made up of ECB and NCB staff. Enlarged meetings may be held to include the representatives of NCBs from non-Eurosystem EU countries. Upon implementation of the accession treaties, NCBs of accession countries will be allowed to send observers to these enlarged meetings. These Committees report, through the Executive Board, to the Governing Council. Specialised working groups and task forces assist these committees. In total there are 13 committees:

- Accounting and Monetary Income Committee, "AMICO",
- Banking Supervision Committee, "BSC",
- Banknote Committee, "BANCO",
- External Communications Committee, "ECCO",
- Information Technology Committee, "ITC",
- Internal Auditors Committee, "IAC",
- International Relations Committee, "IRC",
- Legal Committee, "LEGCO",
- Market Operations Committee, "MOC",
- Monetary Policy Committee, "MPC",
- Payment and Settlement Systems Committee, "PSSC",
- Statistics Committee, "STC",
- Budget Committee, "BUCOM".

### 6.2.3 Economic and Financial Committee (EFC)

A BCL representative participates in the EFC meetings. The EFC is composed of representatives of Finance Ministries and central banks of EU Member States, the European Commission and the ECB. According to the Treaty on European Union, the EFC is to "review the economic and financial situation of the Member States and of the Community and to report regularly thereon to the Council and to the Commission". The EFC contributes to multilateral surveillance in order to monitor compliance of Member States' economic policies with the broad economic policy guidelines and with the Stability and Growth Pact. Moreover, the EFC prepared the ministerial level dialogue with accession countries regarding their economic policies. The EFC also contributed to streamlining the annual economic and employment policy coordination procedures. In a key report, the EFC proposed to extend the "Lamfalussy" approach to all financial markets to make EU agreements in matters of financial regulation, supervision and stability more efficient, more effective and more flexible. Finally, the EFC also worked on economic policy issues discussed at informal ECOFIN meetings, which are attended by the BCL President.

### 6.2.4 Committee on Monetary, Financial and Balance of Payments Statistics

The Committee on monetary, financial and balance of payments statistics (CMFB) was established by a Council Decision in 1991 to assist the European Commission in drawing up and implementing work programs concerning monetary, financial and balance of payments statistics. The CMFB is the forum for



co-ordination of statisticians from the National Statistical Institutes and Eurostat on the one hand, and the NCB and the ECB on the other.

During 2002, progress has been achieved with regard to the statistics on financial accounts, balance of payments, financial services, public finances as well as national accounts.

### 6.2.5 European Convention

The Convention was created following the European Council in Laeken in December 2001, as preliminary talks for the intergovernmental conference starting after the execution of the accession countries. It is organised on the basis of monthly plenary meetings, during which the reports of the different working groups are discussed (11 groups, including the new group on Social Europe).

The President of the Convention, Mr. Valéry Giscard d'Estaing, presented a first draft of the architecture of the constitutional treaty. The EU will be granted the status of a single juristic personality, which entails the merger of the EC and EU treaties. The current three-pillar structure of the EU will thus be reviewed. The Treaty will be structured into 3 sections: institutional architecture, EU policies and actions and final clauses. The drafting of the specific provisions will include the final findings of the various working groups.

The economic governance group planned to keep the institutional *acquis* in monetary matters. Almost all the provisions of the Maastricht Treaty will be taken up again by the treaty. The group proposes to uphold the principle following which Member States remain in charge of the economic policy making. The group, however, considers that coordination mechanisms could be improved. It proposes that the Commission should be able to issue proposals regarding broad economic policy guidelines and not only recommendations. The Commission, instead of the Council, would also have the power to issue first warnings directly to the concerned Member State. Moreover, it has been proposed that the Treaty specifies basic objectives, procedures and limits of the coordination method including an intervention of the European Parliament and the consultation of social partners.

The group advocates upholding the Union's competence in the fiscal field (articles 93, 95 et 175 TEC). Proposals have been made in order to modify voting rules in certain fields and to produce closer fiscal legislations, without prejudice to income tax.

With regard to financial markets, the group refers to the Lamfalussy approach, regarding regulation of the securities market. The group suggested to use such an approach for other financial sectors and to mention this in the treaty. Certain questions concerning the European Parliament's role, the "comitology" or the implication of central banks are still being discussed. Up to now, no agreement has been reached in the external relations field, in particular regarding representation of the euro zone at international organisations.

In this framework, several contributions are worth emphasising:

- The draft treaty introduced by M. Prodi, President of the Commission, suggesting a new appointment procedure for the President of the Commission, the acquiescence of the Commission to a double censorship, the creation of a position of Secretary of the Union, as well as the abolition of the unanimity rule.
- The memorandum of the Benelux countries, introduced on 4 December 2002, whose provisions aim at strengthening the Commission's powers. In particular, it proposes to extend the decision mechanism of the Council to the definition of economic policy within the euro area.
- The French German memorandum aims at strengthening the Eurogroup, improving coordination of economic policies, achieving fiscal convergence and proceeding towards a single chair for the external representation of the euro zone.

### 6.2.6 Stability and Growth Pact

At the end of November 2002, the Commission presented an announcement aiming at improving the interpretation of the Stability and Growth Pact and not at modifying it. The Commission proposed a four-point programme. Its main provisions aim at allowing increased fiscal flexibility to "virtuous" countries and at tightening discipline for "less good pupils" in terms of public deficit and public debt.

In a press release in October 2002, the ECB already had pointed out the importance of the Stability and Growth Pact and expressed its support for the Commission's initiative. In the EMU, which is characterised by a single monetary policy and 12 governments in charge of economic policy, an institutional framework regulating fiscal policy is absolutely necessary. The Stability and Growth Pact allowed to improve fiscal policies and thus contributed to price stability.

The Member States' main commitment under the Pact is to achieve a positive or close to balance fiscal positions in the medium term. In a few countries, the results are disappointing, as they were unable to use the recent period of high economic growth to improve their fiscal positions. Countries, which still experience fiscal imbalances, must commit themselves to following a consolidation strategy. Continued efforts must also be undertaken with regard to economic forecasts and measuring and control instruments on the national and European level.

### 6.2.7 Enlargement process

At the EU Council in Copenhagen on 12 and 13 December 2002, 10 countries have been invited to join the EU as of 1<sup>st</sup> May 2004, after the signature of the accession treaty in 2003. Bulgaria and Rumania will probably become members in 2007.

Although the Eurosystem has not been formally associated to the accession negotiations, it has initiated a productive dialogue with the NCBs of the accession countries and has provided a considerable technical assistance in its fields of expertise, notably regarding payment systems as well as in the legal and statistical areas.

The ECB decided in September 2002 that, upon signature of the accession treaty, the governors of the NCBs of the accession countries will be allowed to attend General Council meetings as observers in order to familiarise themselves with the functioning of the ECB. When their States become EU members in 2004, the governors of the NCBs of the accession countries will become full members of the ECB's General Council. Nevertheless, these NCBs will only become members of the Eurosystem, and their governors members of the Governing Council, after having adopted the euro.

## 6.3 National activity

### 6.3.1 External Committees

#### 6.3.1.1 Economic Committee (*Comité de conjoncture*)

In order to achieve its main objectives, the Eurosystem regularly monitors Member States' economies in the euro zone. In this framework, the BCL monitors current economic developments, in particular at the national level.

The *Comité de conjoncture*, established in 1975, acts within the existing legal framework authorising the Government to take measures meant to stabilise employment and growth. Thus, it provides a framework for examining business cycle fluctuations in the Luxembourg economy and for monitoring economic policy issues as they arise. The BCL participation in the *Comité de conjoncture* is twofold: on the one hand, the BCL collects information on Luxembourg's cyclical position; on the other hand, the BCL contributes to the Committee's work by monitoring and commenting on the latest developments in the monetary domain and in the financial sector.

#### 6.3.1.2 Consumer price index commission (*Commission de l'indice des prix à la consommation*)

The BCL participates as an observer in the Consumer price index commission, which is in charge of advising and assisting the STATEC in the preparation of consumer price indices. This Commission also issues technical opinions on the design of the monthly consumer price index and supervises compliance of this index with national and European regulations.



### 6.3.2 BCL committees

#### 6.3.2.1 Information Technology Committee

This committee mainly elaborated on:

- The events of 11 September 2001 and their consequences on the organisation of informatics in the financial centre;
- The evolution of payment systems with regard to IT;
- The progress of e-business in Luxembourg.

Regarding the reinforcement of contingency plans for IT operations, no changes have been noted since 11 September 2001. The trend is not to limit risk at any cost, but to make investment profitable by optimising organisation. However, the synergies from the common operation of an emergency infrastructure have not been fully exploited yet

With regard to the evolution of payment systems, a trend towards centralisation of computer processing has been noted, which will affect central banks more than commercial banks. The evolution of the SWIFT network could cause some problems to small banks, but it could also offer an opportunity for shared platforms.

The e-business in the financial sector suffers from the reduced business of a certain number of banks. Moreover, the strategy of public administrations remains uncertain in this field, where Luxembourg is lagging behind other countries.



#### 6.3.2.2 Legal Committee (CODEJU)

During 2002, the Legal Committee held two meetings in order to assist the BCL in its legal counsel missions. Activities were essentially related to the implementation of the Action Plan of Financial Services and to the European financial market integration. Related legal developments are detailed under chapter VII of this report.



#### 6.3.2.3 Fiduciary Money Committee

In 2002, the Fiduciary Money Committee, created in 1999 by the BCL as a forum for dialogue and exchange of ideas in matters of fiduciary money, held two meetings in order to analyse the state of progress and finalisation of the cash changeover. After the success of the cash changeover in Luxembourg, the meeting frequency of this Committee was reduced.



#### 6.3.2.4 Market Operations Committee

The Market Operations Committee (*Comité des Opérations de Marché*) was established in 1999 by the BCL and has been interacting as a forum between the BCL and bank experts since then. Discussed topics especially focus on issues such as monetary policy and other banking operations, as well as financial markets and their functioning.

The Committee has a consultative role and meets on a quarterly basis. It produces preliminary work in order to reach a common position for Luxembourg.

Eight experts from the BCL's main counterparties and three BCL members are members of this Committee. They are appointed in their personal capacity. They have extensive skills in operational fields such as treasury, security, front-office and back-office management. They share a wide expertise of financial markets and belong to senior management.

The improvement of the operational framework and of the efficiency of monetary policy, the European short-term security market and the collateral framework were among the topics addressed this year.



#### 6.3.2.5 Statistics Committee

The Statistics Committee was created by the BCL to maintain a permanent dialogue between the various institutions in charge of collecting statistics and the main users of statistical information.

The Statistics Committee acts as a consultative body and assists the BCL in its statistics collection mission. In this respect, it deals with statistics requests from international organisations (ECB, EUROSTAT, OECD, IMF...) as well as the needs of Luxembourg's financial centre. It analyses the means and resources available for meeting these requests, sees to the efficient organisation of data compilation, avoids overlapping activities and attempts to limit the workload of the entities which have to supply the data and by coordinating the needs expressed by different users. The Committee also contributes to the appropriate publication of the collected data.

During 2002, the Statistics Committee expressed its opinion regarding the new statistical reporting formats implemented to meet ECB requirements in the area of money and banking statistics as well as in the area of interest rate statistics. Committee members approved draft amendments regarding data collection presented by the Monetary and Financial Statistics Consultative Commission.

#### **6.3.2.6 Balance of Payments Consultative Commission**

The Balance of Payments Consultative Commission, created in the beginning of 2001, assists the BCL in its statistics collection mission in balance of payments and the global external position.

Commission members are informed of requests by international organisms and especially the ECB in matters of balance of payments statistics.

A meeting held at the end of 2002 discussed the new data collection system implemented on 1st January 2002. The Commission also prepared a study requested by the ECB to determine the feasibility of data collection based on individual identification of debt and equity securities. Members of the Commission and of other banks of the financial centre have provided, on a voluntary basis, information on the different proposed data collection scenarios and on the securities identification issue. This information allowed the BCL to finalise this study.

#### **6.3.2.7 Monetary and Financial Statistics Consultative Commission**

The Monetary and Financial Statistics Consultative Commission was created by the BCL during 2001. This Commission is to guarantee a timely and efficient achievement of monetary and financial data collection and to establish a permanent dialogue with reporting agents.

During 2002, the Commission held several meetings in order to contribute to the modification of BCL's statistical returns which came into force on 1st January 2003. These meetings aimed to promote dialogue between the BCL and representatives of credit institutions, collective investment institutions as well as the financial sector supervisory authority. The objective was to anticipate and solve potential technical difficulties arising from statistical data collection on the basis of the new ECB balance sheet and interest rate regulations.

#### **6.3.2.8 Settlement and Clearing Systems Committee (CSPRT)**

Composed of representatives of the Luxembourg financial sphere, the CSPRT has been created in 2001 with the aim of strengthening the communication between the BCL and the financial institutions established in Luxembourg. This objective is twofold:

On the one hand, the committee, through its members, keeps the financial market informed on relevant issues that are discussed at an international level, notably within the Eurosystem and the ESCB.

On the other hand, the CSPRT enables the BCL to gather the opinions of Luxembourg financial actors on issues linked to payment and settlement systems and to take them into account in decisions in which the BCL is involved.

Two meetings were held in 2002. The main topics for discussion were the implementation of the "SEPA" (Single European Payment Area) and the analysis of the existing contingency measures with regard to the events of 11 September 2001. The committee will continue to analyse these issues in 2003.

### 6.3.3 Professional training actions of the BCL

#### Actions with the ATTF

The Agency for the Transfer of Financial Technology (ATTF) offers training programs and consulting regarding banking and financial matters to transition and developing countries. Moreover the ATTF contributes to the promotion of the financial centre.

The BCL is a shareholder of the ATTF and is a member of its board of administration. BCL employees have held seminars of the ATTF for bankers and executives coming from third countries, notably Russia, Croatia, Vietnam, Mongolia and Egypt.

#### Other actions

On 16 and 18 April 2002, the BCL offered a training session to economics teachers. This training covered the following subjects:

- Institutional aspects of the EMU;
- Strategy and instruments of the Eurosystem's monetary policy;
- Operating of the Eurosystem's monetary policy;
- Settlement and clearing systems;
- Short comparison between Eurosystem and the Federal Reserve system.

### 6.3.4 External events

#### Governing Council in Luxembourg

The Governing Council meets twice a year in a place other than the ECB head office in Frankfurt. After a meeting in Maastricht in February 2002, the Governing Council held on 4 July 2002 its 100th meeting at the BCL premises in Luxembourg. Following this meeting, Mr. Wim F. Duisenberg, President of the ECB, and Mr. Yves Mersch, President of the BCL, gave a press conference. On this occasion, members of the Governing Council were granted an audience by HRH the Grand-Duke.

#### Cultural activities of the BCL

On Friday 25 October 2002, the BCL inaugurated the "*Feiersteppler*" monument, created by Mrs. Yvette Gastauer-Claire, and which was installed in front of the BCL building. The *Feiersteppler* is the most popular monetary image of Luxembourg's monetary history. As a matter of fact, the first coin of the *Feiersteppler* type has been put on the market in 1924 and this image has been used until 1991. The *Feiersteppler* is not only the symbol of the wealth of Luxembourg of yesteryear, but its birth is also the witness of an eventful era of its monetary history. The BCL raised this monument so that this symbol (the Luxembourg franc) stays alive in the collective memory.

#### The Bridge - Forum Dialogue

Yves Mersch is the President of the non-profit association The Bridge - Forum Dialogue, whose day-to-day management is performed by the BCL. Vice-Presidents of this association are Mr Gil Carlos Rodriguez Iglesias, President of the Court of Justice of the European Communities, Mr Juan Manuel Fabra Vallés, President of the European Court of Auditors and Mr Philippe Maystadt, President of the European Investment Bank. The association builds a link between European institutions established in Luxembourg and institutions and actors of the Luxembourg economic and financial life. This new information network organises events on topical political and economic subjects. In 2002, the Bridge Forum Dialogue held following conferences:

- "Lies, damned lies...can statistics contribute to good economic governance in Europe?" by Mr Yves Franchet, Director General of Eurostat;
- "High Noon: Twenty Global Problems, Twenty Years to Solve Them" by Mr Jean-François Rischard,

- Vice-President of the World Bank, in cooperation with the CEPROS (*Centre d'études prospectives*);
- "*L'espace de liberté, de sécurité et de justice : défis et enjeux pour l'Union*" with the participation of Mr Gil Carlos Rodríguez Iglesias, President of the European Court of Justice, Mrs Delmas-Marty, Professor at the Panthéon-Sorbonne university, Mr Luc Frieden, Ministre of Justice and Mrs Sorasio, personal representative of Mr Vitorino, member of the European Commission.

## 6.4 The BCL communication

During 2002, the BCL undertook to improve its communication strategy in general and towards the general public in particular. This new approach should notably entail the publication of a brochure presenting the BCL and its activity on a national, European and international level. For the first time, the BCL's annual report was fully translated into English in order to extend its readership as far as possible.

Unfortunately 2002 was marked by the passing away, on 24 June, of Mr Pierre Werner, former Prime Minister of Luxembourg and member of the BCL Council at its origin. The report of the group placed under his chairmanship, handed to the Heads of State and of Government of the EC Member States in 1970, contains the fundamental elements of what would become 30 years later the framework of the EMU and thus of the BCL. As a tribute to this visionary man, the BCL published a brochure (bilingual English-French) written by Mr Michael Palmer with the title "*Pierre Werner - In memoriam*".

