ANNUAL REPORT
2005

BANQUE CENTRALE DU LUXEMBOURG

EUROSYSTEM

The BCL Annual Report 2005 is an abridged translation of the *Rapport Annuel de la BCL 2005*, which is the binding version.

Banque centrale du Luxembourg
2, boulevard Royal - L-2983 Luxembourg
Telephone: (+352) 4774 - 1
Fax: (+352) 4774 - 4910
Internet: www.bcl.lu
E-mail: sg@bcl.lu

CONTENTS

THE GOVERNOR'S MESSAGE

On 8 June 2006 the Governing Council of the European Central Bank decided to increase the Eurosystem's key interest rates by 25 basis points, thus raising the rate for the main refinancing operations to 2.75%. The process of rate raising which started at the end of 2005 reflects the upside risks to price stability and follows the proven monetary strategy of the Eurosystem. The adjustment of the accommodative stance of monetary policy helps to keep medium and long-term inflation expectations in the euro area anchored at levels compatible with price stability. Pursuing the ECB's key objective of price stability is the best contribution that monetary policy can make over the long term to economic growth and job creation. Following this rise, interest rates are still at historically low levels and liquidity remains abundant; monetary policy continues to be accommodative.

The June 2006 Eurosystem staff macroeconomic projections are based on annual average growth of GDP in volume terms of between 1.8% and 2.4% in 2006 and between 1.3% and 2.3% in 2007. The average rise in the harmonised index of consumer prices (HICP) in the euro area should be between 2.1% and 2.5% in 2006 and between 1.6% and 2.8% in 2007.

In Luxembourg, inflation reached an average of 2.5% in 2005, compared with 2.2% the previous year, widening the gap even more with neighbouring countries. According to the latest projections of the Banque centrale du Luxembourg, inflation measured by the national index of consumer prices should remain, on average, above 2% over the projection horizon and the surge in headline inflation, from 2.5% in 2005 to 2.8% in 2006, should reflect major increases in the energy and services components.

The worsening inflation differential vis-à-vis other euro area countries is a cause of particular concern. It may be the result of the rise in indirect taxes and administered prices, of wage developments that are out of line with partner countries and of entrenched structural inefficiencies. These problems have to be addressed at the national level.

The adjustment to the indexation mechanism should slow down the increase in unit labour costs. However, according to our projections, which incorporate the effects of this adjustment, the deterioration in competitiveness should continue until the end of 2008. Indeed, the indicator based on unit labour costs in the whole economy is likely to deteriorate by a further 3.1% during the period in question.

Economic growth in Luxembourg stabilised at 4% in 2005, as opposed to 4.2% the previous year. However, activity accelerated in the course of the year, reaching a growth rate of 5.7% in the fourth quarter of 2005. The BCL revised upwards its projections for economic growth for 2006, to between 4.4% and 5.0%. The slowdown in international demand forecast for next year suggests a fall in economic growth in 2007 to between 3.4% and 4.4%. Luxembourg would thus experience a fourth consecutive year of significant economic growth.

Despite this growth, which is well above the average for the euro area, a rapid increase in central government spending has deepened the public finance deficit, which rose from 1.1% of GDP in 2004 to 1.9% of GDP in 2005. This figure confirms the validity of the BCL's calls for budgetary prudence in recent years.

When the government presented its package of reforms on 2 May 2006, it also expressed its determination to reduce the general government deficit to 1% of GDP in 2007 and to return to a balanced budget in 2009. On the same occasion, the government also announced a series of specific measures to consolidate the budget.

Unemployment (in the strict sense) rose from 3.9% to 4.2% in 2005. This rise in the rate of unemployment took place despite a 3.2% increase in overall employment in 2005 and continued in the early months of 2006, during which time several large-scale redundancies were announced.

Structural measures remain essential in order to bring about a sustainable consolidation of public finances. They should aim above all to slow down growth in general government spending, including pensions. The government's intention to reduce the increase in expenditure to 4% per year in nominal terms takes on a critical importance in this context. Moreover, structural measures could remedy unemployment while ensuring a better match between supply of and demand for labour. These measures are all the more necessary in view of the fact that the financial sector is likely to reach a maturity threshold in the future.

The pensions sector has only been affected incidentally by the measures announced by the government at the beginning of May 2006. However, outside observers, especially the European Commission, point to the sharp increase expected in pension spending in Luxembourg, which should grow by more than 7% of GDP between 2004 and 2050. This annual report includes some thinking on a move from a pay-as-you-go system to a funded system, a change which should help to improve the budget outlook for social security while protecting the latter against any slowdown in economic growth.

After a thorough analysis, the Banque centrale du Luxembourg has submitted to the government a draft amendment to its Founding Law. This draft amendment envisages giving the BCL a framework which allows for the development of its activities and those of the Eurosystem in general, and the specific need to adapt financial legislation in Luxembourg.

As part of the constant efforts the Banque centrale du Luxembourg is making to improve its efficiency and update its structures, it launched in the second quarter of 2005 an initiative called "BCL in motion". This reorganisation aims, in particular, at broadening the autonomy of decision-makers and at increasing their effectiveness. In addition, staff members' skills will be mobilised more effectively through active human resource management, and internal communications will be strengthened.

Yves Mersch

Artist: Roland Schauls
Title: Untitled
Material: Charcoal on paper
Format: 130 x 120 cm
BCL collection

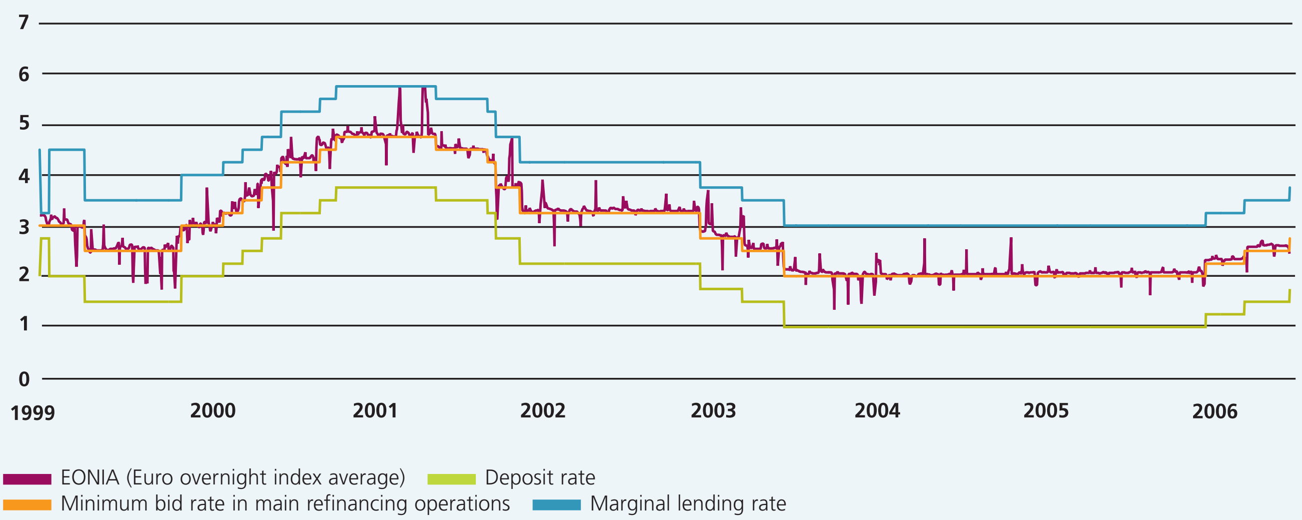
1. ECONOMIC AND FINANCIAL SITUATION

1.1 Economic situation at the international level

1.1.1 Short-term interest rates and monetary policy decisions

After leaving key interest rates at historically low levels for two and a half years, the Governing Council of the European Central Bank decided to raise the Eurosystem's key rates three times in the period under review. Rates were raised by 25 basis points in December 2005, as well as in March and June 2006. The minimum bid rate for the main refinancing operations thus stands at 2.75%, while the interest rates on the marginal lending facility and on the deposit facility were raised to 3.75% and 1.75% respectively.