### 6.4.1 Periodical Bulletins

In 2002, the BCL published 4 bulletins (no. 2002/1, 2002/2, 2002/3 and 2002/4). Besides the new messages and the economic and financial reports, the bulletins provided in 2002 analyses on following subjects:

- "*Les soldes budgétaires apurés des mouvements conjoncturels*"
- "*La production potentielle et l'écart de production au Luxembourg : une revue de méthodes alternatives*"
- "*L'Efficacité productive des banques luxembourgeoises : une analyse comparative*"
- "*Die Eurobargeldeinführung, regionale Preisentwicklung und die wahrgenommene Inflation der Verbraucher*"
- "A descriptive analysis of the Luxembourg financial structure: 1998-2001"
- "*Der Euro und Regionale Preiskonvergenz?*"
- "*La soutenabilité à long terme du régime général de pensions au Luxembourg*"
- "*Indicateurs macroprudentiels: résultats en 2002 jusqu'au troisième trimestre*"

Bulletin no. 2002/2 called "*Stabilité financière*" was a novelty in 2002. It was dedicated to the stability aspects of the financial systems, and closed a gap in the range of the BCL publications. It analysed following issues:

- "Macroprudential indicators on the Luxembourg Banking Sector for the years 1999-2001". This is an analysis of the Luxembourg banking sector on the basis of a macro-prudential indicators system implemented by the Central Bank and covering the Luxembourg credit institutions including their subsidiaries abroad.
- "*La surveillance des systèmes de paiement et de règlement des opérations sur titres à Luxembourg.*" These systems form a vital part of the economic and financial infrastructure and their good functioning is a major concern for central banks.

### 6.4.2 Working papers

The BCL working papers contribute to presenting the research of their respective authors. Four working papers have been published on the following subjects:

- Working paper no. 3, "*Economies d'échelle, économies de diversification et efficacité productive des*



*banques luxembourgeoises*". This study notably performs a comparative analysis regarding the evolution of productivity efficiency from 1995 to 2000 and questions the existence of economies of scale and variety in the performance of the banking activity. Moreover, the study explores the characteristics of the technological process of banks.

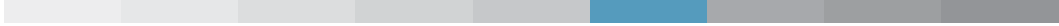
- Working paper no. 4 "Potential Output and the Output Gap in Luxembourg: some alternative methods". The author chose to describe, analyse and compare several alternative methods for the estimation of the output gap, defined as being the difference between the production level observed in the real economy and its potential level. Macroeconomic analysis often uses the output gap to estimate current and future inflationary pressure. Six of these methods have been applied to annual data for Luxembourg.
- Working paper no. 5 "Monetary transmission: empirical evidence from Luxembourg firm-level data". The aim of this study is to introduce first empirical results related to the monetary transmission process. More specifically, authors question the sensitivity of Luxembourg corporate investments to user cost of capital, the influence of monetary policy on the user cost of capital and the existence of a general credit channel. Thus, this study aims at analysing the impact of the interest and credit channel on investment decisions of non-financial companies in Luxembourg.
- Working paper no. 6, "The sustainability of the private sector pension system from a long-term perspective: the case of Luxembourg". This study tries to provide a first estimation of the budget situation of the general pension scheme in Luxembourg. Such an analysis is indeed confronted with multiple difficulties, as it is difficult to foresee the evolution of the determinants of the financial balance of the scheme over a few decades. Nevertheless, the Luxembourg economy shows various characteristics, whose effects stretch out over the very long term. In such a context, it is important to develop tools to be able to mark out future evolutions, if not foreseeing them. The BCL devised such a tool.

#### 6.4.3 Internet site

The Internet site [www.bcl.lu](http://www.bcl.lu) is an information and broadcasting channel, which is complementary to the other communication channels of the BCL. The site is set to increase in relevance within the communication channels of the Bank in the next few years. The BCL also wishes to open the site more largely to the general public. Currently, the site is destined to professionals (bankers, economists, statisticians, researchers...), but also to university students. The site offers news and information on the Bank's organisation and services. It includes a bilingual interface (French-English) and is updated on a daily basis. It is possible for "websurfers" to sign in on the mailing list of the Bank in order to be kept informed of news and recent statistics about the financial centre.

All BCL publications can be viewed and downloaded on the Internet site [www.bcl.lu](http://www.bcl.lu). Hard copies can be obtained at the BCL within the limit of available stocks.







# VII

ANNUAL REPORT 2002



# LEGAL ACTIVITIES

## VII LEGAL ACTIVITIES

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## 7 LEGAL ACTIVITIES

Legal activities of the Bank encompass the general follow-up of legislative evolution within its scope of powers at European and national level. They consist more specifically in contributing to the elaboration and implementation of legal instruments within the Eurosystem. They also include advisory activities, more specifically with respect to the consultative mission assigned to the Governing Council by article 105, indent 4 of the Treaty establishing the European Community. They finally relate to the follow-up of litigations.

### 7.1 New legislation

#### 7.1.1 European and international legislation

##### 7.1.1.1 Legislation in force

Among European and international laws enacted in 2002, the market abuse directive, the financial conglomerate directive as well as the take-over bid directive have contributed to the achievement of the Action Plan for Financial Services.

#### a) Market Abuse

The directive<sup>1</sup> lays down common rules for combating market abuse and ensures the integrity of the European financial markets (Annual report of the BCL, 2001, p. 181 and 182). It notably defines the constituent elements of insider dealing. It also organises the conduct of efficient proceedings designed in order to, on the one hand, ensure the compliance with codes of conduct and, on the other hand, harmonise sanctions. Member States will have 18 months, as from the entering into force of this directive, to transpose it into national law.

#### b) Financial conglomerates

The directive<sup>2</sup> takes into consideration international recommendations on supervision of financial conglomerates adopted in the framework of the G-10 and under the auspices of the BIS. It aims at reinforcing and harmonising prudential supervision of large financial groups. The directive provides for the appointment of competent leaders of good repute, the conduct of appropriate internal control mechanisms and risk management procedures and the designation of a single supervisory authority, in order to coordinate the overall supervision of the conglomerate. All this has to be carried out in cooperation with the other national supervisory authorities. This directive must be transposed into national law within 18 months, following its entering into force.

#### c) Prospectuses

The directive<sup>3</sup> – its main features were already described in the 2001 BCL Annual Report (p. 182 and 183) – evolved as follows in 2002:

- The possibility for the Member States to apply their own national rules for certain types of securities issuances (limited offers of small and medium-sized enterprises and credit institutions in general);
- The freedom of choice of the competent authority for issuers of covered warrants;
- The new conditional express exemption to publish a prospectus for securities, already traded on the stock market of a Member State when the issuer itself or a third party decides to admit them to trading in another Member State;
- The five-year transitional period, in order to allow Member States to align their national rules on the new regime.

1 Common position (EC) No 50 /2002 adopted by the Council on 19 July 2002 with a view to adopting a Directive of the European Parliament and of the Council on insider dealing and market manipulation (market abuse) (2002/ C 228 E/03)

2 Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council (OJ L 35 11.2.2003, 1)

3 Despite the Common position adopted by the Council at the end of March 2003, with a view to adopting Directive of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, the text of this directive was not available on the date of publication of this annual report.

#### d) Financial collateral arrangements

The directive<sup>4</sup> lays down a minimal validity and enforceability regime for financial collateral arrangements, largely defined as collateral arrangements made by any legal entity (private or public) in the form of cash or financial instruments, by way of security interest or by way of title transfer, including repo transactions.

To the extent that this directive favours the integration and the cost efficient functioning of financial markets, it increases the freedom to provide services and the freedom of capital movements in the single financial market.

In its opinion, dated 13 June 2001, the ECB suggested extending the scope of this directive to all types of eligible assets for credit operations within the Eurosystem, including loans granted in the form of bank loans. The European Parliament and the Council rejected this suggestion, insisting that the financial collateral arrangements, subject to the directive, relate to cash or financial instruments. Member States will have 18 months, running as from the publication of this directive, in order to implement it into national law.

#### e) Distance marketing of consumer financial services

In order to increase consumer confidence in the use of techniques for the distance marketing of financial services, the directive<sup>5</sup> achieves the convergence of national rules of Member States in this sector.

The directive consolidates and complements the pre-existing legal framework in order to facilitate the smooth operation of the internal market and to attain an appropriate level of consumer protection. More specifically, the directive grants consumers a non-discriminatory access to a wide range of financial services, defined as any service of a banking, credit, insurance, personal pension, investment or payment nature.

Member States have to transpose this directive into national law within 2 years as from the entering into force of the directive.

#### f) The Hague Convention on the law applicable to certain rights in respect of securities held with an intermediary

The text of the Convention on the law applicable to certain rights in respect of securities held with an intermediary (hereafter "the Convention") was signed in December 2002 in The Hague, on the occasion of a diplomatic conference, attended by a Luxembourg delegation. The objective of the Convention is twofold:

- (i) On the one hand, to provide legal certainty and predictability as to the law applicable to securities, which are now commonly held through clearing and settlement systems or other intermediaries;
- (ii) On the other hand, to reduce legal risk, systemic risk and associated costs in relation to cross-border transactions involving securities held with an intermediary.

For the determination of the law applicable to securities held with an intermediary, the Convention refers to the principle of "Place of Relevant Intermediary Approach" (PRIMA), deemed as the most adequate to provide the required legal certainty and predictability. The Convention restricts however the scope of application of this approach to the following issues (article 2 of the Convention):

- "The legal nature and effects against the intermediary and third parties of the rights resulting from a credit of securities to a securities account;
- The legal nature and effects against the intermediary and third parties of a disposition of securities held with an intermediary;
- The requirements, if any, for perfection of a disposition of securities held with an intermediary;
- Whether a person's interest in securities held with an intermediary extinguishes or has priority over another person's interest;
- The duties, if any, of an intermediary to a person other than the account holder who asserts in competition with the account holder or another person an interest in securities held with that intermediary;

4 Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, (OJ L 168 27.06.2002, 43)

5 Directive 2002/65/EC of the European Parliament and of the Council of 23 September 2002 concerning the distance marketing of consumer financial services and amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC (JO L 271, 9.10.2002, 16)

## I



- The requirements, if any, for the realisation of an interest in securities held with an intermediary; and
- Whether a disposition of securities held with an intermediary extends to entitlements of dividends, income or other distributions, or to redemption, sale or other proceeds.”

Pursuant to article 4, first indent of the Convention, the law applicable to all issues specified here-above is “the law in force in the State expressly agreed in the account agreement as the State whose law governs the account agreement or, if the account agreement expressly provides that another law is applicable to all such issues, that other law.”

## II



The law designated in accordance with this provision applies only if the relevant intermediary has, at the time of the agreement, an office in that State, which exercises activities relating to securities, enumerated in article 4, or “is identified by an account number, bank code, or other specific means of identification as maintaining securities accounts in that State.”

## III



### g) Fight against terrorism and financial sanctions

In 2002, several measures were adopted at the European level, in order to fight against terrorism and its financial resources.

The Council has adopted four decisions, implementing article 2, indent 3 of the Regulation 2580/2001 imposing certain specific measures directed against certain persons and entities in the framework of the fight against terrorism.

## IV



The Council Regulation (EC) No 881/2002 of 27 May 2002 imposing certain specific restrictive measures directed against certain persons and entities associated with Usama bin Laden, the Al-Qaida network and the Taliban, and repealing Council Regulation (EC) No 467/2001 prohibiting the export of certain goods and services to Afghanistan, strengthening the flight ban and extending the freeze of funds and other financial resources in respect of the Taliban of Afghanistan, was modified seven times by European regulations.

## V



In 2002, the Council Regulation (EC) No. 1081/2000 prohibiting the sale, supply, and export to Burma/Myanmar of equipment which might be used for internal repression or terrorism, and freezing the funds of certain persons related to important governmental functions in that country was amended by the Commission Regulation (EC) No. 1883/2002 of 22 October 2002. The Council Regulation (EC) No. 310/2002 of 18 February 2002 concerning certain restrictive measures in respect of Zimbabwe was modified three times through European regulations adopted in 2002.

## VI



The Council Regulation (EC) No.1705/98 of 28 July 1998 relating to the interruption of certain economic relations with Angola, in order to induce the *União Nacional para a Independência Total de Angola* (UNITA) to comply with its duties in the peace process, which repealed the Regulation No. 2229/97, was modified twice in 2002.

In a communication of the ECB Governing Council of 1<sup>st</sup> October 2001, the Eurosystem committed itself to undertake everything within its power to contribute to the adoption, implementation and execution of measures against the use of the financial system for terrorist activities.

## VII



On 28 June 2002, the BCL issued circular letter No. 2002/172, entitled “Protection of payment systems and securities settlement systems against crime and terrorism”. This circular letter contains an annex, inventorying the legislation applicable in Luxembourg, including the texts specified here-above. This annex, which has an information purpose and is regularly updated, is available on the BCL website [www.bcl.lu](http://www.bcl.lu).

## 7.1.1.2 Legislation in preparation

### a) Takeover bids

After the European Parliament rejected a first proposal for a directive on takeover bids in July 2001, the European Commission presented a new proposal on 2 October 2002. This aims to strengthen the legal certainty of these transactions and to ensure protection for minority shareholders<sup>6</sup>.

The ECB, on its own initiative, provided the Commission with its comments in January 2003. The ECB

<sup>6</sup> Proposal for a Directive of the European Parliament and of the Council on takeover bids (COM (2002)534 final)

supports the project and this without prejudice to its formal power of consultation, based on article 105 of the Treaty. The ECB requests that the directive expressly provide that it is not applicable to central banks, in view of their mission of public interest.

#### b) Investment services and regulated markets

The proposal<sup>7</sup> – designed to replace the investment services Directive adopted in 1993, and amended in 1995 and 1997 – follows the Communication of the Commission of 16 November 2000 (discussed in the BCL annual report 2001, p. 180 et 181).

This proposal aims to revise and complete the existing legislation in order to address financial markets efficiently and comprehensively, and in accordance with their recent evolution.

More specifically, this proposal seeks, on the one hand, to harmonise national rules, in order to allow effective mutual recognition of investment firms and, on the other hand, to ensure a high protection of investors in their relation with stock markets, other order-execution platforms and investment firms.

Practically, this proposal completes the list of financial instruments traded on regulated markets and among investment firms. It also extends the range of investment services, for which an agreement is required, by including notably investment advice and, as non-core service, financial analysis or research. In addition the proposal authorises investment firms to internalise the orders of their clients, on condition that the investment firm is able to demonstrate that such internalisation is in the client's interest.

With a view to a consistent enforcement within the EU, the new proposal sets up minimal rules for the attribution of responsibilities and powers at the disposal of national authorities. It creates also efficient real-time co-operation mechanisms in order to investigate and prosecute infringements of obligations provided for by the directive, by reinforcing the duty to co-operate of competent authorities *via* information exchange and joint investigations.

Insofar as this proposal impacts eligible assets in monetary policy operations of the Eurosystem, the ECB shall be consulted. One should note, however, that this proposal would not apply to the members of the ESCB and other national bodies performing similar functions charged or intervening in the management of the public debt.

#### c) Taxation of savings income

The proposal for a directive on taxation of savings income<sup>8</sup> aims at ensuring a minimum level of taxation on interest payments in each Member State to natural persons with tax residence in another Member State. It does not apply to nationals of non-EU states. A political agreement was reached on 21 January 2003 at the ECOFIN level.

This agreement provides for an exchange of information among 12 of the 15 Member States, while Luxembourg, Belgium and Austria may operate a withholding tax system as long as six other countries and territories (*i.e.*, Switzerland, Liechtenstein, Monaco, San Marino, Andorra and the United States) do not share information based on OECD 2002 rules. The withholding tax rate to be applied will be of 15% between 2004 and 2007, 20% between 2007 and 2010 and finally 35% as from 2010.

The agreement of the 15 Member States is subject to an agreement with Switzerland, which should apply the same withholding tax rates under the same conditions as the EU. The exchange of information among authorities on bank accounts held in the EU by a natural person resident of another Member State shall start in 2004.

#### d) Single payment area

In its document entitled "A possible legal framework for a single payment area in the internal market", the Commission assessed the necessity of a global legal framework for retail payments in the internal market. The objective of such a framework would be to increase the efficiency and security of payment means and systems - with a view to greater consumer confidence - and to ensure fair competition among the players on this market. The Commission should launch a general consultation on this topic in 2003.

7 Proposal for a Directive of the European Parliament and of the Council on investment services and regulated markets, and amending Council Directive 85/611/EEC, Directive 93/6/EEC and European Parliament and Council Directive 2000/12/EC (COM(2002) 625 final)

8 Proposal for a Council Directive to ensure effective taxation of savings income in the form of interest payment within the Community (COM (2001) 400 final – OJ C 270 E, 25.9.2001)



## e) External monetary relations – Proposal for a monetary agreement with Andorra

The text of this proposal provides for the assignment to the principality of Andorra of the right to issue numismatic coins in Euro and monetary tokens with legal tender status. In its opinion addressed to the Council, the ECB asked to be fully associated to these negotiations. The ECB insisted that such an agreement should not be seen as a precedent for the opening of negotiations in the monetary field between the Community and other countries.

The BCL is of the opinion that based on article 106 of the Treaty, only banknotes issued by the Eurosystem and coins issued by Member States of the euro area may have legal tender status in the Community.

### 7.1.2 National legislation

#### 7.1.2.1 Adopted legislation

##### 7.1.2.1.1 Bank notes and coins

#### a) Counterfeiting

The administrative regulation (*Règlement Grand-ducal*) of 12 July 2002<sup>9</sup>, based on article 8 of the Law of 12 January 2002 approving the International Convention for the fight against counterfeiting and amending the Criminal Code (*Code Pénal*) and the Criminal procedure Code (*Code d'instruction criminelle*), meets the requirement to designate national competent authorities in the fight against counterfeiting. Pursuant to articles 2, 4 and 5 of the Council Regulation No. 1338/2001 of 28 June 2001 laying down measures necessary for the protection of the euro against counterfeiting, these national authorities are in charge, on the one hand, of the analysis and identification of banknotes and coins suspected to be counterfeits and, on the other hand, of the collection of data relating the counterfeiting and their analysis.

Article 1 of the administrative regulation identifies three national authorities to which the tasks enumerated by the European regulation have been assigned, *i.e.* the BCL, the judicial police and the national central office. Articles 2 to 5 describe the missions assigned to each authority:

- The BCL and the judicial police are jointly in charge of the identification of the counterfeited banknotes and coins;
- The BCL is in charge of the collection and analysis of technical and statistical data relating to counterfeiting of banknotes and coins;
- The central national office is in charge of the collection of data relating to counterfeiting and their analysis.