CHART 1: KEY POLICY RATES OF THE EUROSYSTEM AND THE OVERNIGHT INTEREST RATE



Sources: ECB, Bloomberg.

Note: The rate for main refinancing operations is the rate applicable to fixed rate tenders for operations settled before 28 June 2000. Thereafter, the rate reflects the minimum bid rate applicable to variable rate tenders.

Interest rates were thus left unchanged for most of 2005, largely because of sluggish economic growth at the beginning of the period under review. Growth projections did improve in the course of 2005 though, paving the way for the three above-mentioned rate hikes. After rising by 1.8% annually in 2004, real GDP (partially adjusted for the number of working days) rose by 1.4% in 2005 and by 1.9% in the first quarter of 2006.

Regarding price developments in the euro area, the average annual change in the HICP stood at 2.2% last year and at 2.3% in the first quarter of 2006; in April 2006, annual HICP inflation reached 2.4%, while Eurostat's flash estimate points to an inflation rate of 2.5% in May.

The Governing Council's decisions not to raise the Eurosystem's key rates until end-2005 can largely be explained by the fact that economic activity only improved in the second half of the review period, while inflationary pressures were building up in parallel. The Eurosystem staff growth projections published in June 2006 are broadly unchanged for 2006, while for 2007 there was a slight downward revision; as for the inflation projections, there was a slight upward revision for 2006. The interest rate adjustments will also help medium- and long-term inflation expectations to remain solidly anchored at levels consistent with price stability.

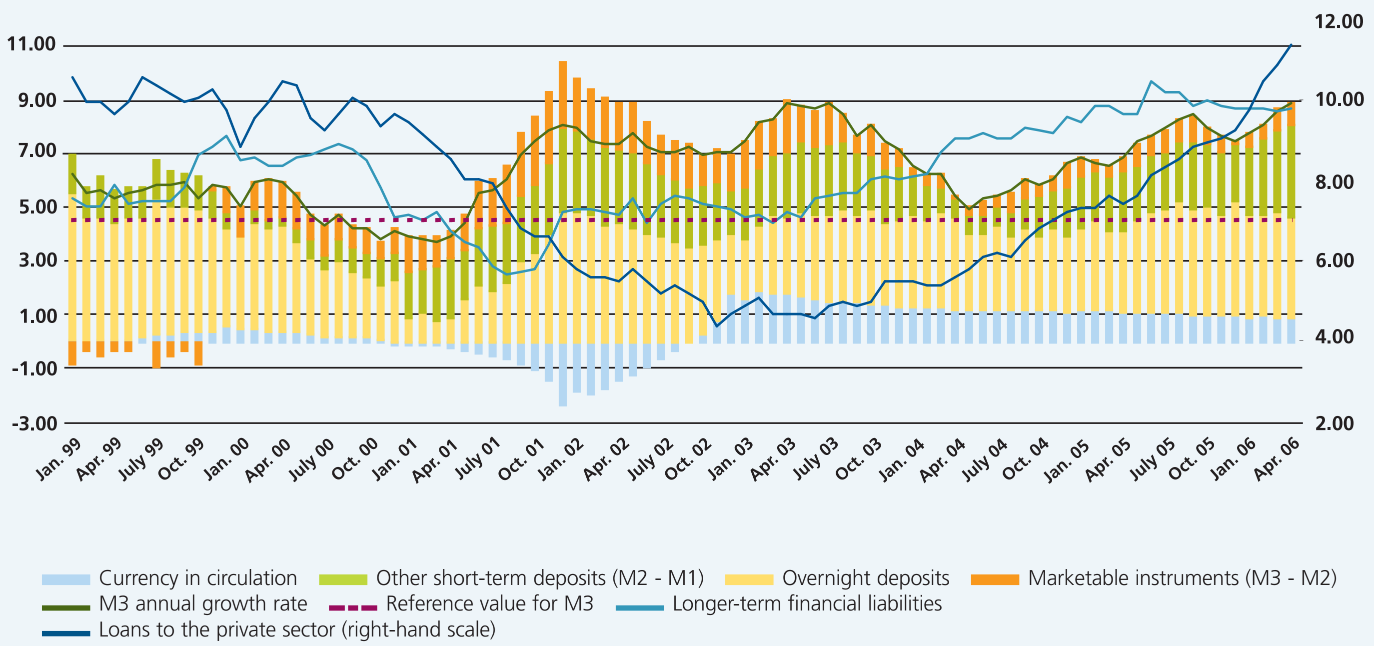
The adjustment to the accommodative monetary policy stance can also be explained in terms of monetary and credit developments. Monetary growth has been very dynamic in the period under review and remains well above the 4.5% reference value; thus, excess liquidity in the euro area has continued to build up and monetary growth remains above the level required for non-inflationary growth.

On an annual basis, M3 grew by 6.6% in the first quarter of 2005 but subsequently increased to 8.2% in the third quarter, before falling slightly, only to exceed 8% again in the first quarter of 2006; in April, the annual growth rate for M3 reached 8.8%.

Monetary dynamics continue to be largely influenced by the low level of interest rates, which implies a low opportunity cost of holding the most liquid assets included in M3. At the same time, portfolio normalisation slowed down in the course of 2005, as evidenced by the decomposition of the broad monetary aggregate, but also by the development of longer-term financial liabilities and net external assets.

The low level of interest rates has also fuelled credit growth to the private sector, in particular mortgage loans; the annual growth rate of loans to the private sector has exceeded 10% since February 2006. In this context, the evolution of housing markets in several countries has required careful monitoring.

CHART 2: MONEY AND CREDIT DEVELOPMENTS



Source: ECB.