Article 6 of the administrative regulation also provides that the technical expertise of the BCL is put at the disposal of the central national office, under to be agreed conditions. This provision aims at organising the practical cooperation required by article 4.2. and 5.2. of the above-mentioned European regulation between the competent monetary authority at national level and the authority in charge of the fight against counterfeiting and this by taking into account the fact that counterfeiting is, from a criminal law point of view, a piece of evidence in criminal proceedings. Article 6 takes into account the requirement, recalled by the national legislation in article 8.2 of the above-mentioned statute and acknowledged by articles 4.3. and 5.4. of the above-mentioned European regulation.

#### b) Private activities of guardianship and surveillance

The statute of 6 December 2002<sup>10</sup> – which replaces the statute of 6 June 1990 – sets up the conditions under which the private activities of guardianship and surveillance (including the guarding of movable and non-movable goods, the management of alarm centres, the conveyance of money or values or the protection of people) must be exercised.

In section IV of the new law, the legislator provides for a description of human and technical means, which undertakings of money conveyance must have at their disposal. At least three vehicles, three vans, a team of twenty agents and a secured centre, equipped with a doorway, a loading premise for the money and vaults are required. The vans used for the conveyance of funds must be tracked from the

<sup>9</sup> Administrative regulation of 12 July 2002 designating the authorities referred to in article 8 of the law of 13 January 2002, approving the International Convention for the fight against counterfeiting as well as the correlative Protocol, executed in Geneva on 20 April 1929 and amending some provisions of the criminal code and the criminal procedure code (Mémorial A-83, 5 August 2002, p. 1733)

<sup>10</sup> Statute of 6 December 2002 relating to the private activities of guardianship and surveillance (Mémorial A-131, 6 December 2002, p. 3047)



secured centre within an area of 75 kilometres.

In addition, pursuant to article 29, regular users of money conveyance services are bound to arrange a parking lot reserved for the van, a secured centre for the collection and deposit of money, the organisation of a control device covering the parking lot and the way of the conveyor as well as communication and alarm device in case of aggression.

All devices must be organised within a year and after inspection by the Luxembourg police. The non-compliance with the provisions in article 29 in spite of a first injunction of the Justice Minister may be sanctioned by a prohibition to perform conveyance services.

### 7.1.2.1.2 Financial and company legislation

#### a) Electronic money

The statute of 14 May 2002<sup>11</sup> – which transposes two directives into national law - sets up a regulatory regime for financial institutions, which are not banks, *sensu stricto*, and which issue electronic money. To date such institutions do not exist in Luxembourg. As electronic money institutions are excluded from the protection organised in the directive 98/26/EC of 19 May 1998 on settlement finality in payment and securities settlement systems, this directive might have to be amended.

#### b) Undertaking for collective investment

The statute of 20 December 2002<sup>12</sup> relating to undertakings for collective investment implements provisions of directives 2001/107/EC of 21 January 2002 (amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities with a view to regulating management companies and simplified prospectuses) and the Directive 2001/108/EC of the European Parliament and of the Council of 21 January 2002 (amending directive 85/611/EEC as far as investment of UCITS are concerned).

As a result of the modalities for transposing the two above-mentioned directives, the Luxembourg Legislator preferred to adopt a new regulation on the undertakings of collective investment. This new statute combines provisions of the two directives, together with provisions of the statute of 30 March 1988, which remain up to date.

#### c) Register of commerce

The statute of 19 December 2002<sup>13</sup> adopts several measures, designed to reorganise the “*Registre de Commerce et des Sociétés*” (Company registrar). More specifically, this statute draws up a global and balanced set of rules in order to ease some administrative formalities performed by undertakings upon their creation or upon amendment of their articles of association. The overall objective of this statute is to improve the quality and update of legal information on administrative bodies of undertakings, to ensure more efficient control over activities of economic players and to create the necessary legal structure, for the setting up of a system managing accounting data for Luxembourg’s economic players.

### 7.1.2.1.3 Miscellaneous

#### a) Administrative Regulation of 26 June 2002 organising the status of BCL agents<sup>14</sup>

This regulation, which implements article 14 (3) of the Statute of 23 December 1998 relating to the monetary status and to the BCL, is applicable to those categories of agents referred to in article 14 (3) (a) et (c) and to whom public status was granted.

The regulation replaces the administrative Regulation of 21 June 1984, setting up the status of the agents of the Luxembourg Monetary Institute, and authorises the BCL to deviate from certain provisions of the general regime of the public office, in order to ensure the smooth functioning of the BCL within the ESCB, in which the BCL takes part.

<sup>11</sup> Statute of 14 May 2002 implementing into the amended statute of 5 April 1993 relating to financial sector of the Directive 2000/12/EC relating to the access to activities of credit undertaking and its exercise and of the Directive 2000/46/EC relating to the access and activities of the undertakings of electronic money and its exercise as well as the prudential supervision of these undertakings (Mémorial A – 51, 22 May 2002, p. 881).

<sup>12</sup> Statute of 20 December 2002 relating to the collective investment funds and amending the amended law of 12 February 1979 relating the value-added tax (Mémorial A – 151, 31 December 2002, p. 3660).

<sup>13</sup> Statute of 19 December 2002 relating to the register of commerce and companies, as well as accounting and annual accounts of undertakings, and amending other legal provisions (Mémorial A – 159, 31 December 2002, p. 3630).

<sup>14</sup> « *Règlement grand-ducal du 26 juin 2002 portant dérogation à l'application des dispositions relatives aux fonctionnaires ou fonctionnaires stagiaires de l'Etat pour les agents de la BCL bénéficiant du statut de droit public défini l'article 14 (3) de la loi du 23 décembre 1998 relative au statut monétaire et à la BCL* »



I

The regulation contains provisions on hiring conditions, work conditions, compensation and promotion of civil servants and trainee civil servants. It also deviates from the regulation on vacation and working hours in order to ensure the continuity of the ESCB missions.

In its opinion of 26 September 2001, the ECB welcomed the draft regulation, to the extent that it gives greater flexibility to the BCL in organising its ESCB tasks.



II

#### b) Protection of personal data

The statute of 2 August 2002<sup>15</sup> - transposing in Luxembourg law the directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 – has a twofold objective: on the one hand, to ensure the free movement of personal data and, on the other hand, to protect fundamental rights and freedoms, notably, the right to privacy.

For this purpose, the above-mentioned statute was designed as a general statute, applicable to private as well as public entities, to defence, public security, State security as well as to the investigation and prosecution of criminal offences. This statute rules special statutes (such as the statute on hospitals, on electronic commerce, including the electronic signature).

It is applicable whenever personal data are concerned, these being defined as any information, whether or not by automatic means, relating to an identified or identifiable individual. In principle, this information must be processed fairly, i.e. it must be collected for specified, explicit and legitimate purposes and it must not be further processed in a way incompatible with those purposes. In addition, this personal data may only be subject to close observation by the employer in the cases restrictively enumerated by the statute: for the sake of security and health of workers, for the sake of protection of assets of undertakings, for the control of production process with respect to machinery only, or for the temporary control of the production or services performed by the worker, designed to measure his / her activity, in order to calculate his / her compensation. The involved person's consent does not legitimise surveillance on the workplace.



III



IV

#### c) Legal interest rate for 2002

According to the administrative regulation of 21 January 2002<sup>16</sup>, the legal interest rate for 2002 is 5%.



V

#### d) Budget statute 2003 and financial relation between the Luxembourg State and the BCL

The financial relations between the Luxembourg State and the BCL are organised in an agreement dated 27 May 1999. This agreement provides for a specific deposit by the State with the BCL for an initial amount of LUF 19 556 786 864 (EUR 484 800 083), remunerated at the rate applicable to the deposit facility set up by the ECB (article II-1 (3) a).

The objective of this deposit is to "allow the BCL to design its financial situation at the end of the transitional period, after the exchange of the bank notes and coins in LUF into Euro" and to meet "the financial needs of the BCL", hence, to ensure its financial independence and to face the criticism of the ECB as to the limited financial means of this institution. Since this deposit is not motivated by the search for a profit, it is not subject to article 93 (1) of the statute of 8 June 1999 on budget, accounting and treasury of the State.



VI



VII

### 7.1.2.2 Legislation in preparation

#### Combating terrorism

The draft statute No. 4954<sup>17</sup> aims first to transpose into national law the requirements contained in the Council framework decision in fighting terrorism.

For the first time, this framework decision organises a comprehensive set of criminal rules relating to terrorism. It creates an autonomous and global definition of the terrorist offence as well as of offences relating to terrorist groups. It also organises efficient and dissuasive sanctions and a strengthened liability regime for legal persons.

<sup>15</sup> Statute of 2 August 2002 relating to the protection of individuals with regard to the processing of personal data (Mémorial A – 91, 13 August 2002, p. 1836).

<sup>16</sup> Administrative regulation of 21 January 2002 fixing the legal interest rate for 2002 (Mémorial A – 11, 11 February 2002, p. 225)

<sup>17</sup> Draft statute N° 4954 (1) relating to the prosecution of terrorism and its financing and (2) approving the International Convention for the prosecution of terrorism financing, opened to signature in New York on 10 January 2000.

In addition, the draft statute provides for approval of the International Convention for the prosecution of financing of terrorism, adopted by the General Meeting of the United Nations on 9 December 1999, and opened for signature at the headquarters of the United Nations in New York on 10 January 2000.

On 18 April 2002, the Justice Minister presented this draft statute, already adopted on 12 April 2002 by the Council of government. Despite the opinion of the latter, the draft statute could not be voted at the Chamber of Deputy during 2002. The Chamber of Officers and Public Employees rendered its opinion on 16 October 2002 and the State Council on 26 November 2002.

## **7.2 Contribution to the elaboration and implementation of the legal instruments of the Eurosystem**

Representatives of the ECB and the NCBs participate in the different committees and working groups, which support the decision making bodies of the ECB in the adoption of regulations, decisions and guidelines. The implementation by the BCL of the operational provisions in its scope of competence entails the issuance of circular letters addressed to specific persons, the amendment of the General Conditions of operations or Rules of LIPS-Gross System, or the adoption of sanctions.

### **7.2.1 Circular letters**

In 2002, the Bank issued ten circular letters.

The circular letter 2002/172 entitled "Protection of payment systems and securities settlement systems against crime and terrorism" is specially noteworthy. It is applicable to the payment systems and securities settlement systems subject to BCL oversight and imposes the to keep track (*traçabilité*) of cash and securities transfers.

In order to avoid partial or total anonymity of order transferees, the BCL details the scope of the obligations to be borne by the systems, subject to its oversight. These systems must identify participants, giving or benefiting from orders and insist that standard messages be duly and completely filled in. They must also ensure that the content of received messages remains unchanged during the processing of the orders. The annex to the circular letter contains an inventory of the legislation applicable in Luxembourg. This annex - of informative nature and regularly updated - is available on the website [www.bcl.lu](http://www.bcl.lu).

The BCL has also issued eight other circular letters, designed to organise the collection of statistical information within the Eurosystem.

### **7.2.2 General conditions for the operations and Rules of LIPS-Gross System**

#### **7.2.2.1 General conditions for the operations**

Further to the amendments to the guidelines adopted by the Governing Council of the ECB and contained in the document "The single monetary policy in the Euro area – General documentation on monetary policy instruments and procedures of the Eurosystem" in April 2002, the General Conditions of the BCL have been slightly amended. The main changes relate to chapter 8 "Eligible assets" as well as to annex 8 of the General Conditions. Thus the securities issued or guaranteed by a counterparty or entity, with which the counterparty has close links are excluded. An updated version of the General Conditions of the BCL is available on the website [www.bcl.lu](http://www.bcl.lu).

#### **7.2.2.2 Rules of LIPS-Gross System**

These rules were amended twice. In August 2002, the management council of RTGS L -GIE amended these rules in order to exclude electronic money institutions from TARGET. In implementation of the circular 2002/172 entitled "Protection of payment systems and securities settlement systems against crime and terrorism", the management council has also insisted that the forms used for the payment order be duly completed.

I

### 7.2.3 Sanctions

In compliance with article 34 of its organic law, the BCL contributes to the adoption of sanctions, decided by the ECB pursuant to European regulations relating to minimum reserves and statistics.

II

## 7.3 Litigation

In 2002, a case of principle concerning the ECB, handled by the Court of Justice of the European Communities, may be noted, as well as some cases handled by national jurisdictions.

### 7.3.1 European litigation

#### 7.3.1.1 The OLAF case

The commission created in 1998 a specific anti-fraud unit (*Office de Lutte Anti-Fraude* - OLAF), based on article 280 of the Treaty. The EC regulations 1073/1999 and 1074/1999 - which organise the activities of OLAF - provide that each institution or body of the Community must adopt a decision defining more detailed rules for the procedures to be followed in internal investigations conducted by OLAF.

Such a decision has not been adopted by the ECB, which preferred to create, by a decision of 7 October 1999, its own anti-fraud committee, to which it assigned the task of checking the activities of the ECB's internal audit directorate. The Commission asked the Court of Justice to annul the decision of 7 October 1999.

In his conclusions dated 3 October 2002, the Advocate General Jacobs rejects the arguments raised by the ECB to motivate the validity of its decision and recommends annulling the challenged decision. The Court has not yet rendered its judgment.

#### 7.3.1.2 Luxembourg Banking Secrecy

The judgment rendered on 10 December 2002 by the Court of Justice of the European Communities on occasion of a preliminary question raised by the examining judge (*juge d'Instruction*) of the First hearings court (*Tribunal de première instance*) of Turnhout (Belgium) on the interpretation of article 49 of the Treaty (on free movement of services) clarified the extraterritorial scope of Luxembourg law with respect to banking secrecy.

Basically, the question was whether an employee of a Luxembourg bank had to testify during a criminal proceeding opened in Belgium, in spite of the banking secrecy he has to abide by under Luxembourg law.

In order to reject this question as inadmissible, the European judge analysed the provisions of Luxembourg law. In the court's opinion, the provisions of Luxembourg law on banking secrecy have an extraterritorial effect, in such a way that the principle of banking secrecy as well as the exceptions thereto provided for by Luxembourg law (here, the duty of a person bound by the principle of the banking secrecy to testify in a legal proceeding) are applicable in other Member States.

### 7.3.2 National litigation

On 13 December 2001, the BCL has sued the Pension and Insurance fund of private employees (*Caisse de Pensions des Employés Privés et Etablissement d'Assurance contre la Vieillesse et l'Invalidité*). As provided for in article 35.4(4) of the organic law of the BCL, the claim aims to recover the social contributions, paid on behalf of persons hired by the BCL and previously registered with the above-mentioned fund. For further details, see Chapter VIII, section 2.4 of this annual report.

At the time of the drafting of this report, the trial is still in progress.

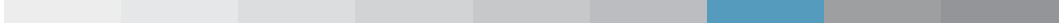
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# VIII

ANNUAL REPORT 2002



## THE BCL AS AN ORGANISATION

### VIII THE BCL AS AN ORGANISATION

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## 8 THE BCL AS AN ORGANISATION

### 8.1 Organisation of the BCL

#### 8.1.1 The Council

In 2002, the members of the Council of the BCL were:

- President: Yves Mersch
- Members:
  - Andrée Billon
  - Jean Hamilius
  - Pit Hentgen
  - Mathias Hinterscheid
  - Serge Kolb
  - Patrice Pieretti
  - Nico Reyland
  - Michel Wurth.



From the left to the right: Nico Reyland, Pit Hentgen, Andrée Billon, Patrice Pieretti, Yves Mersch, Mathias Hinterscheid, Michel Wurth, Serge Kolb, Jean Hamilius.

The government appointed Mr Hamilius, Mr Hentgen and Mr Hinterscheid for a sixyear period starting from 1st August 2002, the mandates of Mr Hamilius and Mr Hinterscheid being renewed.



In accordance with article 6 of the law of 23 December 1998, the Council of the Bank has following powers:

- a) To discuss the implications of monetary policy, without prejudice to its President's independence of all instructions in his capacity as member of the Governing Council of the ECB and without prejudice to the provisions relating to professional secrecy applicable to the ESCB.
- b) To determine the business policy of the Central Bank and draft guidelines relating to the financial situation of the Central Bank.
- c) Each year, to approve the budget, the financial accounts and the report of the Board of Directors.
- d) To give its consent prior to the use of the Central Bank's reserve fund.
- e) To assist in the drafting of the Central Bank's business reports as referred to in Article 11.
- f) To propose to the Government the appointment of the Central Bank's auditor.
- g) To approve the internal rules of procedure of the Board of Directors.
- h) To deliver its opinion prior to any decision to dismiss a Director.
- i) To deliver an opinion on any Grand-Ducal regulation adopted pursuant to Article 14 of the present law concerning the agents of the Central Bank.
- j) To give its assent prior to the application of any disciplinary action against an agent of the Central Bank, when the preliminary opinion of the civil service disciplinary board has been requested.

During 2002, the Council held 5 meetings.

Within the framework of its patrimonial competence, the Council approved the financial accounts as of 31 December 2001, the budget lines and subsequently the budget for the financial year 2003.

In order to improve the efficiency of the Bank's governance in terms of flexibility and rapidity, the Council reviewed its internal rules and those of the Board of Directors.

The Council regularly observed and commented the economic and financial evolution on the national and international level and has been kept informed of the decisions made by the Governing Council of the ECB.

Finally, the Council appointed the members of the Audit Committee for 2003.

### 8.1.2 The Board of Directors

The Board of Directors is the superior executive authority of the Central Bank. It shall draw up the measures and take the decisions required for the fulfilment of the tasks of the Central Bank.

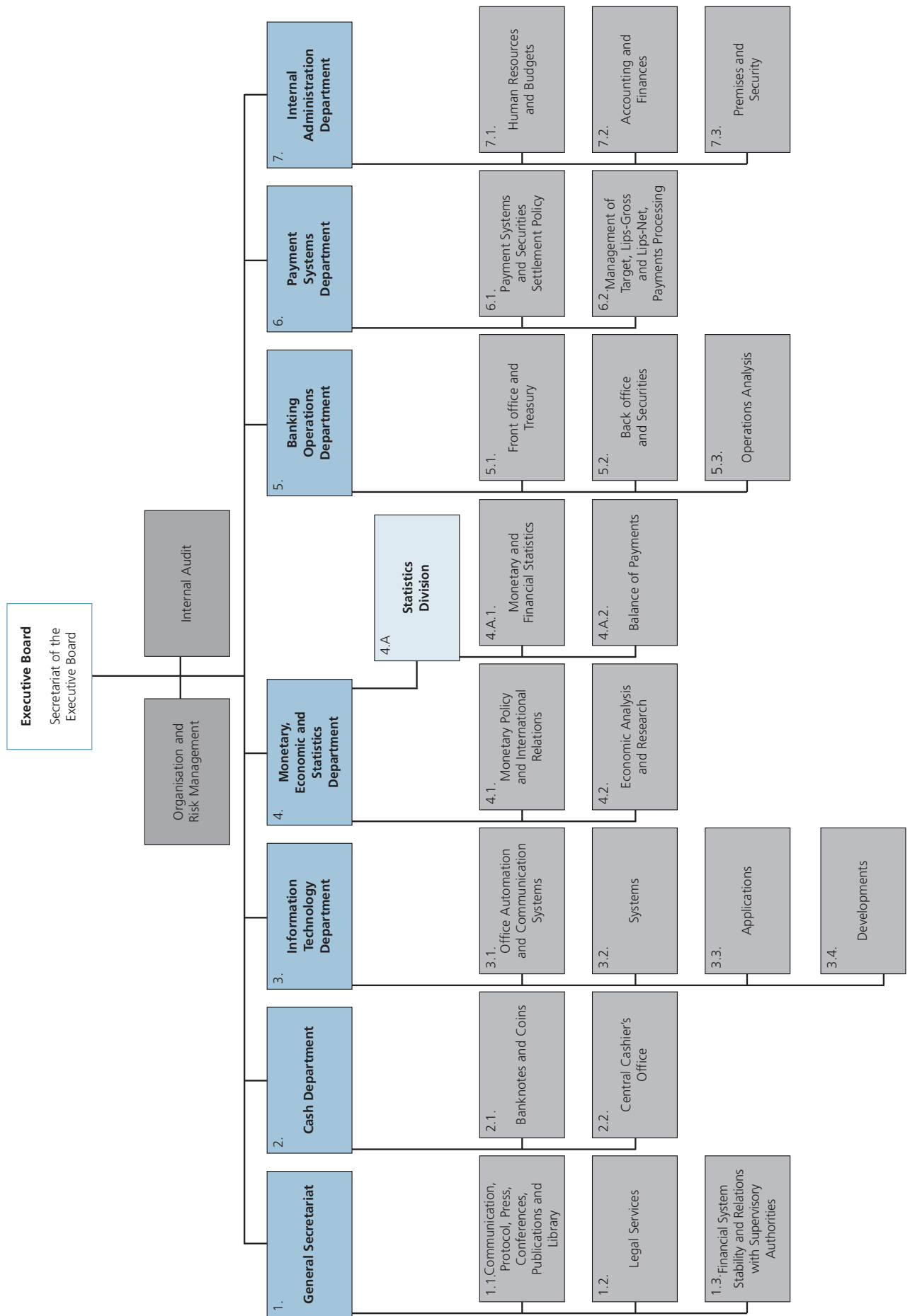
Without prejudice to the independence of its president with regard to all instructions in his capacity as member of the Governing Council of the ECB, the decisions of the Board of Directors shall be taken collectively.

The Board of Directors shall comprise a Director-General and two Directors.

Director-General: Yves Mersch

Directors: Andrée Billon and Serge Kolb.

8.1.3 Organisation chart of the Banque centrale du Luxembourg



## 8.1.4 Corporate Governance

### 8.1.4.1 Audit Committee

Created by the Council at its meeting of 13th December 2001, the Audit Committee's objective is to assist the Council in the performance of its missions related to the approval of the financial accounts (articles 6 (c) and 29 (1) of the law<sup>1</sup>) and to the work of the statutory auditors of the BCL (article 6 (f) and 16 of the law).

The Committee has a preparation role and has no decision power. It reports to the Council.

It counts 3 non-executive members of the Council and the President of the Council. It may invite the internal audit manager and the statutory auditor of the Bank to participate to its work. Each member of the Council has the right to request to be invited.

Members are appointed by the Council for a renewable mandate. The Committee is chaired by one of its non-executive members.

The Committee plans to hold at least three meetings a year. The logistical support necessary to for the tasks of the Committee is provided by the BCL.

The Audit Committee has several missions:

- it assists the Council in its choice of the statutory auditor to be proposed to the Government;
- in addition to the legal mandate of the statutory auditor, the Committee assists the Council in specifying the scope of the potential specific controls to be performed by the statutory auditor (article 16 of the Law);
- it is kept informed of the audit programme of the statutory auditor in order to assist the Council in the analysis of the reports issued by the statutory auditor;
- it is kept informed of the internal audit plan auditor in order to assist the Council in the analysis of the internal audit report;
- it is kept informed of the follow-up of the statutory auditor's and internal audit's recommendations.

In 2002, the Audit Committee held three meetings. During its meeting on 12 December 2002, the Council appointed the members of the Audit Committee for 2003: Jean Hamilius, Pit Hentgen and Nico Reyland. Mr Mersch is an ex officio member in his function as President of the Council.

### 8.1.4.2 Code of Conduct

The Code of Conduct, drafted in 2001, is destined to the people working with the BCL. This code comprises ethical rules and the standards the addressees have to keep to. It is directly inspired by the one enforced at the ECB. It is not detrimental to the application of the legal rules regarding the civil service, the social regulations and contractual commitments between the BCL and its employees.

Specific provisions, which are complementary, are applicable to employees appointed at specific work functions as well as to those working with the markets.

## 8.2 The BCL staff

### 8.2.1 Quantitative evolution

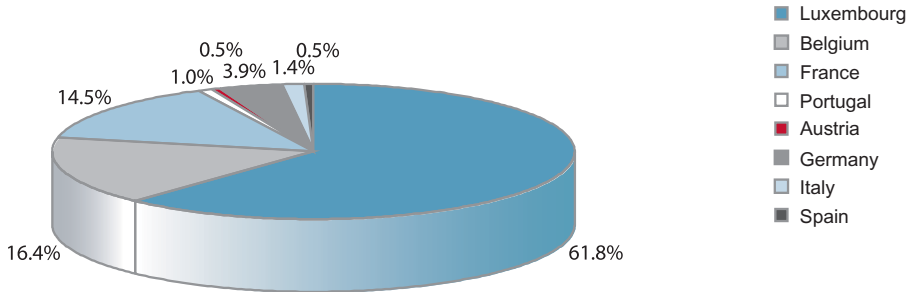
During 2002, the BCL staff has increased by 13.74% to reach a total of 207 agents on 31 December 2002 (including Executive Board members); this is equivalent to 202.5 full time positions. On 31 December, 9 agents have worked part-time. The BCL has recruited 30 new agents, while 5 agents left.

As during the last few years; the BCL continued to make considerable efforts to recruit qualified staff in 2002. Recruitment has been based on high-level academic degrees and people having a potential. 86% of new agents have a university degree or a bac+2 level (undergraduate). A competitive entrance exam was organised on 20 and 21 June 2002 for which a total of 680 candidates applied. Moreover, the BCL received approximately 750 spontaneous job applications and around 350 applications for internships.

1 Law of 23 December 1998 concerning the monetary status and the Central Bank of Luxembourg.

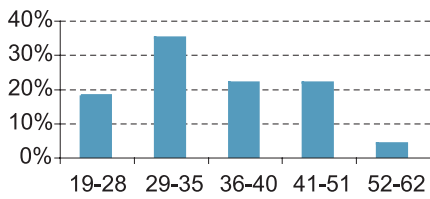
Staff members are of eight different nationalities and this contributes to cultural enrichment and to the diversity of human capital.

GRAPH 1 AGENTS BY NATIONALITY

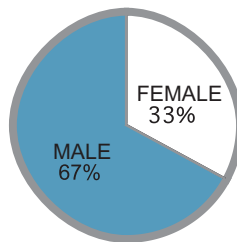


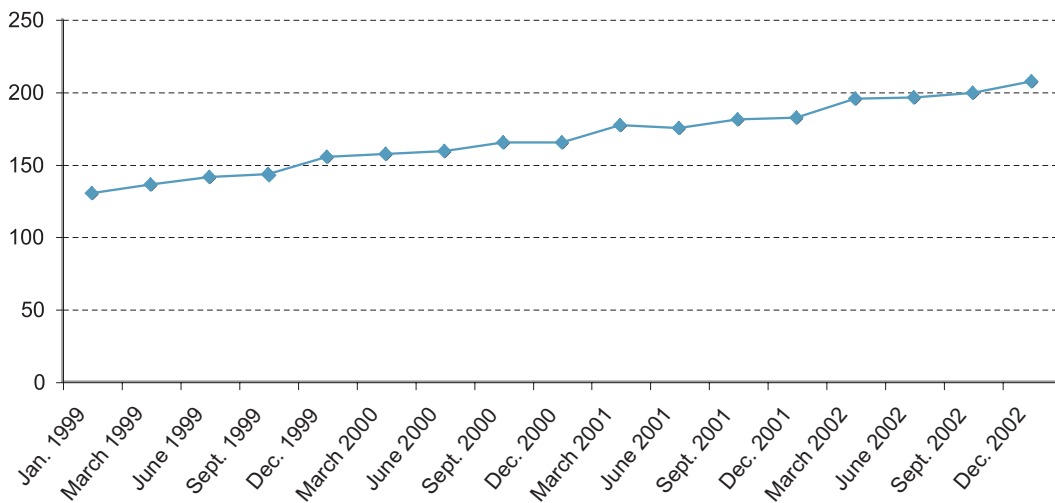
The average age of BCL staff members has slightly increased from 35.5 in 2001 to 35.63 on 31 December 2002. On this date, the staff counted 33% female and 67% male agents, meaning that the proportion of female agents has slightly increased in comparison with 2001.

GRAPH 2 DISTRIBUTION OF AGENTS PER AGE GROUP

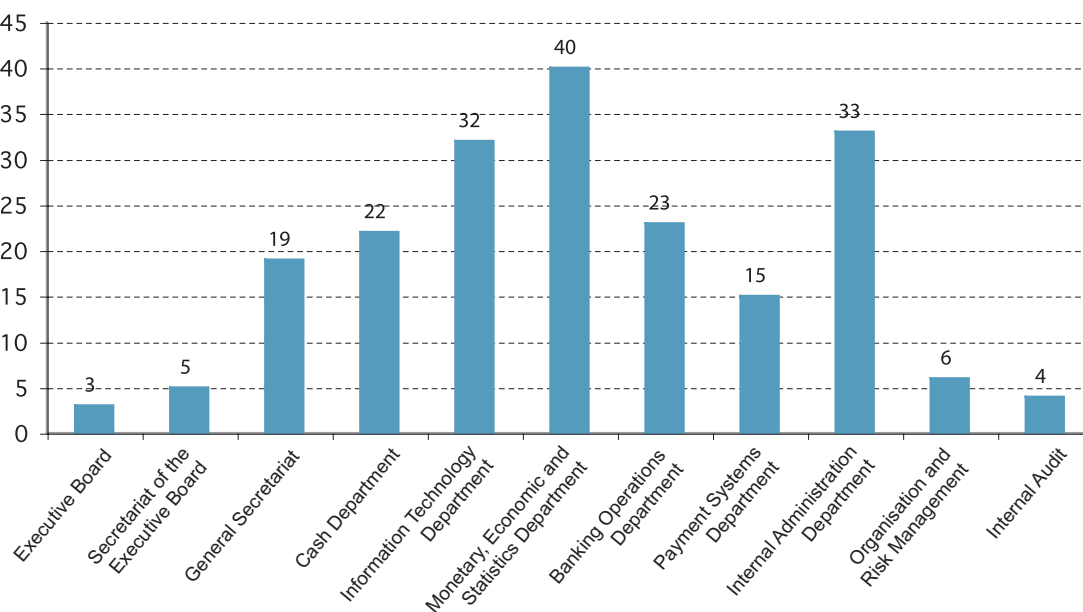


GRAPH 3 PROPORTION FEMALE / MALE



GRAPH 4 EVOLUTION IN NUMBERS PER QUARTER SINCE THE 1<sup>ST</sup> JANUARY 1999

GRAPH 5 NUMBERS PER ENTITY ON 31 DECEMBER 2002



### 8.2.2 Human resources management

In 2002, the concept of an annual appraisal discussion was introduced at the BCL. Its aim is to achieve a high level of competence for all staff members. It was elaborated with the intention to link the performance of each staff member to the objectives of the Bank. In this context, the annual assessment has to be perceived as a tool:

- setting up a constructive dialogue;
- offering a support for the management of potentials;
- optimising human resources management by using appropriate corrective measures;
- favouring the elaboration of individual training schemes.



2002 was marked by a high number of recruitments (30 new staff members), and this requested considerable efforts for the organisation of the competitive entrance exam and for the follow-up of the acceptable applications. The staff increase of 2002 provides the BCL with the necessary resources to achieve the defined objectives, namely consolidation and internal stabilisation.

These recruitments have also mobilised important resources with regard to the management and the administrative follow-up of the internal training courses for the new agents. This trend should decrease over the next years and reach a steady rhythm according to the normal line-up of the staff. The BCL Council decided not to create any additional positions for 2003, which means that the recruitment for 2003 will be limited to the remaining vacancies of the 2002 organisation chart.

### 8.2.3 Staff training

In order to be able to reach the objective of excellence stated in the Bank's positioning and in parallel with quality recruitment, the BCL emphasises particularly the training of new agents as well as the permanent training of all staff. Thus staff members have different opportunities to widen their knowledge. Besides a basic training programme that each new agent is invited to follow as part of his internal training, all staff members are encouraged to participate in external training courses, notably in other NCBS in the ESCB. In order to target the pursued training objectives more precisely and to be able to fully satisfy its national, European and international obligations, the Bank made a sizeable coordination effort by grouping the different training possibilities. This has led to the elaboration of the bases for a training policy adapted to the Bank's specific needs. This training policy will be set up during 2003.

During 2002, a total number of 5 150 training hours were completed, which represents an average of 3.3 training days per agent.

### 8.2.4 Pension fund of the BCL

Article 14 of the statute of 23 December 1998 relating to the monetary status of the BCL provides that legal pension entitlements of BCL agents are determined by their status (i.e., civil servant, State employee, private employee or worker).

The costs and financing of pensions are governed by article 14, indent 4 (b), which reads as follows:

"Costs of pensions of BCL agents are incurred by the BCL. These costs are financed by the BCL pension fund. Legal withholdings on agents' compensations, according to the rules governing the pension system corresponding to their status, on the one hand, and payments made by the BCL itself on the other hand, finance the pension fund."

Article 35, indent 4(a) organises the transitory regime applicable to BCL agents, who contributed previously to another pension fund, as follows: "Luxembourg pension funds, which received contribution from people who are or become BCL agents as of the date of entry into force of the present statute, transfer these contributions to the BCL pension fund". In addition, "the periods within which these agents contributed to these pension funds are automatically validated as contribution periods with the BCL."

Operational as of 2001, the BCL pension fund adopted internal rules. In addition, it created both a decision-making Executive Committee (Comité directeur), composed of BCL Executive Board members, two elected representatives of BCL agents and two co-opted members, acting as delegated managers) and a consultative Tactical Benchmark Committee.

On 13 December 2001, the BCL sued the Pension and Insurance fund of private employees (Caisse de Pensions des Employés Privés et Etablissement d'Assurance contre la Vieillesse et l'Invalidité) before the Luxembourg court (tribunal d'arrondissement de Luxembourg), in order to obtain the payment of the contributions owed in relation to people hired by the BCL and previously registered with the above-mentioned fund.

With regard to the default of the Pension and Insurance fund of private employees and the legal duty imposed by article 14 upon itself, the BCL withheld an amount of 33,8 Mio euros, in addition to the withdrawal from its reserve fund provided for in article 35(a) (c), in order to "bring its pension fund up to the required size".

At the time of the drafting of this report, the trial is still in progress.

### 8.3 Buildings/Facilities

The upgrading of the technical equipments was one of the important tasks of 2002. During the course of the year the functioning of most installations was optimised and currently the reliability rate is very high.

At the administrative level, the Bank introduced a programme allowing the straightforward management of recurrent tasks like ordering office stationary and maintenance material, filing, stock management and the handling of technical interventions.

A fitness room was installed which staff may use outside normal working hours.

During the first half of the year, preparatory work has been performed concerning the renovation of the new building of the bank on the so-called "Prince Henri" site.

The draft building project has been validated. Works are planned to start in September 2003 and end in September 2006.

### 8.4 Accounting and budget

#### 8.4.1 Accounting

European integration implies the obligation to report balance sheet data for each member of the Eurosystem on a daily basis and according to harmonised rules.

In 2002, the BCL continued to strengthen its accounting system and its procedures in order to meet its internal quality standards and those of the Eurosystem. The controlling systems in place have shown to be efficient during the year.

The Bank regularly checks the development of balance sheet, off-balance-sheet and profit & loss items. Investments, revenues and expenses are particularly closely monitored with respect to the internal procedures of authorised signatures. Since January 2002, the monthly balance sheet of the Bank is published on its Internet site.

The management information system has been extended and meets the essential requirements for monitoring the Bank's activities. It is based on a set of indicators, which are calculated daily, weekly, monthly, quarterly or annually. These tables include all activities of the Bank. The analysis of the profit & loss items is completed by a result analysis of the various activities. The Bank strictly controls the development of the interest margin and compares the profitability of its investments to benchmarks. The BCL regularly checks its risk exposure and controls the appropriateness of own funds and of short-, middle- and long-term provisions. The Bank has adopted a prudent policy of constituting and maintaining provisions for general and specific bank risks.