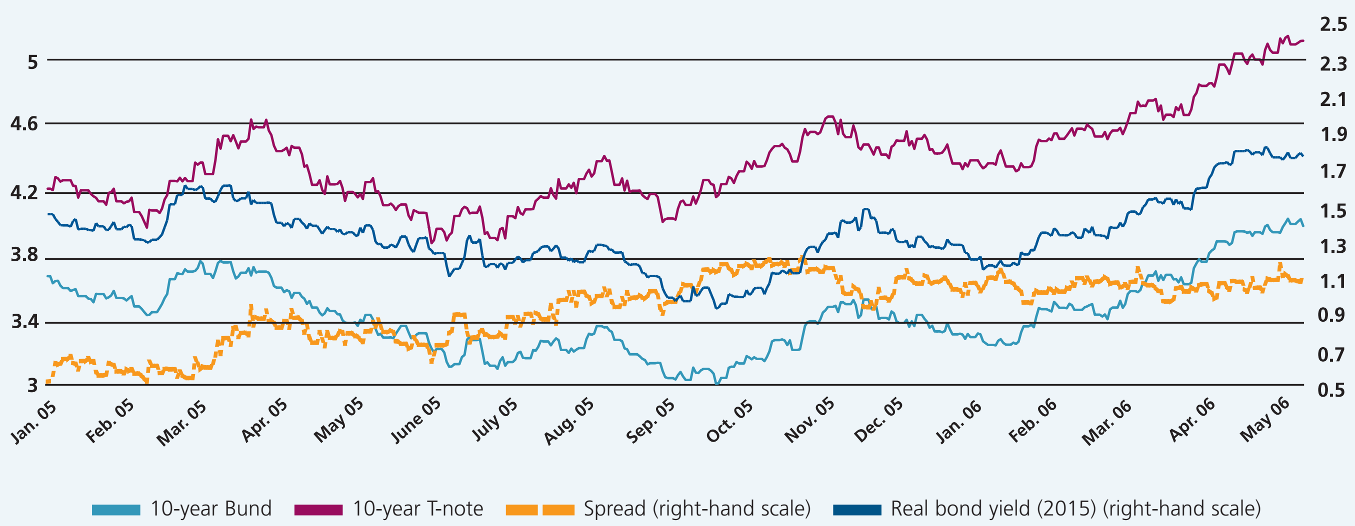
1.1.2 Long-term government bond yields

In 2005, long-term government bond yields in the euro area reached historical lows. More generally, these developments occurred in the context of very low yields in all major bond markets, mainly because of structural elements that affected bond markets across the world. Bond yields on both sides of the Atlantic moved largely in parallel, even though cyclical factors implied that yield developments were diverging on occasion. These cyclical factors also had an impact on the respective monetary policy decisions in the euro area and in the United States: while the Federal Reserve raised rates by 275 basis points between early 2005 and May 2006, rate hikes were much more moderate in the euro area.

Yields on long-term government bonds in the euro area, as measured here by the yield on the 10-year Bund, stood at 3.7% in early 2005, before embarking on a downward trajectory and reaching a historical low of 3.1% in September. Subsequently, this downward trend was reversed and yields moved up again, reaching roughly 4% at the end of May 2006. The yield on the 10-year T-note went from 4.2% in early 2005 to over 5.1% in May 2006.

The structural factors that put such downward pressure on long-term yields are, in essence, related to increased demand from various market participants. In the first place, increased demand from institutional investors (and from pension funds in particular) has contributed to the very low level of bond yields. Also, baby boomers and oil-exporting countries have pushed up demand by investing their excess savings in government bonds, while Asian central banks have continued to build up foreign reserves. Other factors likely to have had a significant impact on bond markets were carry trades, excess liquidity and firmly anchored inflation expectations.

CHART 3: LONG-TERM GOVERNMENT BOND YIELDS



Source: Bloomberg.

Note: Real bond yields are derived from the market prices of French government bonds linked to the euro area HICP (excluding tobacco).

In the euro area, two major periods can be distinguished: between January and September 2005, 10-year bond yields were on a downward path, a trend which was reversed around the end of the third quarter of 2005. These major trends were also discernible in the United States, although some shorter-term developments stand in stark contrast to euro area bond markets. In the euro area, yields reflected to a large extent rather modest growth prospects, as evidenced by the yield on French index-linked bonds.

In the context of heightened demand from institutional investors, yields stood at very low levels from the beginning of the year under review. Following a brief rebound between mid-February and mid-March 2005, bond yields continued to fall in the United States and in the euro area, largely as a result of a downward revision in growth expectations, but also due to lower inflation expectations. When growth prospects began to hint at an improvement in the course of 2005, bond yields started to edge up again, only to reach historical lows (in the euro area) in September 2005 in the wake of the devastating hurricanes in the United States.

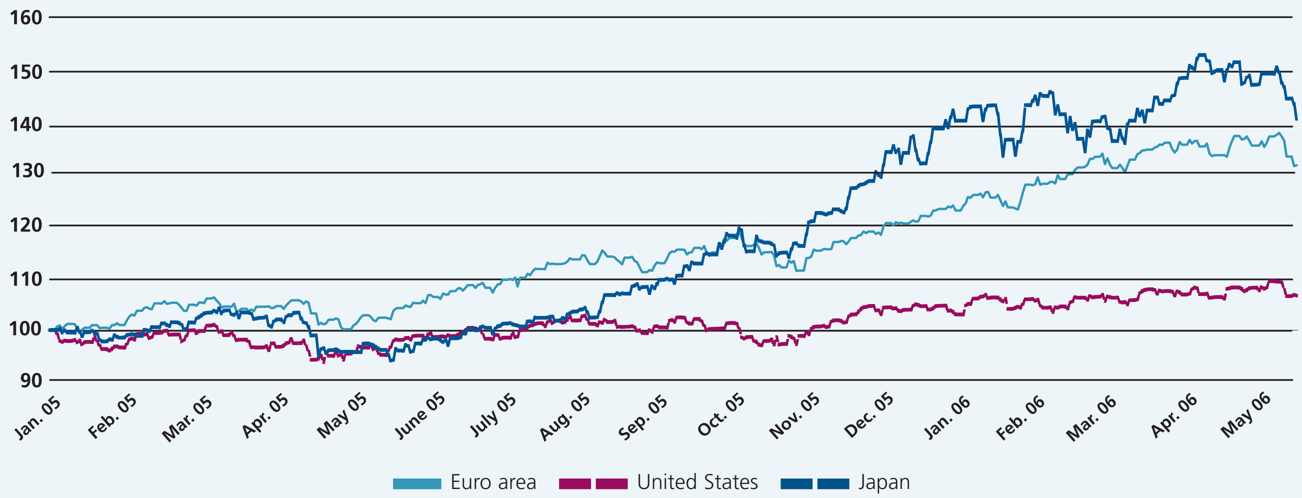
Growth prospects have continued to improve in 2006, though inflationary pressures have strengthened somewhat (especially in the United States) following new and continuous oil price hikes in early 2006. The upward drift in longer-term yields also reflects interest rate expectations in the euro area and in the United States, although market participants are beginning to wonder when the US tightening cycle will come to a halt.

1.1.3 Equity markets

Following a rather modest and sometimes negative performance by all the major equity indices between January and May 2005, markets recovered and progressed strongly, in particular in the euro area but even more so in Japan. The outstanding performance of the Nikkei 225 is by and large attributable to the ongoing economic recovery in Japan, which gathered pace in the course of 2005, and by plans to privatise the post office, while the weak performance of the Standard & Poor's 500 may in part be linked to the strengthening of the dollar with regard to the yen and the euro in 2005.

Between end-2004 and end-2005, the Nikkei 225 progressed by 40%, finishing at 16,111; the Standard & Poor's 500 and the Dow Jones EURO STOXX increased by 3% and 23% respectively, finishing the year under review at 1,248 and 329. Overall, in the first five months of 2006, the euro area and the US indices rose further, though only slightly, while the Japanese index lost some ground. The steep stock market declines in May 2006 are linked to a rekindling of inflation fears and the revision of policy rate expectations this generally entails, as well as to increased volatility in all major stock markets.

CHART 4: MAJOR STOCK PRICE INDICES IN THE EURO AREA, THE UNITED STATES AND JAPAN (INDEX: 1 JANUARY 2005 = 100; DAILY DATA)



Source: Bloomberg.

Note: Dow Jones EURO STOXX broad index for the euro area, Standard & Poor's 500 index for the United States and Nikkei 225 index for Japan.

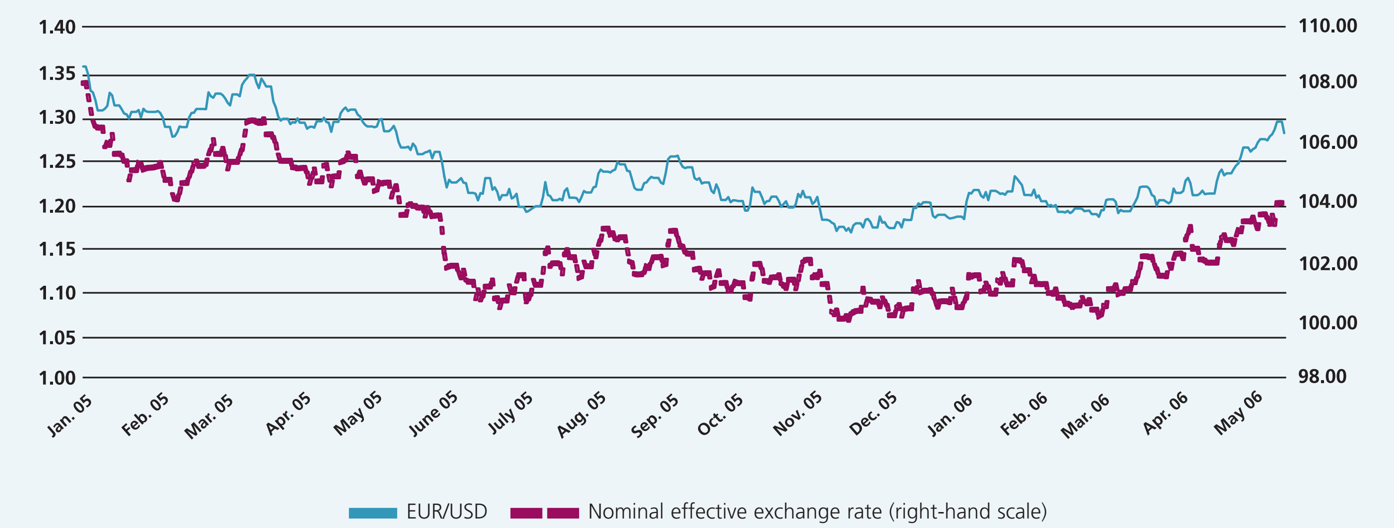
Perhaps somewhat surprisingly, the outstanding stock market rally occurred at a time when oil prices were peaking repeatedly. Rising oil prices generally entail bearish stock markets; however, stock markets have proved extraordinarily resilient to peaking commodity prices. Several explanations may be put forward for this resilience: first of all, major economies are much less oil-dependent than they used to be; second, the oil price hikes are mostly the result of higher demand, implying that economic growth was unlikely to be slowed down considerably by rising oil prices. These elements were, however, exacerbated by supply-side factors such as geopolitical tensions and insufficient investment. Overall, the demand-supply balance in oil markets remains tight, which implies high oil price sensitivity that may occasionally spill over into stock markets. Finally, several other factors, such as the absence of second-round effects on wage-setting and the low level of longer-term government bond yields, supported stock markets; actual and expected earnings per share were also very high.

These factors had a major impact on equity markets throughout the entire review period. As the uncertainty regarding the economic outlook gradually receded, Japanese and euro area markets embarked on an upward trend that gained pace considerably in the second half of 2005. The economic upswing and the outstanding performance of a large number of firms that operate at an international level continued to support the bullish stock market, mitigating the impact of other factors likely to have had a negative market impact. More recently, stock markets took a dive as fears of inflation resurged, leading market participants to revise their interest rate expectations.

1.1.4 Exchange rate developments

Overall, for most of the year under review, the euro depreciated against almost all major currencies that make up the nominal effective exchange rate (NEER), in particular against the US dollar, whose weight is of considerable importance in the computation of the NEER. In the course of 2005, the NEER depreciated by 7%, largely due to the single currency's depreciation against the dollar, which stood at 1.19 to the euro at end-2005.

CHART 5: BILATERAL EURO-DOLLAR AND NOMINAL EFFECTIVE EURO EXCHANGE RATES



Sources: Bloomberg, ECB.

The euro also depreciated against the pound sterling, while remaining broadly unchanged against the yen; these two currencies also have a significant weight in the calculation of the NEER. Between January and May 2006, the NEER appreciated by 4%; while the euro appreciated by 8% against the dollar, it dropped slightly against the pound.

Two major forces drove the bilateral euro-dollar exchange rate in the period under review. On the one hand, market participants were worried about the structural deficits in the United States, which put downward pressure on the dollar. On the other hand, rising interest rate differentials in the United States with regard to most other major economies, and the associated rise in portfolio inflows, often outweighed the effect of structural influences. The Homeland Investment Act has also supported the dollar. Bilateral euro-sterling and euro-yen exchange rates broadly followed the euro-dollar rate. The yen was further supported by the economic upswing in Japan and by large inflows into Japanese stock markets.

The rejection of the Treaty establishing a Constitution for Europe in France and in the Netherlands in May and June respectively led to a further depreciation of the euro.

After a short recovery, the bilateral euro-dollar exchange rate and the NEER trended down further for most of the year, although this trend was slowed down by increasing confidence in improving growth prospects in the euro area, and the upward revision of rate expectations this generally entails. These same elements eventually reversed the depreciative trend of the euro and the NEER.

The decision by the Chinese authorities, on 21 July 2005, to gradually introduce more flexibility into China's exchange rate regime only had a transitory impact on exchange rate markets.

On 2 May 2005, Cyprus, Latvia and Malta joined the European Exchange Rate Mechanism (ERM) II; on 28 November, Slovakia also joined.

1.1.5 Consumer prices

HICP inflation in the euro area averaged 2.2% in 2005, 0.1 percentage point higher than in 2003 and 2004. The most significant upward impact was related to the oil price increase. Underlying domestic inflationary pressures remained subdued in 2005, reflecting continued wage moderation and a lower contribution from indirect taxes and administered prices.

TABLE 1: CONTRIBUTIONS TO HICP INFLATION IN THE EURO AREA FROM MAIN COMPONENTS (ANNUAL PERCENTAGE CHANGES)

	2003	2004	2005	2004 Q4	2005 Q1	2005 Q2	2005 Q3	2005 Q4	2006 Q1	2005 Dec.	2006 Jan.	2006 Feb.	2006 Mar.	2006 Apr.	2006 May
Overall HICP	2.1	2.1	2.2	2.3	2.0	2.0	2.3	2.3	2.3	2.3	2.4	2.4	2.2	2.4	2.5
of which:															
- Unprocessed food	2.1	0.6	0.8	-0.8	0.5	0.8	0.8	1.4	1.4	1.5	2.0	1.7	0.6	1.3	
- Processed food	3.3	3.4	2.0	2.8	2.4	1.5	1.8	2.2	2.0	1.8	1.9	1.9	2.3	2.2	
- Non-energy industrial goods	0.8	0.8	0.3	0.8	0.3	0.3	0.1	0.4	0.3	0.4	0.2	0.3	0.5	0.6	
- Energy	3.0	4.5	10.1	8.5	7.6	8.7	12.7	11.1	12.2	11.3	13.6	12.6	10.5	11.0	
- Services	2.5	2.6	2.3	2.7	2.4	2.3	2.2	2.1	1.9	2.1	2.0	2.0	1.9	2.1	
HICP excluding unprocessed food and energy	2.0	2.1	1.5	2.0	1.6	1.5	1.4	1.5	1.4	1.4	1.3	1.3	1.4	1.6	

Source: Eurostat.