The Bank performs static and dynamic assessments of its long-term financial situation and carries out prospective analyses of external factors such as interest rates, exchange rates and other variables of the Eurosystem.

The Council and the Executive Board of the Bank are regularly informed of the temporary and estimated results in order to be in a position to decide on the future orientations and actions to undertake.

Moreover, an asset/liability committee was set up in 2002 in order to follow more closely the risk exposure and the financial situation during the year, and in particular the risk resulting from the appropriateness of assets and liabilities.

#### 8.4.2 Budget

Every year in December, the BCL's Council approves the budget for the coming year. The elaboration of the 2002 budget was done in accordance with the budgetary procedure aiming at managing the Bank's resources in a rational manner.

The budgetary procedure ensures that the limit set beforehand will not be exceeded. Within this limit expenses can be committed only as far as they are abiding by the bank's rules regarding profitability and economic efficiency. It should be mentioned that operational costs for 2002 have stayed within the budgetary limit approved by the Council.

In order to continually improve the BCL's budgetary procedure, 2002 has seen the implementation of a software for electronic data processing allowing to elaborate the budgetary requests within a predefined framework and not only offering an enhanced reliability but also being less time consuming with regard to the consolidation of the different budgetary requests. Furthermore, the software allows a daily monitoring of each budgetary item in real time, thus shortening the margin for possible deviations.

## 8.5 Internal audit activities

The BCL set up an internal control system based on generally accepted standards prevailing in the financial sector. Internal control principles, as well as the various responsibilities resulting thereof, are described in the internal Manual of Procedures.

The main activity of internal audit function is to assess the internal control system. This task is ensured by an independent Internal Audit Unit that reports directly to the President of the Bank. The definition of the internal audit function is based on the rules and regulations prevailing in the Luxembourg financial centre, as well as on the standards promoted by the Institute of Internal Auditors and the ESCB Audit Policy.

The annual audit plan comprises audit assignments on the level of the ESCB that are coordinated by the ECB Internal Auditor's Committee and audit assignments defined and performed on a national level. During 2002, the Internal Audit Unit performed various assignments in the field of payment systems, monetary policy operations, banknotes and coins, accounting, facility management and information systems.

The Internal Audit Unit is in charge of the follow-up of the recommendations issued during its audit activities.

## 8.6 Financial statements as at 31 December 2002

### 8.6.1 Key figures as at year-end

	2001	2002	Change in % 2002/2001
Total assets	18,273,636,286	24,990,130,072	37%
Banks' current accounts	5,981,169,410	4,638,044,452	-22%
Claims on credit institutions	16,511,127,821	23,370,585,585	42%
Own funds <sup>(1)</sup> , revaluation accounts, administrative provisions and specific banking risks	296,879,839	362,808,977	22%
Net result of banking activities <sup>(2)</sup>	47,532,693	86,224,016	81%
Administrative expenses	23,776,660	26,483,970	11%
Gross operating profit <sup>(3)</sup>	61,197,976	69,745,992	14%
Net profit	5,535,573	4,970,236	-10%
Cash Flow <sup>(4)</sup>	61,370,384	74,701,802	22%
Personnel	182	204	12%
BCL's part in the capital of the ECB	0.1492%	0.1492%	
BCL's part in the Eurosystem's monetary policy operations	8.076%	9.852%	

<sup>(1)</sup> Capital, reserves, provisions for general banking risks and net profit to be affected to the reserves

<sup>(2)</sup> Net interest income, net result from fees and commissions, net result on financial operations

<sup>(3)</sup> Total revenues less total costs (excluding transfers to and from depreciations and provisions)

<sup>(4)</sup> Net profit plus depreciation of tangible / intangible assets and write-downs on financial assets, as well as net transfers to administrative provisions and provisions for banking risks



## 8.6.2 Report of the Independent Auditor

To the Council of the Banque centrale du Luxembourg

To the Government

To the Chamber of Representatives

We have audited the attached financial statements of the Banque centrale du Luxembourg for the year ended 31 December 2002. The financial statements are the responsibility of the Directors and are approved by the Council. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Directors, as well as evaluating the overall financial statements presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the attached financial statements give, in conformity with the generally accepted accounting principles and those defined by the European System of Central Banks, a true and fair view of the financial position of the Banque centrale du Luxembourg as at 31 December 2002 and of the results of its operations for the year then ended.

PricewaterhouseCoopers S.à r.l.

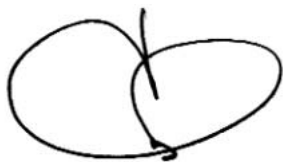
Luxembourg, 11 March 2003

Réviseur d'entreprises

Represented by



Pierre Krier



Didier Mouget

## 8.6.3 Balance sheet as at 31 December 2002

(IN EUROS)

	Note	2002	2001
		EUR	EUR
<b>ASSETS</b>			
Gold and gold receivables	3	24,958,618	24,052,246
Claims on non-euro area residents denominated in foreign currency	4	144,650,120	119,723,095
- Receivables from the IMF		144,481,474	119,576,877
- Balances with banks, security investments, external loans and other external assets		168,646	146,218
Claims on non-euro area residents denominated in euros		301,182	1,626,956
- Balances with banks, security investments and loans		301,182	1,626,956
Lending to euro area credit institutions related to monetary policy operations denominated in euros	5	23,307,712,900	16,443,086,730
- Main refinancing operations	5.1	19,591,455,200	13,298,064,800
- Longer-term refinancing operations	5.2	3,716,257,700	3,145,021,930
Other claims on euro area credit institutions denominated in euros	6	62,872,685	68,041,091
Securities of euro area residents denominated in euro	7	204,171,319	200,053,535
Intra-Eurosystem claims	8	83,176,316	82,060,000
- Participating interest in ECB	8.1	7,460,000	7,460,000
- Claims related to the transfer of foreign reserves	8.2	74,600,000	74,600,000
- Other claims within the Eurosystem	8.3	1,116,316	-
Items in course of settlement		250	404,860
Other assets	9	1,162,286,682	1,334,587,773
- Tangible and intangible fixed assets	9.1	61,693,547	62,342,524
- Other financial assets	9.2	1,028,411,411	638,785,285
- Off-balance sheet instruments revaluation differences		1,996,500	253,938
- Accruals and prepaid expenses	9.3	49,019,675	54,600,170
- Sundry	9.4	21,165,549	578,605,856
<b>TOTAL ASSETS</b>		<b>24,990,130,072</b>	<b>18,273,636,286</b>

## Balance sheet as at 31 December 2002

(IN EUROS)

	Note	2002	2001
		EUR	EUR
<b>LIABILITIES</b>			
Banknotes in circulation	10	614,169,272	647,418,833
Liabilities to euro area credit institutions related to monetary policy operations denominated in euros	11	4,638,044,452	5,881,093,187
- Current accounts (covering the minimum reserve system)		4,637,844,452	5,881,093,187
- Deposit facility		200,000	-
Other liabilities to euro area credit institutions denominated in euros		-	100,076,223
Liabilities to other euro area residents denominated in euros	12	525,914,231	596,710,486
- General government	12.1	525,909,890	581,405,933
- Other liabilities	12.2	4,341	15,304,553
Liabilities to non-euro area residents denominated in euros	13	53,947,531	63,571,015
Counterpart of special drawing rights allocated by the IMF	14	21,978,716	24,152,567
Intra-Eurosystem liabilities	15	18,568,559,665	10,575,042,860
- Net liabilities related to the allocation of euro banknotes within the Eurosystem	15.1	9,254,574,795	-
- Other liabilities within the Eurosystem	15.2	9,313,984,870	10,575,042,860
Items in course of settlement	16	14,515,834	-
Other liabilities	17	132,622,382	41,313,143
- Off-balance sheet instruments revaluation differences		1,816,500	57,125
- Accruals and income collected in advance		114,444,118	38,775,867
- Sundry		16,361,764	2,480,151
Provisions	18	243,363,505	181,013,810
Revaluation accounts	19	37,302,358	28,502,272
Capital and reserves	20	134,741,890	129,206,317
- Capital	20.1	25,000,000	25,000,000
- Reserves	20.2	109,741,890	104,206,317
<b>Profit for the year</b>		<b>4,970,236</b>	<b>5,535,573</b>
<b>TOTAL LIABILITIES</b>		<b>24,990,130,072</b>	<b>18,273,636,286</b>

#### 8.6.4 Off-balance sheet as at 31 December 2002

(IN EUROS)

	Note	2002	2001
		EUR	EUR
Custody deposits	21	87,077,073,455	77,322,587,983
Commitments and similar instruments	22	1,000,000,000	-
Foreign currency reserve assets administrated on behalf of the ECB	23	78,565,861	86,133,972
Forward transactions	24	410,582,250	28,432,437
Numismatic collection		107,972	107,972
		<b>88,566,329,538</b>	<b>77,437,262,364</b>

#### 8.6.5 Profit and loss account for the year 2002

(IN EUROS)

	Note	2002	2001
		EUR	EUR
Interest income		708,247,980	889,797,713
Interest expense		(606,739,095)	(843,094,782)
<b>Net interest income</b>	<b>25</b>	<b>101,508,885</b>	<b>46,702,931</b>
Realised (losses) / gains arising from financial operations		(9,751,967)	1,485,245
Write-downs on financial assets and positions	26	(4,955,810)	(172,408)
Transfer to/from provisions for foreign exchange rate and price risks	27	(61,377,778)	(41,716,374)
<b>Net result of financial operations, write-downs and risk provisions</b>		<b>(76,085,555)</b>	<b>(40,403,537)</b>
Fees and commissions income		5,533,284	4,727,254
Fees and commissions expense		(6,110,375)	(5,210,329)
<b>Net result from fees and commissions</b>	<b>28</b>	<b>(577,091)</b>	<b>(483,075)</b>
Income from participating interest	29	3,801,103	3,009,213
Net result of pooling of monetary income	30	(9,665,168)	(1,141,306)
Other income	31	24,750,115	35,815,538
<b>Total net income</b>		<b>43,732,289</b>	<b>43,499,764</b>
Staff costs	32	(15,366,065)	(12,916,121)
Other administrative expenses	33	(8,416,991)	(7,346,125)
Depreciation of tangible and intangible fixed assets	34	(4,858,986)	(4,840,724)
Banknote production services	35	(2,462,941)	(3,005,101)
Other expenses	36	(7,657,070)	(9,856,120)
<b>PROFIT FOR THE YEAR</b>		<b>4,970,236</b>	<b>5,535,573</b>

The accompanying notes form an integral part of the financial statements.

## 8.6.6. Notes to the financial statements as at 31 December 2002

### Note 1 - General

The Banque centrale du Luxembourg ("BCL") was founded on 1 June 1998 in accordance with the law of 22 April 1998. The law of 23 December 1998 provides that the main task of the BCL shall be to take part in the accomplishment of the tasks of the European System of Central Banks ("ESCB") so as to achieve the objectives of the ESCB. The BCL is a public institution, endowed with legal personality and financial independence.

### Note 2 – Accounting policies

The accounting policies applied in preparing the financial statements are described below:

#### 2.1 *Layout of the financial statements*

The financial statements of the BCL have been prepared and drawn up in accordance with the generally accepted accounting principles and the rules adopted by the ESCB.

#### 2.2 *Accounting principles*

The following accounting principles have been applied:

- economic reality and transparency;
- prudence;
- recognition of post-balance sheet events;
- accruals principle;
- consistency and comparability.

#### 2.3 *Basic principles*

The financial statements are based on historical cost and are adjusted to take account of the valuation at market prices of securities, financial instruments, gold and of all the elements, both on-balance-sheet and off-balance-sheet denominated in foreign currencies.

Transactions in financial assets and liabilities are reflected in the accounts of BCL on their settlement date.

#### 2.4 *Assets and liabilities in gold and foreign currencies*

Assets and liabilities denominated in foreign currencies (including gold) are converted into euros at the exchange rate in force on the balance sheet closing date. Proceeds and costs are converted at the exchange rate prevailing on the date of the transaction.

Foreign currencies are revalued on a currency-by-currency basis including on-balance-sheet and off-balance-sheet items.

Securities are revalued at market prices separately from the revaluation of foreign exchange for securities denominated in foreign currencies.

Gold is revalued on the basis of the euro price per fine ounce as derived from the quotation in US dollars established at the time of the London fixing on the last working day of the year.

#### 2.5 *Securities*

Negotiable securities denominated in foreign currencies and in euros are valued at the market price prevailing on the balance sheet date. The revaluation took place item-by-item on the basis of the ISIN code.

#### 2.6 *Recognition of gains and losses*

Income and expenses are assigned to the financial year during which they are earned or incurred.

Realised gains and losses on foreign exchange transactions, securities and financial instruments linked to interest rates and market prices are taken to the profit and loss account.



At the end of the year, unrealised revaluation gains on foreign currencies, securities and financial instruments were not considered in the profit and loss account, but transferred to a revaluation account on the liabilities side of the balance sheet.

Unrealised losses were recognised in the profit and loss account when they exceeded previous revaluation gains registered in the corresponding revaluation account. They may not be reversed against new unrealised gains in subsequent years. Unrealised losses regarding a specific security, financial instrument, currency or gold holding were not netted with unrealised gains in other securities, financial instruments, currencies or gold holdings.

In order to calculate the acquisition cost of securities or currencies that are sold, the average cost method is used on a daily basis. If any negative revaluation differences are taken to the profit and loss account, the average cost of the asset in question is adjusted downwards to the level of the current exchange rate or market price thereof.

For fixed-income securities, the premiums or discounts arising from the difference between the average acquisition cost and the redemption price were calculated and presented on a pro rata basis as part of interest income and amortised over the remaining life of the securities.

### **2.7 Post balance sheet events**

Assets and liabilities are adjusted to take account of events occurring between the balance sheet date and the date on which the BCL's Council approves the annual accounts if such events have a material effect on the assets and liabilities on the balance sheet date.

### **2.8 Banknotes in circulation**

The ECB and the 12 participating NCBs, which together form the Eurosystem, have issued euro banknotes since 1st January 2002. The total value of euro banknotes in circulation is allocated on the last working day of each month in accordance with the banknote allocation key.

The ECB has been allocated a share of 8% of the total value of euro banknotes in circulation as from 2002, whereas the remaining 92% has been allocated to NCBs according to their weightings in the capital key of the ECB. The share of banknotes allocated to each NCB is disclosed under the balance sheet liability item "Banknotes in circulation".

The difference between the value of the euro banknotes allocated to each NCB in accordance with the banknote allocation key and the value of the euro banknotes that it actually puts into circulation gives rise to remunerated intra-Eurosystem balances. These claims or liabilities, which incur interest are disclosed under the sub-item "Intra-Eurosystem: Net claim/liability related to the allocation of euro banknotes within the Eurosystem" (see "Intra-ESCB balances" in the notes on accounting policies).

From 2002 until 2007 the intra-Eurosystem balances arising from the allocation of euro banknotes will be adjusted in order to avoid significant changes in NCBs relative income positions as compared with previous years. The adjustments are effected by taking into account the differences between the average value of banknotes in circulation of each NCB in the period between July 1999 and June 2001 and the average value of banknotes that would have been allocated to them during that period under the ECB's capital key. The adjustments will be reduced in annual stages until the end of 2007, after which income on banknotes will be allocated fully in proportion to the NCBs' paid-up shares in the ECB's capital.

The interest income and expense on these balances is cleared through the accounts of the ECB and is disclosed under "Net interest income".

The Governing Council of the ECB has decided that the seigniorage income of the ECB arising from the 8% share of euro banknotes allocated to the ECB shall be distributed separately to the NCBs in the form of an interim distribution of profit. It shall be so distributed in full unless the ECB's net profit for the year is less than its income earned on euro banknotes in circulation. For 2002, one interim distribution was made on the second working day of 2003. This is disclosed in the Profit and Loss Account under "Income from equity shares and participating interest".

From 2003 onwards, interim distributions will be made after the end of each quarter.

### **2.9 Intra-Eurosystem claims and liabilities**

Intra-Eurosystem balances arising from the allocation of euro banknotes within the Eurosystem are

included as a net single asset or liability under “Net claim/liability related to the allocation of euro banknotes within the Eurosystem”.

Intra-Eurosystem claims and liabilities arising from TARGET balances and counterparties accounts are shown as a single net asset or liability on the balance sheet.

### 2.10 Treatment of tangible and intangible assets

The tangible and intangible assets are recorded at their acquisition cost less depreciation. Depreciation was calculated on a straight-line basis over the expected economic lifetime of the assets:

	Years
Buildings	25
Renovation of buildings	10
Furniture and equipment	3-5
Computer hardware and software	4

### 2.11 Pension fund

As at 1st January 1999, after the introduction of the law of 23 December 1998, the pension claims of its agents are fully supported by the BCL. A pension fund, whose aim it is to cover the risks related to aging, infirmity or survival, has been created in 2000. The actuarial method for determining the BCL's liabilities towards its agents has been approved by the pension fund's board as at 12 February 2001.

The actuarial method determines the pension fund's liability related to aging, infirmity or survival for each agent. The model is based on each agent's personal and career data, on the level of inflation for the next sixty years as well as an average rate of return generated by the fund's assets.

The BCL's liabilities related to pensions are shown in the account “Provisions for pensions”. The increase of the provision results from the regular transfer of the employee's part and the BCL's employer's part. In addition, if necessary, periodic transfers from the account “Booking reserve of the pension fund”, equivalent to the revenues generated by the fund's assets, to adjust the account “Provision for pensions” to its actuarial value are booked. In the case of insufficient transfers in order to cover the BCL's pension liabilities, the difference between the existing provision and the real claim is covered by a special transfer to be supported by the BCL (see also note 18.2).