Turning to consumer price developments in early 2006, oil prices kept euro area HICP inflation well above 2% between January and April.

According to Eurostat's flash estimate, euro area HICP inflation was 2.5% in May. Although no detailed breakdown of the HICP components in May is available yet, the increase in the annual growth rate of the headline index is likely to have resulted from energy prices.

According to the recent Eurosystem staff projections, the average rate of increase in the overall euro area HICP is projected to be between 2.1% and 2.5% in 2006, and between 1.6% and 2.8% in 2007. These ranges imply an upward revision of HICP inflation in 2006, reflecting the increases in the oil price assumptions.

1.1.6 Output, demand and labour market developments

Real GDP growth in the euro area was 1.4% in 2005 and significantly below that observed in 2004 (1.8%). This deceleration was mainly due to a temporary slowdown in global demand in the first half of 2005, oil price strength persistence and the lagged effects of the appreciation of the euro. However, the available flash estimate suggests that the recovery gained momentum at the start of 2006 (0.6% annual growth for the first quarter of 2006), implying that the slowdown observed in the fourth quarter of last year was temporary. In terms of the composition of growth, the moderation in growth in 2005 can be attributed to lower contributions from both domestic demand and export growth. On the one hand, the smaller contribution from domestic demand reflects a more subdued private consumption contribution to GDP annual growth essentially because of low increases in real disposable income due to restrained growth in nominal income and the rise in energy prices. On the other hand, the negative net trade contribution in 2005 stems from a more pronounced deceleration in exports than in imports.

Labour market conditions gradually improved in the euro area in 2005. Employment growth strengthened during the year (by 0.8% in annual terms after 0.5% in 2004) and, at the same time, the unemployment rate has continuously fallen over the year, reaching 8.6% on average (after 8.9% in 2004). Improvements in employment expectations support this view, but only a more determined commitment to the structural labour market reforms embodied by the Lisbon agenda will allow unemployment rates to be significantly reduced in the years ahead.

1.1.7 External trade

In 2005 the euro area trade surplus fell to €22.7 billion, down from €71.5 billion in 2004, as import values grew more rapidly than exports. The higher price of oil resulted in a 12.6% increase in import prices while export prices increased by 4.8%. As a result, the euro area terms of trade deteriorated by 7.3% in 2005, further accelerating the drop in the euro area trade surplus. The euro area even recorded a trade deficit of €11.6 billion during the first quarter of 2006, compared with a surplus of €5.8 billion in the corresponding period of 2005. In 2005 as a whole, the geographical breakdown of trade shows that the euro area surplus with the United States increased by 8% (€65 billion), while the surplus vis-à-vis the United Kingdom declined by 14.2% (€52 billion). Large trade deficits were recorded with oil-exporting countries: OPEC members (€35.7 billion), Russia (€30 billion), Norway (€21.5 billion) and some African oil-exporting countries (€22 billion). Moreover, the usual heavy trade deficit with China broadened (from €52 billion in 2004 to €74 billion in 2005), while the deficit with Japan was down by 11.2%, reaching €18.7 billion in 2005.

1.1.8 Balance of payments

In 2005 the euro area current account recorded a deficit of €22.6 billion compared with a surplus of €49.7 billion in 2004. This deterioration reflected to a greater extent the drop in goods surplus and to a lesser extent the rise in the income and in the current transfers deficits, while the balance for services improved.

In the financial account, the euro area recorded net inflows of €90 billion in 2005 compared with net outflows of €11 billion in 2004. Driven by the stronger growth outlook for the "rest of world" economy, net outflows in direct investments increased to €145 billion in 2005 from €41 billion in 2004. However, in 2005, net outflows were largely offset by net inflows in portfolio investments of €162 billion as a result of net purchases of euro area equity securities and money market instruments by non-resident investors.

1.2 Economic situation in Luxembourg

1.2.1 Prices and costs

1.2.1.1 Consumer prices

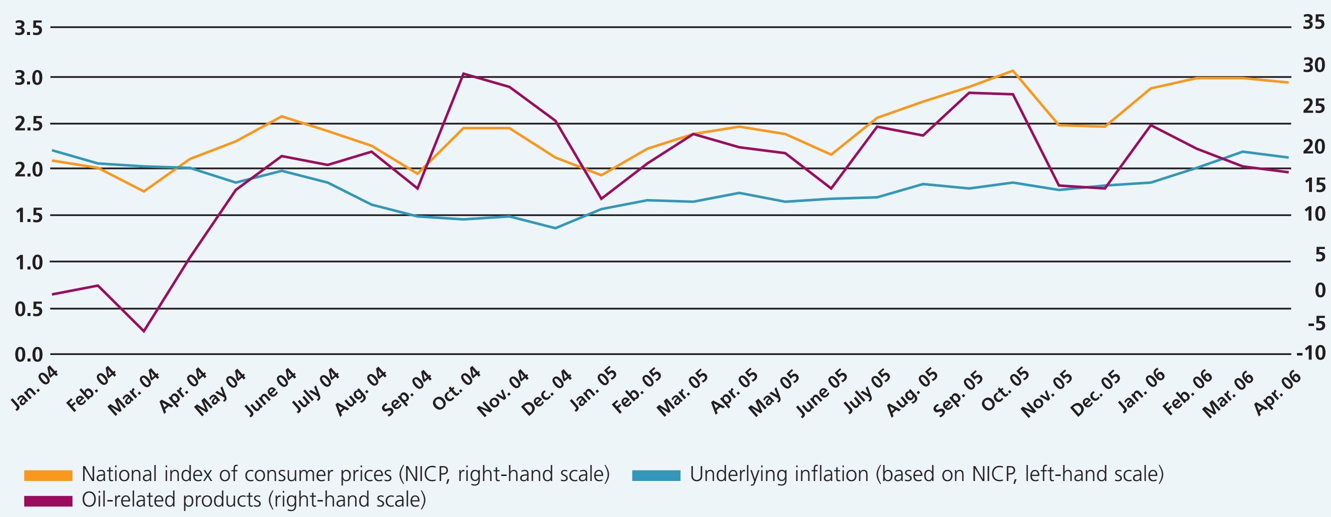
HICP inflation in Luxembourg averaged 3.8% in 2005, which represents an increase of 0.6 percentage point compared with the previous year, while the national index of consumer prices (NICP), which better reflects consumption by Luxembourg residents, was at 2.5%, up from 2.2% in 2004. This rise in overall inflation reflected to a large extent the sharp oil price hike.

The easing of underlying inflationary pressures, observed between 2002 and 2004, reversed in early 2005, even though the 2005 average underlying inflation remained unchanged with respect to the previous year.

The annual growth rate of the services component moderated by 0.1 percentage point compared with 2004, while remaining high at 2.6% on average. Its contribution to overall inflation remained almost unchanged at 0.9 percentage point.

The direct impact of the fiscal policy on the NICP was 0.46 percentage point in 2005, 0.1 percentage point lower than in 2004.

CHART 6: INFLATION AND OIL-RELATED PRODUCTS (ANNUAL PERCENTAGE CHANGES)

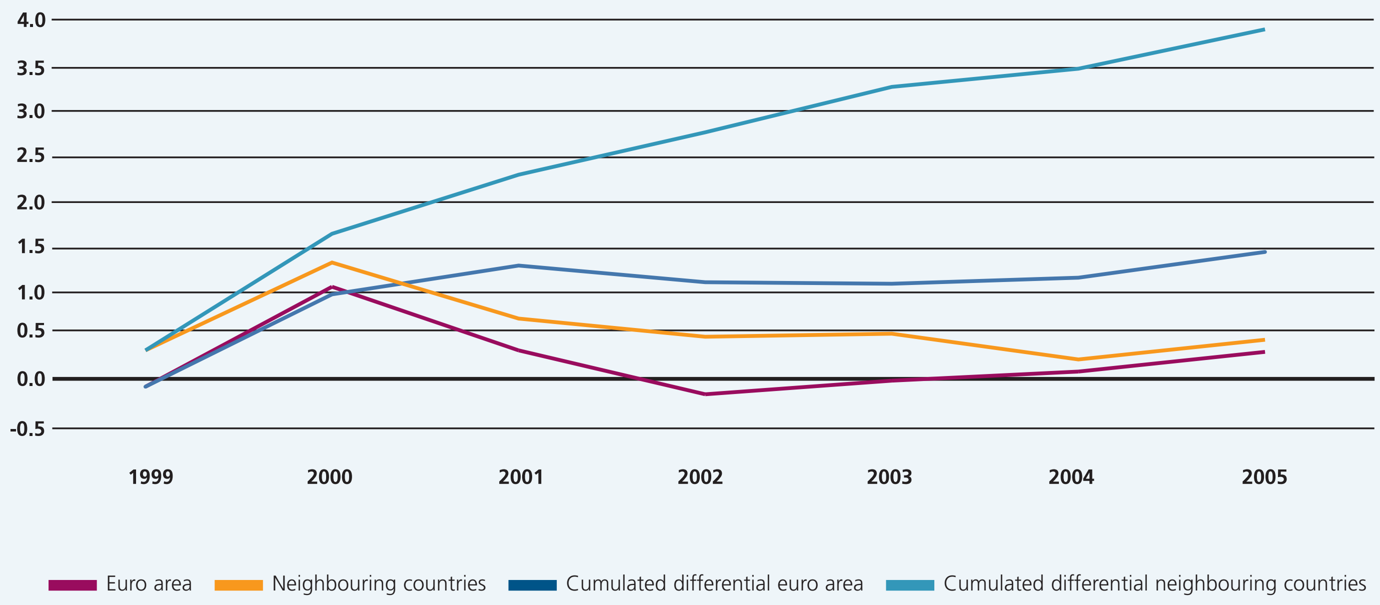


Source: STATEC.

Turning to developments in early 2006, inflation increased to around 3% between January and April. Oil prices have remained a key factor driving inflation, while underlying inflation pressures continued the upward trend observed since early 2005.

The inflation differentials between Luxembourg and the euro area and between Luxembourg and its neighbouring countries worsened markedly in 2005, as the chart below shows. In 2005 the cumulated inflation differentials between Luxembourg and the euro area and between Luxembourg and its neighbours stood at 1.4 and 3.9 percentage points respectively. The unfavourable trend of inflation differentials continued in early 2006.

CHART 7: INFLATION DIFFERENTIALS (PERCENTAGE POINTS)



Sources: STATEC, Eurostat, BCL calculations.

Inflation projections

Assumptions

The underlying assumptions for the HICP energy projections 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-May, the dollar stood at 1.27 to the euro, which represents an appreciation with respect to both the average for 2005 and the assumptions of the previous exercise. The price of oil fluctuated around the USD 73 per barrel level and markets were anticipating a marginal increase to a level close to USD 74 per barrel in June 2007, a significant upward revision compared with the previous exercise. Detailed assumptions are given in the following table.

TABLE 2: ASSUMPTIONS UNDERLYING THE INFLATION PROJECTIONS

	2004	2005	2006	06-Q1	06-Q2	06-Q3	06-Q4	07-Q1	07-Q2
Price of oil in USD per barrel	38.3	54.4	70.3	62.1	71.5	73.3	74.2	74.4	74.1
Exchange rate USD/EUR	1.24	1.24	1.25	1.20	1.25	1.27	1.27	1.27	1.27
Price of oil in EUR (annual percentage changes)	20.7	42.3	28.1	42.3	38.9	14.7	22.3	13.7	2.7

Source: BCL.

The government has decided to increase the level of excise duties on diesel and petrol by €12.5 and by €20 per 1,000 l respectively; these excise duties take effect in January 2007. According to our estimates, the additional impact of the two fiscal measures on the NICP corresponds to 0.07 percentage point in 2007. The impact on the HICP is slightly higher, around 0.2 percentage point.

The HICP excluding energy is usually driven by imported inflation and wage developments. Beyond this, specific measures such as indirect tax adjustments, public charges and administered prices may also influence inflation developments. Avian flu has not yet had an impact on HICP excluding energy inflation. However, the recently less favourable outcome can be traced, first, to a rise in tariffs for public services and, second, to an increased pass-through of the higher energy costs to consumer price inflation. In spite of the increasing oil price, economic growth in the euro area is continuing its recovery, which started in the third quarter of 2005. Attention is gradually shifting to the speed at which the output gap is closing and provoking inflation tensions. Imported inflation remains muted at the current juncture. Although Germany will raise its standard VAT rate by 3 percentage points from 1 January 2007 onwards, this measure is unlikely to have a direct or indirect effect on consumer prices in Luxembourg. While wage moderation is still a feature in several euro area countries, the risks of second-round effects from the persistently high oil price in the context of an improving labour market, and notably a fall in the unemployment rate, become more likely as the economic situation improves.

The assumptions for tobacco prices have remained unchanged compared with the previous exercise. In the absence of tax adjustments, it is assumed that tobacco prices will not be increased in 2007. For 2008 however, a price rise has again been incorporated into the projections.

Results

On the basis of the euro oil price assumptions, the energy component is expected to develop rather unfavourably over the forecast horizon, especially in the short term. The annual rate of change in HICP excluding energy is assumed to drop from 2.4% in 2005 to 2.1% in 2006 on the basis of an absence of a tax rise on tobacco products. However, the NICP excluding energy, which is less affected by the tobacco component, should accelerate from 1.7% in 2005 to 2.1% in 2006. Both projections have been significantly revised upwards. NICP inflation should gradually decline as the impact of the rise in the oil price on inflation rates gradually diminishes. It is projected to decline from 3.0% in the first quarter of 2006 to around 2.5% in the second half of 2006 and the first quarter of 2007 before dropping further to 2.0% in the second quarter of 2007.