### Note 3 – Gold and gold receivables

As at 31 December 2002, BCL holds 365.75 ounces of fine gold amounting to EUR 0.1 million (76 358.757 ounces of fine gold amounting to EUR 24.0 million as at 31 December 2001) and a first rated gold bond issued by the International Bank for Reconstruction and Development purchased in 2002 and valued at EUR 24.8 million.

### Note 4 – Claims on non-euro area residents denominated in foreign currency

Under this item are recorded the BCL's foreign exchange reserve holdings with counterparties located outside the euro area (including international and supranational institutions and central banks that are not members of the Eurosystem).

This item is broken down into two sub-items:

- receivables from the International Monetary Fund (“IMF”);
- balances held on accounts with banks which do not belong to the euro area as well as securities, loans and other foreign currency assets issued by non-residents of the euro area.

### Note 5 - Lending to euro area credit institutions related to monetary policy operations denominated in euro

This balance sheet item represents the liquidity-providing transactions executed by the BCL with Luxembourg credit institutions.

The item is divided into various sub-items depending on the type of instrument used to provide liquidity

to the financial sector.

### 5.1 *Main refinancing operations*

This sub-item records the amount of liquidity provided to credit institutions by way of weekly 14-day tenders.

### 5.2 *Long-term refinancing operations*

This sub-item records the amount of credit extended to credit institutions by way of monthly 3-month tenders.

#### Note 6 - Other claims on euro area credit institutions denominated in euros

This item includes the BCL's current accounts and fixed-term deposits with Luxembourg credit institutions.

#### Note 7 - Securities of euro area residents denominated in euros

This item covers the BCL's portfolio in euros which could be used, if needed, for monetary policy operations. It was intended that the size of this portfolio should stay stable during the first 3 years of stage III of the EMU according to the decision taken by the Governing Council of the ECB in 1998. The agreement was extended for at least one year in November 2001.

This portfolio consists solely of government bonds denominated in euros issued by Member States of the European Union and top-rated bonds issued by euro area resident companies. Securities are valued at market prices. As at 31 December 2002, their value at market prices included an unrealised loss amounting to EUR 21 677 (EUR 4 888 as at 31 December 2001).

#### Note 8 – Intra-Eurosystem claims

##### 8.1 *Participating interest in ECB*

This sub-item represents the BCL's contribution to the capital of the ECB. It corresponded to 0.1492% in the subscribed capital of the ECB (EUR 5 billion). A decision allowing for an increase of the authorised capital up to EUR 10 billion has been taken in May 2001 by the Council of the European Union based on the ESCB/ECB statutes.

##### 8.2 *Claims equivalent to the transfer of foreign reserves*

This sub-item represents the euro-denominated claims on the ECB in respect of the transfer of part of the BCL's foreign reserves.

This claim is remunerated at 85 % of the interest rate on the main refinancing operations, which means 2,42 % on the balance sheet date.

In May 2001, the Council of the European Union has taken a decision, based on the ESCB/ECB statutes, allowing the ECB to ask for the transfer of supplementary foreign reserves in order to reconstitute the initial transfer of foreign reserves.

##### 8.3 *Other claims within the Eurosystem*

This sub-item represents the interim distribution of profit of the ECB related to the euro banknotes allocated to the ECB (see explanatory note 2.8).

#### Note 9 – Other assets

##### 9.1 *Tangible and intangible assets*

Tangible and intangible fixed assets developed as follows:





	Buildings EUR	Furniture and equipment EUR	Software EUR	TOTAL EUR
Cost as at 01.01.2002	65,143,498	6,651,697	2,805,125	74,600,320
Acquisitions	2,389,562	1,319,802	513,685	4,223,049
Disposals	-	(25,938)	-	(25,938)
<b>COST AS AT 31.12.2002</b>	<b>67,533,060</b>	<b>7,945,561</b>	<b>3,318,810</b>	<b>78,797,431</b>
Accumulated depreciation as at 01.01.2002	(8,163,426)	(2,901,438)	(1,192,933)	(12,257,797)
Depreciation	(2,932,092)	(1,336,873)	(590,021)	(4,858,986)
Reversal	46	10,894	1,959	12,899
Accumulated depreciation as at 31.12.2002	(11,095,472)	(4,227,417)	(1,780,995)	(17,103,884)
<b>NET BOOK VALUE AS AT 31.12.2002</b>	<b>56,437,588</b>	<b>3,718,144</b>	<b>1,537,815</b>	<b>61,693,547</b>

The sub-item "Buildings" comprises the acquisition cost of the premises located on the 2 boulevard Royal, the costs incurred in relation to the reconstruction and transformation of the new site ("Pierre Werner" building), the renovations made on the main building ("Royal" headquarters) and the acquisition cost of the premises located on the boulevard Prince Henri.

The "Pierre Werner" is considered as a new building and is amortised over a period of 25 years while the costs incurred in relation to the transformation of the "Royal" are considered as renovations and are amortised over 10 years.

## 9.2 Other financial assets

The components of this item are as follows:

	2002 EUR	2001 EUR
Other participating interests	231,344	143,168
Pension fund	47,066,258	46,935,872
Securities portfolio	981,113,809	591,706,245
	<b>1,028,411,411</b>	<b>638,785,285</b>

The other participating interests comprise the entry fees to LIPS-Net (EUR 50 000) together with the BCL's investments in Swift (EUR 90 168), ATTF (EUR 3 000) and RTGS-L GIE (EUR 88 104).

The assets of the pension fund are recorded in the accounts under "Pension fund BCL". The balance of this account corresponds to the net asset value of the fund as calculated by the depositary bank as at 31 December 2002. In accordance with the decision of the fund's board, following the annual computation of the pension commitments, a transfer amounting to EUR 5.2 million has been executed by BCL to the pension fund in January 2003.

The securities portfolio recorded under this heading corresponds to the securities held by BCL for the purpose of the investment of the own funds and amounts owed to third parties amounting to a total of EUR 981,1 million (EUR 591.7 million as at 31 December 2001). Securities are valued at market prices. As at 31 December 2002, their value at market prices included an unrealised loss amounting to EUR 0.2 million (EUR 0.1 million as at 31 December 2001).

## 9.3 Accruals and prepaid expenses

Most of this item consists of the accrued interests on monetary policy operations, securities and receivables from the IMF.

Are also included under this item the commissions receivables, prepaid expenses of which salaries for January 2003 and other income receivable.

#### 9.4 Sundry

	2002 EUR	2001 EUR
Claim on the NBB in relation to Belgian banknotes circulating in Luxembourg	-	578 592 711
Withdrawals in advance	14 515 000	-
Others	6 650 549	13 145
	<b>21 165 549</b>	<b>578 605 856</b>

The claim on the Banque Nationale de Belgique ("BNB") which corresponded to the counterpart of the theoretical amount of Belgian banknotes circulating in Luxembourg recorded under liabilities item "Banknotes in circulation" has been cancelled following the introduction of the euro banknotes.

The sub-item "Withdrawals in advance" corresponds to the amount of euro banknotes ordered by the credit institutions as at 31 December 2002 and which were not yet put into circulation on that date.

The sub-item "Others" consists mainly of the counterpart of the unrealised loss on SDRs recorded in the financial statements of the BCL which is guaranteed by the State according to the agreement signed in May 1999 establishing the financial relationship between the State of Luxembourg and the BCL.

#### Note 10 – Banknotes in circulation

Since 2002, this caption includes, besides the amount of Luxembourg banknotes not yet returned at the end of the year (EUR 6.5 million), the BCL's share of the total euro banknotes put into circulation by the 12 central banks of the Eurosystem according to their weightings in the capital of the ECB, which totalled EUR 607.7 million (see explanatory note 2.8).

#### Note 11 - Liabilities to euro area credit institutions related to monetary policy operations denominated in euros

This item primarily comprises credit institutions' accounts held within the framework of the requirements of the minimum reserve system.

#### Note 12 - Liabilities to other euro area residents denominated in euros

##### 12.1 Liabilities to general government

This item records the amounts owed to the Luxembourg Treasury including a current account balance of EUR 0.9 million (EUR 2.8 million as at 31 December 2001) and a fixed-term deposit amounting to EUR 525.0 million (EUR 578.6 million as at 31 December 2001). The fixed-term deposit relates to the agreement signed in 1999 between the State of Luxembourg and the BCL which originally specified that the State should maintain at the BCL a deposit equivalent to the BCL's claim on the BNB in relation to Belgian banknotes circulating in Luxembourg. The fixed-term deposit matured on 1 March 2002 and was replaced, following agreement between the parties, by a term deposit renewed on a monthly basis. The remuneration on the term deposit is calculated using the ECB rate applied to the deposit facility. Interest expense in relation with this term deposit for the financial year 2002 amounts to EUR 10.5 million and is recorded under the caption "Interest expense".

In accordance with the articles of the agreement which foresee this possibility, the State renounced on the remuneration of its term deposit for the financial year 2002. An equivalent income (EUR 10.5 million) is recorded under "Other income" in order to reinforce BCL's own funds.

##### 12.2 Other liabilities

The amount owed to the BNB which totalled EUR 15.3 million as at 31 December 2001, equivalent to the amount that BCL had to pay for the purchase of gold at its historical cost pursuant the Intergovernmental Agreement of 23 November 1998 between Belgium and Luxembourg, has been

reimbursed during the year.

#### Note 13 – Liabilities to non-euro area residents denominated in euros

This item includes current accounts held by central banks, international and supranational institutions and other account holders outside the euro area.

#### Note 14 - Counterpart of special drawing rights allocated by the IMF

The amount shown under this caption represents the exchange value of SDR, converted to euros at the same rate as applied to the SDR assets, which should be returned to the IMF if SDR are cancelled, if the SDR Department established by the IMF is closed or if Luxembourg decides to withdraw from it. This liability, of unlimited duration, amounts to SDR 17 million, or EUR 22.0 million (SDR 17 million, or EUR 24.2 million as at 31 December 2001).

#### Note 15 – Intra-Eurosystem liabilities

##### 15.1 Net liabilities related to the allocation of euro banknotes within the Eurosystem

This item consists of the liabilities of the BCL towards the Eurosystem in relation to the allocation of euro banknotes within the Eurosystem (see explanatory note 2.8).

##### 15.2 Other liabilities within the Eurosystem

This item comprises the BCL's net liabilities towards the Eurosystem, mostly from transactions resulting from cross-border payments initiated for monetary or financial operations, made via the TARGET system, between BCL and the other NCBs as well as the ECB. The liabilities amounted to EUR 9,3 billion as at 31 December 2002 (EUR 10,6 billion as at 31 December 2001).

This item also includes the liability resulting from the net result arising from the calculation and allocation of monetary income pooled within the Eurosystem. As at 31 December 2002, the liability amounted to EUR 9.7 million (EUR 1.1 million as at 31 December 2001).

#### Note 16 – Items in course of settlement

This item contains mainly the counterpart of the euro banknotes ordered by credit institutions as at 31 December 2002 which were not yet put into circulation on that date.

#### Note 17 – Other liabilities

This item comprises mainly the negative revaluation differences on financial instruments linked to interest rates and market prices, accrued interest, of which accrued interest on intra-Eurosystem liabilities, as well as miscellaneous expenses payable, of which suppliers.

As at 31 December 2001, this item also included the booking reserve of the pension fund for EUR 587 727. To the extent that the result of the pension fund is dedicated to the beneficiaries of the fund, the corresponding expenses and revenues are not included in the profit and loss account of the BCL, but are part of this specific account. During the year 2002, this reserve has been used to increase the pension provisions.

#### Note 18 - Provisions

Provisions developed as follows:	2002 EUR	2001 EUR
Provisions for banking risks	183,785,756	122,407,978
Provisions for pensions	59,045,736	56,709,839
Other provisions	532,013	1,895,993
	<b>243,363,505</b>	<b>181,013,810</b>

## 18.1 Provisions for banking risks

Provisions for banking risks include the following items:

	2002 EUR	2001 EUR
<b>Provisions for specific banking risks</b>		
Provision covering credit risk	63,990,305	46,560,326
Provision covering foreign exchange risk	-	14,920,000
Provision covering operational risk	14,400,000	14,250,000
Provision covering liquidity risk	7,907,276	5,493,612
Provision covering interest rate risk	200,000	2,750,000
	<b>86,497,581</b>	<b>83,973,938</b>
<b>Provisions for general banking risks</b>		
Provision for liabilities resulting from monetary agreements	35,324,827	35,324,827
Other provision for general banking risks	61,963,348	3,109,213
	<b>97,288,175</b>	<b>38,434,040</b>
	<b>183,785,756</b>	<b>122,407,978</b>

### 18.1.1 Provision covering credit risk

The provision for EUR 64.0 million (EUR 46.6 million as at 31 December 2001) corresponds to:

- 4% of the BCL's own securities portfolio valued at market price as at 31 December 2002 (portfolio affected to monetary policy operations if necessary and structural portfolio) and participations other than the participating interest in the ECB;
- 4% of the total amount lent by the Eurosystem as at year-end for monetary policy reasons multiplied by the capital key corresponding to BCL (0.1842%).

### 18.1.2 Provision covering foreign exchange risk

This provision, initially created to cover risks related to the participation in the ESCB for potential losses incurred by the ECB between 1999 and 2001 following different mechanisms, has been dissolved during the year.

### 18.1.3 Provision operational risk

This provision was created in 2001 and is intended to cover the risk of losses resulting from the inadequacy or the failure of procedures and processes, and relating to human factor or external causes. Because of a lack of relevant statistics on the measure of risk, the transfer to the provision in 2002 has been based on the Basic Indicator Approach described by the consultative working-paper of the Basel Committee as being 15% of the net banking product (30% as at 31 December 2001). The increase is due to the fact that the net banking product more than doubled in 2002.

### 18.1.4 Provision for liabilities resulting from monetary agreements

The provision for liabilities resulting from monetary treaties was initially created in 1984 by the Institut Monétaire Luxembourgeois ("IML") together with the Ministry of Treasury to be able to face any future monetary liabilities.

### 18.1.5 Other provision for general banking risks

For prudence's sake and to safeguard its assets, BCL has transferred EUR 58.9 million to the provision for general banking risks to cover any inherent risks related to central bank activities.

## 18.2 Provisions for pensions

Provisions for pensions include the following items:

Provisions for pensions include the following items:		
	2002 EUR	2001 EUR
Provision for pensions	57,087,000	46,151,874
Provision for retained risks related to infirmity and death	-	1,261,158
Provision for equalisation and financial risks	850,252	3,000,000
Provision for increase of PBO	1,108,484	6,296,807
	<b>59,045,736</b>	<b>56,709,839</b>

#### 18.2.1 Provision for pensions

The pensions claims of its agents are fully supported by the BCL. The corresponding liability is calculated on the basis of the actuarial method described in note 2.11 in consideration of current factors and amounts to EUR 57.1 million as at 31 December 2002.

The increase of the provision during the year results from:

- monthly withdrawals on the gross salaries of BCL employees (employee's part) and the employer's part;
- periodic transfers from the account "Booking reserve of the pension fund" to adjust the account "Provision for pensions" to its actuarial value ;
- a transfer for the year 2002 to adjust the account "Provision for pensions" to its actuarial value.

During the year 2001 and according to article 35 paragraph 4(c) of its institutional law, BCL operated a unique transfer from its reserves in order to adjust the pension fund to the required amount as at 31 December 2001. In addition, article 35 paragraph 4(a) of the same law indicates that "the Luxembourg pension offices that received contributions from persons that are or become BCL agents, pay these amounts to the BCL's pension fund".

As of today, the Luxembourg pension funds did not fulfil their obligations mentioned in article 35 paragraph 4(a). Consequently, the unique transfer from the reserves in 2001 for EUR 33,8 million was determined without considering the claim on the pension funds, which will be used for the reconstitution of the reserves.

#### 18.2.2 Provision for retained risks related to infirmity and death

A provision covering the retained risks related to infirmity and death not subject to any insurance contract had been created during the year 2001 for EUR 1,3 million. This provision has been totally dissolved in 2002.

#### 18.2.3 Provision for equalisation and financial risks

A provision of EUR 3 million for equalisation and financial risks has been created in 2001 to cover fluctuations in the pension fund's liabilities in the beginning years and/or to compensate a lower return on assets. During the year 2002, an amount of EUR 2.1 million has been used.

#### 18.2.4 Provision for increase of PBO

In 2001, a provision of EUR 6.3 million has been created based on the average expense in relation with pensions, infirmity and death for agents already being part of BCL personnel or included in the budgeted figures of 2002 but not included in the pension fund's liabilities calculation as at 31 December 2002. The liability ("Projected Benefit Obligation" or "PBO") equals the potential payments at their present value considering individual parameters and the actuarial method used. During the year 2002, an amount of EUR 5.2 million has been used to cover the BCL's increased pension liabilities resulting from the recruitment of 22 new agents.

### Note 19 – Revaluation accounts

This item includes positive revaluation differences related to the spread between the exchange rate as at year-end and the average exchange rate of BCL's currency and gold positions, as well as positive

revaluation differences related to the spread between the market value as at year-end and the amortised cost for securities positions.

## Note 20 - Capital and reserves

### 20.1 Capital

The Luxembourg State is the unique shareholder of the BCL's capital which is fixed to EUR 25 million (EUR 25 million as at 31 December 2001).

### 20.2 Reserves

The reserves amount to EUR 109.7 million. This amount has been increased by EUR 5.5 million during the year following the allocation of profit of the year 2001 according to the decision of the BCL's Board and its institutional law (article 31).

## Note 21 – Custody deposits

This item includes the securities given into custody by Luxembourg financial institutions to cover their liabilities related to refinancing operations, marginal lending facilities and intra-day credits.

This caption also includes the securities given into custody in Luxembourg and used as a guarantee by commercial banks incorporated in other member states according to the agreement "Correspondent Central Banking Model" ("CCBM"). This agreement allows commercial banks to obtain funding with their country of residence's central bank by using the securities held in another member state as a guarantee.

As at 31 December 2002, the market value of these securities amounts to EUR 87.1 billion (EUR 77.3 billion as at 31 December 2001).