TABLE 3: INFLATION PROJECTIONS AND REVISIONS COMPARED WITH THE PREVIOUS EXERCISE (ANNUAL PERCENTAGE CHANGES; PERCENTAGE POINTS)

	2004	2005	2006	2006-first half	2006-second half	2007-first half
NICP	2.2	2.5	2.8 (0.6)	3.0 (0.4)	2.6 (0.8)	2.3
NICP excluding energy	1.8	1.7	2.1 (0.3)	2.1 (0.3)	2.1 (0.3)	2.0
HICP	3.2	3.8	2.9 (0.5)	3.7 (0.4)	2.2 (0.8)	2.6
HICP energy	11.8	14.9	9.5 (3.4)	14.6 (1.7)	5.0 (4.9)	4.9
HICP excluding energy	2.5	2.4	2.1 (0.3)	2.3 (0.3)	1.9 (0.3)	2.3
Impact of government measures[1] on the NICP, in percentage points	0.6	0.4	0.5 (0.2)			0.5
Impact of government measures on the HICP, in percentage points	1.5	1.4	0.6 (0.1)			0.9

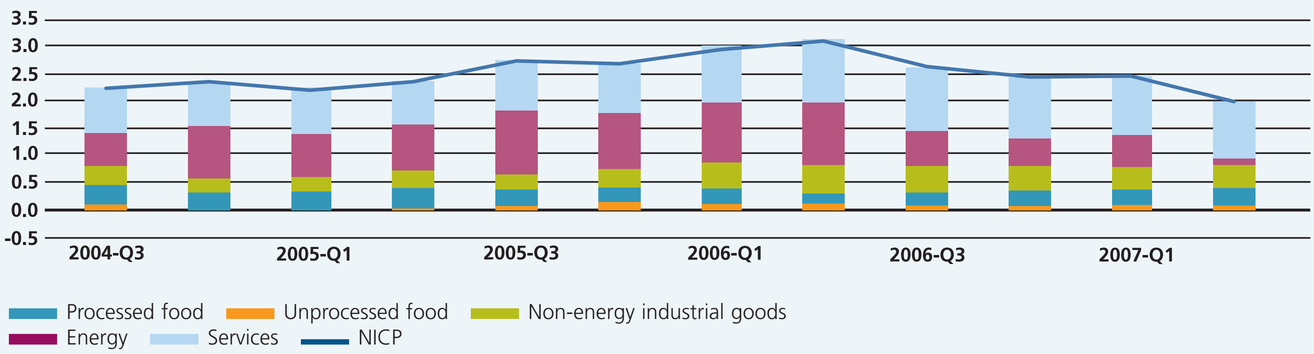
[1] *Impact of administered prices, indirect taxation and tobacco. For further details, please see BCL Bulletin No 2004/3, pp.76-81.*

Source: BCL.

After a temporary decline in 2005, the impact of government measures on NICP inflation will accelerate again in 2006, mainly on the basis of the rise in administered prices that was observed at the beginning of 2006.

As announced by the government, the payout of the upcoming automatic wage indexation, projected for August 2006, has been postponed until December 2006. The same announcement foresees no automatic wage adjustment for 2007.

CHART 8: CONTRIBUTIONS TO GROWTH FROM THE NICP



Sources: STATEC, BCL calculations.

Risk analysis

The central scenario of a deceleration in headline inflation as explained above might cause surprise in light of the high oil price level. However, since the oil price is assumed to remain relatively flat over the projection horizon, it is normal that the inflation rates for the HICP including energy should gradually converge to zero. A more pronounced acceleration in headline inflation must therefore come either from another rise in the oil price level, additional indirect taxation measures, or a more pronounced acceleration in the annual rate of change of the HICP excluding energy.

The oil price developments probably pose the greatest risk to our central scenario. The expected spread of the oil price around the futures-based assumptions, as can be inferred from the implied volatility of options on the oil price, highlights two issues: first, the uncertainty surrounding the baseline assumptions is considerable and, second, the risks are tilted towards the upside.

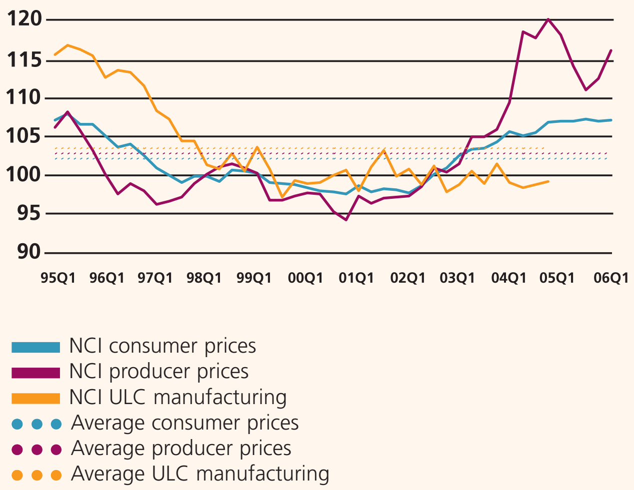
Impact on competitiveness of the adjustment to the wage indexation mechanism

On 2 May 2006 the government announced an adjustment to the automatic wage indexation mechanism. Instead of the automatic increases in nominal wages whenever the consumer price index increases by 2.5%, only two increases will be made, at predetermined points in time (December 2006 and March 2008). This adjustment to the indexation mechanism aims to restrain the recent deterioration of Luxembourg's cost competitiveness. To assess the extent of this deterioration, this box provides an update of the different competitiveness indicators produced by the BCL. Three of these indicators are then extended to 2008 using the latest Eurosystem projections. Finally, to quantify the impact of the measures announced, the competitiveness indicator based on unit labour costs (ULCs) is extended through 2008 under the counterfactual hypothesis that wages are automatically indexed to prices (the adjustment is ignored).

The competitiveness indicators produced by the BCL are effective exchange rates that are deflated using different price or cost indices. These indicators compare prices or costs in Luxembourg with a weighted average of the same prices or costs in the main trading partners, prices and costs being expressed in a common currency and weighted according to the importance of the respective country in Luxembourg's international trade (see BCL Bulletin No 2003/3). Conditional on data availability, these indicators are calculated for a group of 35 countries (the 25 members of the European Union plus ten other trading partners, see BCL Bulletin No 2005/2).

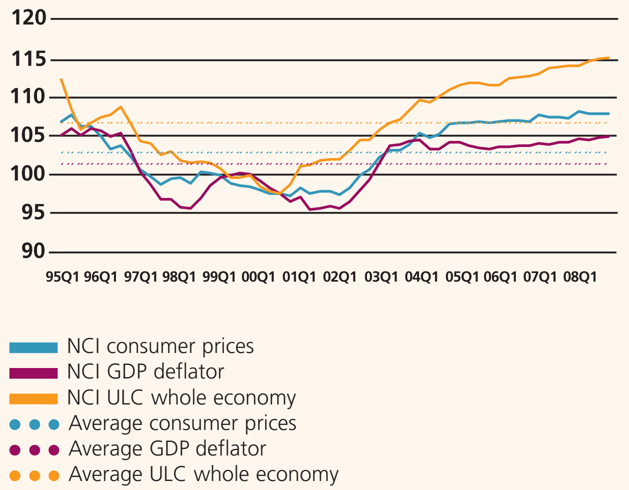
The first figure presents Luxembourg's competitiveness indicators based on consumer price indices, producer price indices and unit labour costs in the manufacturing sector. An increase in the indicator represents a deterioration in Luxembourg's competitiveness (prices/costs rising faster in Luxembourg than abroad). Newly available data confirm the rising trend of the indicator based on consumer prices, already noted in previous BCL publications. According to the most recent observations (first quarter of 2006) this indicator exceeds its historical average (calculated since the first quarter of 1995) by 4.9%. The indicator based on producer prices peaked in the fourth quarter of 2004 (nearly 17% above its average), but in the first quarter of 2006 it still exceeded its average by 12.8%. These large fluctuations probably reflect the recent volatility of steel prices, as this sector still dominates Luxembourg's industry. Therefore, the indicator based on producer prices probably gives a distorted view of the changes in competitiveness in the overall economy. Finally, the competitiveness indicator based on unit labour costs in the manufacturing sector is still below its historical mean (-4.1% in the fourth quarter of 2004). However, manufacturing represents less than 10% of value added in the national economy and the development of this indicator in 2005 is not yet known, as some partner countries have not yet published the necessary data.