## Note 22 – Commitments and similar instruments

This item corresponds to the guarantee issued by BCL for the project "Night Time Link". This liability is guaranteed by assets received in custody for the same amount.

## Note 23 - Foreign currency reserves assets administrated on behalf of the ECB

This caption includes the foreign currency reserves at market value that have been transferred to the ECB in January 1999 and are managed by BCL on behalf of the ECB. These reserves are shown under asset item "Claims related to the transfer of foreign currency reserves" (see also note 8.2).

## Note 24 – Forward contracts

BCL is engaged in bond and stock index futures. These instruments are mainly held for hedging purposes of interest rate risks related to the securities portfolio.

As at 31 December 2002, the total liabilities related to these forward contracts amount to EUR 410.6 million (EUR 28.4 million as at 31 December 2001). One security has been given as a guarantee in order to cover the initial margin deposit. This security remains on the balance sheet of BCL for an amount of EUR 3.5 million as at 31 December 2002 (EUR 2.0 million as at 31 December 2001).

## Note 25 – Net interest income

This item includes interest income, after deduction of interest expense, on assets and liabilities in currency and in euros. Interest income and expense are detailed as follows:



**COMPOSITION OF INTEREST INCOME**

	AMOUNTS IN FOREIGN CURRENCY EUR		AMOUNTS IN EUROS EUR	
	2002	2001	2002	2001
IMF	2,928,216	3,297,253	-	-
Monetary policy	-	-	658,390,717	847,708,312
Claims related to the reallocation of euro banknotes in the Eurosystem	-	-	3,601,306	-
Intra-Eurosystem claims	-	-	3,662,707	2,780,476
Securities	-	-	39,092,983	34,814,883
Gold	393,544	154,018	-	-
Other	23	61	178,484	1,042,710
<b>TOTAL</b>	<b>3,321,783</b>	<b>3,451,332</b>	<b>704,926,197</b>	<b>886,346,381</b>

**COMPOSITION OF INTEREST EXPENSE**

IMF	514,552	831,508	-	-
Current accounts (including minimum reserves)	-	-	240,169,924	308,566,615
Liabilities related to the reallocation of euro banknotes in the Eurosystem	-	-	102,062,893	-
Other Intra-Eurosystem liabilities	-	-	252,290,832	531,394,729
Interests on term deposits	-	-	10,530,938	-
Other liabilities	-	-	1,169,956	2,301,930
<b>TOTAL</b>	<b>514,552</b>	<b>831,508</b>	<b>606,224,543</b>	<b>842,263,274</b>

**Note 26 - Write-downs on financial assets and positions**

This item includes revaluation losses on securities for EUR 3.1 million and on financial instruments linked to interest rates and market prices for EUR 1.8 million (EUR 0.1 million and EUR 0.1 million respectively in 2001).

**Note 27 – Transfer to/from provisions for foreign exchange rate and price risks**

This caption includes the transfers to and from provisions for banking risks (see also note 18.1).

**Note 28 – Net result from fees and commissions**

Fees and commissions income and expense are detailed as follows:

	FEES AND COMMISSIONS INCOME EUR		FEES AND COMMISSIONS EXPENSE EUR	
	2002	2001	2002	2001
Securities	5,351,425	4,566,425	5,846,379	5,064,391
Others	181,859	160,829	263,996	145,938
<b>TOTAL</b>	<b>5,533,284</b>	<b>4,727,254</b>	<b>6,110,375</b>	<b>5,210,329</b>

## I

**Note 29 – Income from participating interest**

This item includes the dividend distributed by the ECB for the year 2001.

Also included under this heading is the distribution of the ECB's income on euro banknotes amounting to EUR 1.1 million. In 2002, the amount of the ECB's distributed income on euro banknotes in circulation was reduced by EUR 118 million in accordance with a decision of the Governing Council of the ECB in respect of expenses incurred by the ECB in connection with the issue and handling of euro banknotes. These expenses related to the costs, borne by the ECB, of the establishment of a strategic stock of euro banknotes for the Eurosystem.

## II

**Note 30 - Net result of pooling of monetary income**

In 2002 the amount of each NCB's monetary income was determined by multiplying the liability base of each NCB by the main refinancing operations rate.

The liability base consists of the following items:

- banknotes in circulation (including both euro banknotes and non-returned national banknotes);
- liabilities to credit institutions related to monetary policy operations denominated in euro;
- net intra-Eurosystem liabilities resulting from TARGET transactions;
- and net intra-Eurosystem liabilities related to the allocation of euro banknotes within the Eurosystem.

Any interest paid on liabilities included within the liability base is to be deducted from the monetary income to be pooled.

The monetary income pooled by the Eurosystem is to be allocated among NCBs according to the subscribed capital key (0.1842% for BCL).

The difference between the monetary income pooled by BCL, amounting to EUR 27.4 million, and reallocated to BCL, amounting to EUR 17.7 million, is the net result arising from the calculation of monetary income.

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**Note 31 – Other income**

Other income includes revenues for EUR 10,5 million that reflect the renunciation by the State of Luxembourg on the interests due for 2002 on its term deposit with BCL (see also note 12.1). This item also includes revenues for services rendered to third parties, transfers from administrative provisions and income from numismatic activities.

## VI

**Note 32 – Staff costs**

This item includes the salaries and compensations as well as the employer's part of the contributions to the pension and social security regimes. The compensations paid to the Directors amount to EUR 424 389 for the year 2002 (EUR 409 167 for the year 2001).

As at 31 December 2002, BCL's personnel amounts to 204 agents (182 as at 31 December 2001). The average number of persons working for BCL from 1st January to 31 December 2002 amounted to 194 agents (175 for the year 2001).

## VII

**Note 33 - Administrative expenses**

This caption includes all general and recurring expenses, meaning rents, cleaning and reparations of buildings and equipment, small goods and materials, fees paid and other services and furniture as well as recruitment expenses. The compensations paid to the members of the Board amount to EUR 58 397 in 2002 (EUR 55 780 in 2001).

## VIII

**Note 34 – Depreciation of tangible and intangible fixed assets**

This item shows the depreciation applied on buildings, renovations on buildings, furniture and office equipment, computer hardware and software (see also note 9.1).



#### Note 35 – Banknote production services

This caption shows mainly the costs related to the production and issue of banknotes denominated in euros.

#### Note 36 – Other expenses

The bulk of other expenses are related to the transfer to the administrative provisions.



# IX

ANNUAL REPORT 2002



## ANNEXES

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## 9. ANNEXES

### 9.1 List of BCL circular letters

BCL circular letter 98/151 of 24 September 1998 regarding accounting aspects of the euro changeover

BCL circular letter 98/152 of 6 November 1998 regarding the introduction of a minimum reserve system

BCL circular letter 98/155 of 9 December 1998 regarding the reminder with regard to minimum reserve requirements

BCL circular letter 98/156 of 21 December 1998 regarding the breakdown of value corrections built up by credit institutions as of 31 December 1998

BCL circular letter 99/157 of 17 December 1999 regarding the revision of the percentage of the regular deduction from the reserve base

BCL circular letter 2000/158 of 25 February 2000 regarding the modification of statistical tables S 1.1 "*Bilan statistique mensuel*" and S 1.2 "*Bilan statistique mensuel simplifié*"

BCL circular letter 2000/159 of 11 August 2000 regarding the enforcement of security pricing quotas applicable to eligible securities "*Eligibilité des créances privées néerlandaises*"

BCL circular letter 2000/160 of 13 November 2000 to all monetary UCIs regarding the accession of Greece to the EMU

BCL circular letter 2000/161 of 13 November 2000 regarding the delivery date of monthly statistical reports to the BCL

BCL circular letter 2000/162 of 13 November 2000 to all credit institutions regarding the accession of Greece to the EMU

BCL circular letter 2001/163 of 23 February 2001 regarding the surveillance by the Central bank of the payment and settlement systems in Luxembourg

BCL circular letter 2001/164 of 28 March 2001 regarding the registering of the global exchange and derivatives market

BCL circular letter 2001/165 of 5 May 2001 – to all credit institutions and to the financial services of the Postal and Telecommunications Services Company – Takeover of the activities of the Belgian Luxembourg Exchange Institute by the BCL and the STATEC

BCL circular letter 2001/166 of 5 July 2001 – to all credit institutions and to the financial services of the Postal and Telecommunications Services Company (giro accounts service) – Instructions regarding modification of the data collection with regard to the balance of payments

BCL circular letter 2001/167 of 19 November 2001 – to all credit institutions – regarding the delivery date of monthly statistical reports to the BCL

BCL circular letter 2001/168 of 5 December 2001 – Policy and procedures with regard to surveillance payment and settlement systems in Luxembourg.

BCL circular letter 2002/169 of 30 May 2002 – Studies on investment abroad – to all credit institutions and to the financial services of the Postal and Telecommunications Services Company

BCL circular letter 2002/170 of 5 June 2002 - to all credit institutions - Modification of statistical tables S 1.1 "*Bilan statistique mensuel*" and S 2.5 "*Bilan statistique trimestriel*" and abolition of statistical tables S 1.2 "*Bilan statistique mensuel simplifié*" and S 2.6 "*Détail des créances sur la clientèle*"

BCL circular letter 2002/171 of 5 June 2002 – to all Luxembourg UCITS - Modification of statistical tables S 1.3 "*Bilan statistique mensuel des OPC*", S 2.10 "*Ventilation par pays*", S 2.11 "*Ventilation par devises*" and S 2.12 "*Détail sur les titres détenus par les OPC*"

BCL circular letter 2002/172 of 28 June 2002 - Protection of payment and settlement systems against crime and terrorism – to technical operators and agents of payment and settlement systems

BCL circular letter 2002/173 of 3 July 2002 - Modification of the General Conditions of the BCL - to all credit institutions

BCL circular letter 2002/174 of 17 July 2002 - Modification of the statistical data collection with regard to interest rates - to all credit institutions

BCL circular letter 2002/175 of 17 July 2002 - New statistical data collection with regard to the EMU - to all credit institutions - Modification of statistical table S 1. 4 "*Ajustements liés aux effets de valorisation*"

BCL circular letter 2002/176 of 20 December 2002 – Delivery date of monthly statistical reports to the BCL – to all credit institutions

BCL circular letter 2002/177 of 20 December 2002 – List of country codes for the statistical reporting of the balance of payments record and of the quarterly statistical reporting S 2.5 – to all credit institutions

BCL circular letter 2002/178 of 20 December 2002 – Delivery dates of monthly statistical reports to the BCL – to all Luxembourg UCITS

## 9.2 Publications of the BCL

Paper copies of publications may be obtained at the BCL public counters within the limit of available stocks and according to its specified conditions. These publications may also be read and downloaded from the website [www.bcl.lu](http://www.bcl.lu).

### Bulletins of the BCL

- [BCL Bulletin 1999/1, November 1999](#)
  - *Les statistiques de politique monétaire*
  - *Les évolutions monétaires et financières dans la zone euro et au Luxembourg*
  
- [BCL Bulletin 1999/2, January 2000](#)
  - *Les billets et les pièces : le rôle de la BCL*
  - *La balance des paiements et la position extérieure globale au Luxembourg*
  - *Les effets technologiques sur les systèmes bancaires de l'Union européenne*
  
- [BCL Bulletin 2000/1, June 2000](#)
  - *L'accélération de l'inflation au Luxembourg*
  - *La présentation de l'évolution de la masse monétaire au Luxembourg*
  - Consolidation in the European securities settlement systems environment
  
- [BCL Bulletin 2000/2, September 2000](#)
  - *Evolution du marché interbancaire à Luxembourg*
  - *L'inflation des prix des actifs immobiliers : une application au cas Luxembourg*
  - *Le virement en droit luxembourgeois*
  
- [BCL Bulletin 2000/3, December 2000](#)
  - *Description générique de l'environnement informatique à la BCL*
  - *L'architecture de la BCL pour l'échange électronique des données*
  - The role of the Eurosystem with regard to the payment and securities settlement systems

## I

- [BCL Bulletin 2001/1, June 2001](#)
  - *Les effets du développement de la monnaie électronique*
  - "The European contribution to international financial stability", by Richard Portes
  - "The European Central Bank, the Eurosystem and the European System of Central Banks", by Dr. Willem F. Duisenberg

## II

- [BCL Bulletin 2001/2, September 2001](#)
  - *L'évaluation d'actions de la nouvelle et de l'ancienne économie*
  - *La protection des systèmes de paiement et de règlement-titres. Analyse de la directive 98/26/CE et de sa transposition en droit luxembourgeois*

## III

- [BCL Bulletin 2001/3, December 2001](#)
  - The euro cash changeover: a note on the effects of bounded rationality and rules of thumb
  - *Recensement triennal sur l'activité des marchés des changes et des profits dérivés*
  - *Transmission monétaire : Analyse de données des entreprises non financières luxembourgeoises*

## IV

- [BCL Bulletin 2002/1, June 2002](#)
  - *Les soldes budgétaires apurés des mouvements conjoncturels*
  - *La production potentielle et l'écart de production au Luxembourg : une revue des méthodes alternatives*
  - *Efficacité productive des banques luxembourgeoises : une analyse comparative*

## V

- [BCL Bulletin 2002/2 – Special edition re: financial stability, September 2002](#)

- [BCL Bulletin 2002/3, September 2002](#)
  - *Die Eurobargeldeinführung, regionale Preisentwicklung und die wahrgenommene Inflation der Verbraucher*
  - A descriptive analysis of the Luxembourg financial structure: 1998-2001

## VI

- [BCL Bulletin 2002/4, December 2002](#)
  - *Der Euro und Regionale Preiskonvergenz?*
  - *La soutenabilité à long terme du régime général de pensions au Luxembourg*
  - *Indicateurs macroprudentiels : résultats en 2002 jusqu'au troisième trimestre*

#### BCL Annual reports

- Annual Report 1998, April 1999
- Annual Report 1999, April 2000
- Annual Report 2000, April 2001
- Annual Report 2001, April 2002
- Annual Report 2002, April 2003

## IX

### **BCL Working papers**

- [Working paper no. 1, April 2001](#)  
"An assessment of the national labour market – On employment, unemployment and their link to the price level in Luxembourg", by Erik Walch
- [Working paper no. 2, November 2001](#)  
"Stock market valuation of old and new economy firms", by Patrick Lünemann
- [Working paper no. 3, March 2002](#)  
"*Economies d'échelle, économies de diversification et efficacité productive des banques luxembourgeoises : une analyse comparative des frontières stochastiques sur données en panel*", by Abdelaziz Rouabah
- [Working paper no. 4, June 2002](#)  
"Potential output and the output gap in Luxembourg: some alternative methods", by Paolo Guarda
- [Working paper no. 5, October 2002](#)  
"Monetary transmission: empirical evidence from Luxembourg firm-level data", by Patrick Lünemann and Thomas Mathä
- [Working paper no. 6, January 2003](#)  
"The sustainability of the private sector pension system from a long-term perspective: the case of Luxembourg", by Muriel Bouchet
- [Working paper no. 7, February 2003](#)  
"The analysis of risk and risk mitigation techniques in payment and securities settlement systems and the impact on central bank's oversight", by Simona Amati

### **BCL brochures**

- *Euro Pratique – Vade-mecum sur l'introduction de l'euro*  
(in French, German and Portuguese), May 1998
- Introducing euro notes and coins in the Grand-Duchy of Luxembourg (in French, German, English and Portuguese), October 2000
- *Les emplois à la Banque centrale of Luxembourg, November 2001*

**"The Banque centrale of Luxembourg in the European System of Central Banks"**, by Michael Palmer, May 2001

**In Memoriam – Pierre Werner** – A tribute, by Michael Palmer, August 2002

### **BCL euro documentation**

#### **General Conditions for BCL operations**

## I

**9.3 Economic and financial statistics of the BCL**

Statistical tables listed hereunder are available on the BCL Internet site [www.bcl.lu](http://www.bcl.lu) ("Statistics") and are regularly updated. You may also sign in on the BCL mailing list, which allows the BCL to inform you of major changes affecting statistics and other important documents. These tables are also published in the quarterly BCL Bulletin.

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- 1 Monetary policy statistics
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  - 1.2 Minimum reserves statistics in Luxembourg
- 2 Monetary and financial developments in the euro area
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  - 2.2 Outstanding MFI loans to households and non-financial corporations by type and original maturity
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  - 3.9 Evolution of undertakings of collective investment in Luxembourg
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  - 4.3 Assets and liabilities: share of Luxembourg
- 5 Price and cost developments in Luxembourg
  - 5.1 Developments in the Harmonised Index of Consumer Prices (HICP) and the National Index of Consumer Prices (NICP)
  - 5.2 Industrial goods and commodity prices
  - 5.3 Costs indicators and terms of trade
- 6 Luxembourg real economy indicators
  - 6.1 GDP at market prices and its components (based on ESA95)
  - 6.2 Selected other real economy indicators
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- 7 Luxembourg public finances

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- 8 Luxembourg current account and the Banque centrale du Luxembourg's reserve position
- 8.1 Balance of payments: Summary
- 8.2 Balance of payments: Current account
- 8.3 Balance of payments: Direct investment
- 9 Luxembourg trade balance
- 10 Luxembourg francs denominated banknotes and coins in circulation

#### 9.4 Documents published by the European Central Bank

For a complete list of the documents published by the ECB and for the versions in all official languages of the EU, please visit the ECB's web site [www.ecb.int](http://www.ecb.int).

#### 9.5 List of abbreviations

ABBL	<i>Association des Banques et Banquiers, Luxembourg</i>
AGDL	<i>Association pour la garantie des dépôts, Luxembourg</i>
BCL	<i>Banque centrale du Luxembourg</i>
BIS	Bank for International Settlements
BLEU	Belgian Luxembourg Economic Union
BNB	<i>Banque Nationale de Belgique</i>
CCBM	Correspondent central banking model
CEPR	Centre for Economic Policy Research
CESR	Committee of European Securities Regulators
CETREL	<i>Centre de transferts électroniques Luxembourg</i>
CPI	Consumer Price Index
CMFB	Committee on monetary, financial and balance of payments statistics
CSSF	<i>Commission de surveillance du secteur financier</i>
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
ECG	Enlarged Contact Group on the Supervision of Investment Funds
EFC	Economic and Financial Committee
EIB	European Investment Bank
EMI	European Monetary Institute (1994-1998)
EMS	European Monetary System
EMU	Economic and Monetary Union
ESCB	European System of Central Banks
EU	European Union
EUR	euro
EUROSTAT	Statistical office of the European Communities
FATF	Financial Action Task Force against money laundering
FSAP	Financial Sector Assessment Program
GDP	Gross domestic product



HICP	Harmonised Index of Consumer Prices
IADB	Inter American Development Bank
IMF	International Monetary Fund
IML	<i>Institut Monétaire Luxembourgeois (1983-1998)</i>
IOSCO	International Organisation of Securities Commissions
LIPS-Gross	Luxembourg Interbank Payment System Real-Time Gross Settlement System
LIPS-Net	Luxembourg Interbank Payment System Real-Time Net Settlement System
MFI	Monetary Financial Institution
MRO	Main refinancing operation
NAIRU	Non-accelerating inflation rate of unemployment
NAV	Net Asset Value
NCB	National central bank
OECD	Organisation for Economic Cooperation and Development
OFI	Other Financial Intermediaries
OLAF	European Anti-Fraud Office
OPEC	Organisation for Petroleum Exporting Countries
LTRO	Longer term refinancing operation
PBO	Projected Benefit Obligation
PCSS	Payment and Settlement Systems Committee
PSPWG	Payments Systems Policy Working Group
ROA	Return on Assets
ROE	Return on Equity
RTGS system	Real-Time Gross Settlement system
RTGS-GIE	Economic interest grouping for real-time gross settlement of payments in Luxembourg
SDDS	Special Data Dissemination Standard
SDR	Special Drawing Rights
SEC	European System of National Accounts
SGP	Stability and Growth Pact
SWIFT	Society for Worldwide Interbank Financial Telecommunication s.c.
SYPAL-GIE	Economic interest grouping for the promotion and management of payment systems in Luxembourg
STATEC	Central service for statistics and studies
TARGET system	Trans-European Automated Real-time Gross settlement Express Transfer system
UCI	Undertaking for Collective Investments
UCITS	Undertaking for Collective Investments in Transferable Securities

## 9.6 Glossary

**Acquis communautaire:** term commonly used to refer to all Community law including EU treaties, regulations and directives. Countries joining the EU must have implemented the existing *acquis communautaire* by the time of accession.

**Attractive price:** Attractive prices means psychological prices, *i.e.* prices which end with the figures 9, 95, 98, fractional prices which end with the figures 0 and 5 and rounded prices which are multiples of 100.

**Base effect:** When analysing business cycles, the evolution of annual variation rates of a variable are often explained by "base effects". There is a base effect when the evolution of a variable's annual rate from month  $t$  to month  $t+1$  varies because of the evolution of the variable's level 12 months before and not because of the variation of the variable's level between month  $t$  and month  $t+1$ .

**Central securities depository (CSD):** an entity which holds and administers securities or other financial assets and enables securities transactions to be processed by book entry. Assets may exist either physically (but immobilised within the CSD) or in a dematerialised form (*i.e.* only as electronic records).

**Collateral:** assets pledged (e.g. by credit institutions with central banks) as a guarantee for the repayment of loans, as well as assets sold (e.g. to central banks by credit institutions) as part of repurchase agreements.

**Consolidated MFI balance sheet:** this is obtained by netting out inter-MFI positions (e.g. inter-MFI loans and deposits) on the aggregated MFI balance sheet. It provides statistical information on the MFI sector's assets and liabilities *vis-à-vis* non-MFI euro area residents (*i.e.* general government and other euro area residents) and on its external assets and liabilities (*i.e.* balances *vis-à-vis* non-euro area residents). This consolidated balance sheet is the main statistical source for the calculation of monetary aggregates and it provides the basis for the regular analysis of the counterparts of M3.

**Correspondent central banking model (CCBM):** a mechanism established by the European System of Central Banks with the aim of enabling counterparties to obtain credit from the central bank of the country in which they are based using collateral held in another country. In the CCBM, an NCB acts as custodian for the other NCBs with regard to the securities held in its domestic securities settlement system (SSS).

**Counterparty:** the opposite party in a financial transaction (e.g. any party transacting with a central bank).

**Credit institution:** an institution covered by the definition in Article 1 of Directive 2000/12/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions. Thus, a credit institution is: (i) an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credit for its own account.

**Currency in circulation:** comprises banknotes and coins in circulation that are commonly used to make payments. Throughout 2002, currency in circulation included banknotes issued by the Eurosystem and by other monetary financial institutions (MFIs) (in Ireland and Luxembourg) as well as coins issued by the euro area central governments denominated in both euro and the legacy currencies, even though the euro has been the sole legal tender in all euro area countries since 1 March 2002. From 1 January 2003 onwards, however, only euro banknotes and coins are taken into account. Currency in circulation as included in M3 is a net concept, meaning that it refers only to banknotes and coins in circulation held outside the MFI sector (*i.e.* currency held by MFIs or "vault cash" has been subtracted). Furthermore, it includes neither central banks' stocks of own banknotes (as they have not been put into circulation), nor commemorative coins (that are not commonly used to make payments).

**Deposit facility:** a standing facility of the Eurosystem which counterparties may use to make overnight deposits at a national central bank and which are remunerated at a pre-specified interest rate (see key ECB interest rates).

**Economic and Financial Committee:** a consultative Community body set up at the start of Stage Three of Economic and Monetary Union (EMU), when the Monetary Committee was dissolved. The Member States, the European Commission and the European Central Bank (ECB) each appoint no more than two members of the Committee. One of the two members appointed by each of the Member States is selected from among senior officials from the respective national administration and the other from among senior officials from the respective national central bank. Article 114 (2) of the Treaty contains a list of the tasks of the Economic and Financial Committee, which include reviewing the economic and financial situation of the Member States and of the Community.

**Economic and Monetary Union (EMU):** the Treaty describes the process of achieving EMU in the European Union (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 for, *inter alia*, the establishment of the **European Monetary Institute (EMI)**, the prohibition of financing of the public sector by the central banks, the prohibition of privileged access to financial institutions by the public sector and the avoidance of excessive government deficits. Stage Three started on 1 January 1999 with the transfer of monetary competence to the **European Central Bank (ECB)** and the introduction of the **euro**. The cash changeover on 1 January 2002 completed the set-up of EMU.

**Effective (nominal/real) exchange rates (EERs):** nominal EERs consist of a geometric weighted average of various bilateral exchange rates. Real EERs are nominal EERs deflated by a weighted average of foreign, relative to domestic, prices or costs. They are thus measures of price and cost competitiveness. The **European Central Bank (ECB)** calculates nominal EER indices for the **euro** against the currencies of a narrow and a broad group of trading partners of the **euro area**. Since January 2001, the narrow group has consisted of 12 industrial and newly industrialised partner countries, while the broad group has been made up of 38 trading partners including emerging market and transition economies. The real EER indices for the euro are calculated using alternative measures of prices and costs.

**Electronic money (e-money):** an electronic store of monetary value on a technical device that may be widely used as a prepaid bearer instrument for making payments to undertakings other than the issuer, without necessarily involving bank accounts in the transactions.

**EURIBOR (euro interbank offered rate):** the rate at which a prime bank is willing to lend funds in **euro** to another prime bank. The EURIBOR is computed daily for interbank deposits with a maturity of one to three weeks and one to 12 months as the average of the daily offer rates of a representative panel of prime banks, rounded to three decimal places.

**Euro:** the name of the European single currency adopted by the European Council at its meeting in Madrid on 15 and 16 December 1995 and used instead of the term **ECU** originally employed in the **Treaty**.

**Euro area:** the area encompassing those Member States in which the **euro** has been adopted as the single currency in accordance with the **Treaty** and in which a single monetary policy is conducted under the responsibility of the **Governing Council** of the **European Central Bank (ECB)**. The euro area currently comprises Belgium, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland.

**European Central Bank (ECB):** the ECB lies at the centre of the **European System of Central Banks (ESCB)** and the **Eurosystem** and has legal personality under Community law. It ensures that the tasks conferred upon the Eurosystem and the ESCB are implemented either through its own activities or the national central banks, pursuant to the Statute of the European System of Central Banks and of the European Central Bank. The ECB is governed by the **Governing Council** and the **Executive Board**, and, as a third decision-making body, by the **General Council**.

**European Monetary Institute (EMI):** a temporary institution established at the start of Stage Two of **Economic and Monetary Union** on 1 January 1994. The two main tasks of the EMI were to strengthen central bank co-operation and monetary policy co-ordination and to make the preparations required for the establishment of the **European System of Central Banks**, for the conduct of the single monetary policy and for the creation of a single currency in Stage Three. It went into liquidation upon the establishment of the **European Central Bank** on 1 June 1998.

**European System of Central Banks (ESCB):** composed of the **European Central Bank (ECB)** and the national central banks of all 15 Member States, *i.e.* it includes, in addition to the members of the **Eurosystem**, the national central banks of the Member States which have not yet adopted the **euro**. The ESCB is governed by the **Governing Council** and the **Executive Board** of the ECB, and, as a third decision-making body of the ECB, by the **General Council**.

**Eurosystem:** comprises the **European Central Bank (ECB)** and the national central banks (NCBs) of the Member States which have adopted the **euro** in Stage Three of **Economic and Monetary Union** (see also **euro area**). There are currently 12 NCBs in the Eurosystem. The Eurosystem is governed by the **Governing Council** and the **Executive Board** of the ECB.

**Eurosystem's international reserves:** these comprise the reserve assets of the **European Central Bank (ECB)** and the reserve assets held by the national central banks (NCBs) of the participating

Member States. Reserve assets must be under the effective control of the relevant monetary authority, whether the ECB or the NCB of one of the participating Member States, and comprise highly liquid, marketable and creditworthy foreign (*i.e.* non-euro) currency-denominated claims on non-euro area residents, plus gold, special drawing rights and the reserve positions in the International Monetary Fund of the participating NCBs.

**Executive Board:** second decision-making body of the **European Central Bank (ECB)**. It comprises the President and the Vice-President of the ECB and four other members appointed by common accord by the Heads of State or Government of the Member States that have adopted the **euro**.

**Fine-tuning operation:** a non-regular **open market operation** executed by the **Eurosystem** mainly in order to deal with unexpected liquidity fluctuations in the market.

**Foreign exchange swap:** simultaneous spot and forward transactions exchanging one currency against another. The **Eurosystem** can execute **open market operations** in the form of foreign exchange swaps, where the national central banks (or the **European Central Bank**) buy or sell **euro** spot against a foreign currency and, at the same time, sell or buy them back in a forward transaction.

**General Council:** one of the decision-making bodies of the **European Central Bank (ECB)**. It comprises the President and the Vice-President of the ECB and the governors of all 15 EU national central banks.

**Governing Council:** the supreme decision-making body of the **European Central Bank (ECB)**. It comprises all the members of the **Executive Board** of the ECB and the governors of the national central banks of the Member States that have adopted the **euro**.

**Harmonised Index of Consumer Prices (HICP):** the measure of prices used by the **Governing Council** for the purpose of assessing **price stability**. The HICP was developed by the European Commission (Eurostat) in close liaison with the national statistical institutes and the **European Monetary Institute**, and later the **European Central Bank**, in order to fulfil the **Treaty** requirement for a consumer price index constructed on a comparable basis, taking into account differences in national definitions.

**Longer-term refinancing operation:** a regular **open market operation** executed by the **Eurosystem** in the form of a **reverse transaction**. Longer-term refinancing operations are carried out through monthly **standard tenders** and have a maturity of three months.

**Lump-sum allowance:** a fixed amount which a **credit institution** deducts in the calculation of its **reserve requirement** within the minimum reserve framework of the **Eurosystem**.

**M1, M2, M3:** see **monetary aggregates**.

**Main refinancing operation:** a regular **open market operation** executed by the **Eurosystem** in the form of a **reverse transaction**. Main refinancing operations are conducted through weekly **standard tenders** and normally have a maturity of two weeks.

**Marginal lending facility:** a **standing facility** of the **Eurosystem** which **counterparties** may use to receive overnight credit from a national central bank at a pre-specified interest rate against eligible assets.

**Monetary aggregates:** **currency in circulation**, plus outstanding amounts of certain liabilities of **monetary financial institutions** and central governments that have a relatively high degree of liquidity and are held by non-MFI **euro area** residents outside the central government sector. The narrow monetary aggregate **M1** has been defined as currency in circulation plus overnight deposits. The “intermediate” monetary aggregate **M2** comprises M1 plus deposits with agreed maturity of up to two years and deposits redeemable at notice of up to three months. The broad monetary aggregate **M3** includes M2 plus **repurchase agreements**, money market fund shares and units, money market paper and debt securities with a maturity of up to two years. In October 1998 the **Governing Council** announced a reference value for the growth of M3, which it has since reconfirmed (see also **reference value for monetary growth**).

**Monetary financial institutions (MFIs):** financial institutions which form the money-issuing sector of the **euro area**. These include the **Eurosystem**, resident **credit institutions** (as defined in Community law) and all other resident financial institutions whose business is to receive deposits and/or close substitutes for deposits from entities other than MFIs and, for their own account (at least in economic



terms), to grant credit and/or invest in securities. The latter group consists predominantly of money market funds. At the end of 2002, there were 8,545 MFIs in the euro area (13 central banks, 6,907 credit institutions, 1,620 money market funds and five other financial institutions).

**Open market operation:** an operation executed on the initiative of the central bank in the financial markets involving one of the following transactions: (i) buying or selling assets outright (spot or forward); (ii) buying or selling assets under a **repurchase agreement**; (iii) lending or borrowing against underlying assets as **collateral**; (iv) issuing central bank debt certificates; (v) accepting fixed-term deposits; or (vi) conducting **foreign exchange swaps** between domestic and foreign currencies.

**Outright transaction:** a transaction whereby assets are bought or sold up to their maturity (spot or forward).

**Price stability:** the maintenance of price stability is the primary objective of the **European Central Bank**. In October 1998, the **Governing Council** published a quantitative definition of price stability in order to give clear guidance to expectations of future price developments and to be accountable. The Governing Council defined price stability as a year-on-year increase in the **Harmonised Index of Consumer Prices (HICP)** for the **euro area** of below 2%. The Governing Council announced that price stability according to this definition is to be maintained over the medium term. The definition delineates an upper boundary for the rate of measured inflation; at the same time, the use of the word "increase" signals that deflation, *i.e.* prolonged declines in the level of the HICP, would not be deemed consistent with price stability.

**Quick tender:** the tender procedure used by the **Eurosystem** for **fine-tuning operations**. Quick tenders are executed within a time frame of one hour and are restricted to a limited set of **counterparties**.

**Reference value for monetary growth:** the **Governing Council** assigns money a prominent role in the conduct of the single monetary policy, implying that **monetary aggregates** and their counterparts are thoroughly analysed regarding their information content for future price developments. This is signalled by the announcement of a reference value for the growth rate of the monetary aggregate **M3**. The reference value is derived in a manner which is consistent with and serves the achievement of the **Governing Council's** definition of **price stability** on the basis of medium-term assumptions regarding trend real GDP growth and the trend in the velocity of circulation of M3. Substantial or prolonged deviations of M3 growth from the reference value would, under normal circumstances, signal risks to price stability over the medium term. However, the concept of the reference value does not entail a commitment on the part of the Governing Council to correct mechanistically deviations of M3 growth from the reference value.

**Reserve base:** the sum of the balance sheet items (in particular liabilities) which constitute the basis for calculating the **reserve requirement** of a **credit institution**.

**Reserve ratio:** a ratio defined by the central bank for each category of balance sheet items included in the reserve base. The ratios are used to calculate reserve requirements.

**Reserve requirement:** the requirement for **credit institutions** to hold minimum reserves with the central bank. In the minimum reserve framework of the **Eurosystem**, the reserve requirement of a credit institution is calculated by multiplying the **reserve ratio** for each category of items within the **reserve base** by the amount of those items on the institution's balance sheet. In addition, institutions are allowed to deduct a **lump-sum allowance** from their reserve requirement.

**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**.

**SEC 95:** The European System of National Accounts is an accounting framework applicable on an international level and allowing to describe in a systematic and detailed way what is called a "total economy" (*i.e.* a region, a country, a group of countries), its components and its relations with other total economies.

**Securities settlement system (SSS):** a system which permits the holding and transfer of securities or other financial assets, either free of payment or against payment (delivery versus payment).

**Standard tender:** a tender procedure used by the Eurosystem in its regular open market operations. Standard tenders are carried out within 24 hours. All counterparties fulfilling the general eligibility criteria are entitled to submit bids.

**Standing facility:** a central bank facility available to counterparties on their own initiative. The Eurosystem offers two overnight standing facilities: the marginal lending facility and the deposit facility.

**TARGET (Trans-European Automated Real-time Gross settlement Express Transfer system):** the real-time gross settlement (RTGS) system for the euro. It is a decentralised system consisting of 15 national RTGS systems and the European Central Bank payment mechanism. These are interconnected by common procedures (Interlinking mechanism) to allow cross-border transfers throughout the EU to move from one system to another.

**Treaty:** refers to the Treaty establishing the European Community (TEC). The Treaty was signed in Rome on 25 March 1957 and entered into force on 1 January 1958. It established the European Economic Community, which is now the European Community, and is often referred to as the "Treaty of Rome". The Treaty on European Union (which is often referred to as the "Maastricht Treaty") was signed on 7 February 1992 and entered into force on 1 November 1993. The Treaty on European Union amended the TEC and established the European Union. The "Treaty of Amsterdam", which was signed in Amsterdam on 2 October 1997 and entered into force on 1 May 1999, and most recently the "Treaty of Nice", which was signed on 26 February 2001 and entered into force on 1 February 2003, amended both the TEC and the Treaty on European Union.