CHART 9: NATIONAL COMPETITIVENESS INDICATORS (NCIs) BASED ON CONSUMER PRICES, PRODUCER PRICES AND UNIT LABOUR COSTS IN MANUFACTURING



Sources: ECB, IMF and BCL calculations.

CHART 10: NATIONAL COMPETITIVENESS INDICATORS (NCIs) BASED ON THE CONSUMER PRICE INDEX, THE GDP DEFLATOR, AND UNIT LABOUR COSTS IN THE WHOLE ECONOMY



Sources: ECB, IMF and BCL calculations.

The recent Eurosystem projections make it possible to extend the three competitiveness indicators until 2008 (see Chart 10 above). These are: the indicator based on consumer prices, the one based on the GDP deflator, and the one based on unit labour costs in the whole economy. For these three indicators, newly available data confirm that Luxembourg's competitiveness continued to deteriorate, and that currently all three indicators are above their historical averages (since the first quarter of 1995). The indicator based on consumer prices increased by 9.5% between the first quarters of 2002 and 2006 respectively, the latest available observation. This accumulated deterioration over four years means that, on average, yearly inflation was 2.3 percentage points higher in Luxembourg than in a weighted average of trading partners (weights reflect each country's share in Luxembourg's foreign trade). For the other two competitiveness indicators, the latest available observation is the fourth quarter of 2005. Over the three years before this date, the accumulated deterioration of the indicator based on the GDP deflator reached 7.7% (on average, inflation was 1.9 percentage points higher in Luxembourg). For the indicator based on unit labour costs in the whole economy, the accumulated deterioration over four years was 9.0% (on average, inflation was 2.2 percentage points higher in Luxembourg).

According to the projections (which are based on the adjustment to wage indexation), the competitiveness deterioration should continue for all three indicators until the end of the projection horizon in the fourth quarter of 2008. The indicator based on consumer prices should deteriorate by an additional 0.7% between the fourth quarters of 2005 and 2008 respectively. These projections also imply that the indicator based on the GDP deflator should increase by 1.9% until the end of the projection. Finally, the indicator based on unit labour costs in the whole economy should deteriorate by an additional 3.1%.

To quantify the impact on competitiveness of the adjustment to automatic wage indexation, the future path of these indicators was calculated by abstracting from the government measures mentioned above. This analysis is limited to the impact on unit labour costs of an alternative trajectory of nominal wages, without considering the possible effects of the announced measures on labour productivity (effects on output or employment). The following table shows the contribution of wage indexation to growth in unit labour costs under the scenario with and without adjustment to the indexation mechanism.

TABLE 4: UNIT LABOUR COSTS IN THE WHOLE ECONOMY (YEARLY GROWTH RATES)

	2006	2007	2008
Without adjustment to the indexation mechanism			
(1) Real wage	1.6	1.2	1.6
(2) Contribution of indexation	2.9	1.7	2.3
(3) Compensation per employee (1)+(2)	4.6	2.9	3.9
(4) Labour productivity	1.8	1.0	1.4
(5) Unit labour costs (3)-(4)	2,8	1.9	2.5
Impact of adjustment (percentage points)	-0.8	0.6	-0.2
With adjustment to indexation mechanism			
(1) Real wage	1.6	1.2	1.6
(2) Contribution of indexation	2.1	2.3	2.1
(3) Compensation per employee (1)+(2)	3.7	3.5	3.7
(4) Labour productivity	1.8	1.0	1.4
(5) Unit labour costs (3)-(4)	1,9	2.5	2.3

Source: BCL calculations.

The contribution of wage indexation to growth in unit labour costs depends on the timing at which indexation is triggered. Without adjustment, the BCL expected the index mechanism to be triggered in August 2006 and again in December 2007 but not in 2008. The adjustment to the indexation mechanism envisages that the mechanism will be activated at fixed points in time, namely in December 2006 and in March 2008 (conditional on oil prices), but not in 2007. Thus, without adjustment, indexation would have contributed 2.9 percentage points to growth in unit labour costs in 2006 and 1.7 points in 2007. With adjustment, these contributions are 2.1 points in 2006 and 2.3 points in 2007. Thus the impact of adjustment to the indexation mechanism on the growth of unit labour costs, as measured by the difference between these numbers, is -0.8 point in 2006 and 0.6 point in 2007. The positive impact in 2006 reflects a base effect (the wage level in 2007 is relatively unchanged by the adjustment but the level in 2006 is lower). Finally, in 2008 the impact of adjustment on the growth of unit labour costs is weaker and negative (-0.2). Between 2005 and 2008 unit labour costs are projected to grow by 6.9% with adjustment to the indexation mechanism (annual average 2.3%) against 7.4% without adjustment (annual average 2.4%). Thus, the adjustment to the indexation mechanism should hold back growth in unit labour costs. However, competitiveness will not improve unless unit labour costs increase more slowly in Luxembourg than in its main trading partners.

It should be noted that these calculations could be strongly influenced by alternative hypotheses regarding the future level of oil prices. In fact, the BCL's inflation projections are relatively optimistic compared with those the government considered when presenting the adjustment to the indexation mechanism. Without adjustment, the government expects a hypothetical indexation in August 2007, while the BCL expected an indexation only in December 2007. This conservative assumption by the government implies that the wage level is higher in 2007 without adjustment, creating a negative impact this year as well. Similarly, without adjustment the government expected a third hypothetical indexation in August 2008, but in the BCL's projections this does not take place until 2009. By adopting the hypothetical indexations of the BCL or of the government, two counterfactual paths for unit labour costs can be calculated in the absence of adjustment to the indexation mechanism. For each of these two paths, the counterfactual evolution of the competitiveness indicator can be calculated to quantify the impact of the adjustment to the indexation mechanism. According to the latest available observations, this competitiveness indicator deteriorated by 1.5% in 2005. Adopting the government scenario without adjustment, competitiveness would deteriorate by 4.2% between the fourth quarters of 2005 and 2008 respectively (on average 1.4% at an annual rate). The adjustment to the indexation mechanism makes it possible to limit this additional deterioration to only 3.1% (on average 1.0% at an annual rate). On the other hand, the BCL's scenario without adjustment expects an additional deterioration of competitiveness over this period of only 3.4% (on average 1.1% at an annual rate).

In conclusion, the update of the competitiveness indicators confirms that the deterioration continued until end-2005. Extending some of these indicators using the Eurosystem projections suggests a further deterioration. The adjustment to the wage indexation mechanism could reduce this decline in competitiveness but will not be able to reverse the trend. According to the projections, the deterioration will continue to the end of 2008 at an annual rate of 1.0% on average, i.e. unit labour costs will continue rising faster in Luxembourg than abroad. Of course, these results are based on a very simple calculation that does not consider possible positive impacts on growth or productivity from the adjustment to the wage indexation mechanism. It must be acknowledged that the adjustment to the indexation mechanism has the advantage of reducing the uncertainty companies face regarding their future wage costs. The recent increase in Luxembourg's inflation was tied to unexpected rises in energy prices and administered prices, which were propagated through the indexation mechanism into wage costs. The announced adjustment to the wage indexation mechanism over the years to come will reduce the risk that companies will face new unexpected increases in wage costs and thus allow them to establish production plans on a more solid basis.

1.2.1.2 Producer prices in industry

Industrial producer prices increased on average by 8% in 2005 compared with 2004. While this represents a decline compared with the previous year, it remains considerable and it is also well above the price increases observed in the euro area. However, the average inflation figure can largely be traced to base effects and the sharp price increase that was observed in the course of 2004. The price level hardly changed throughout 2005.

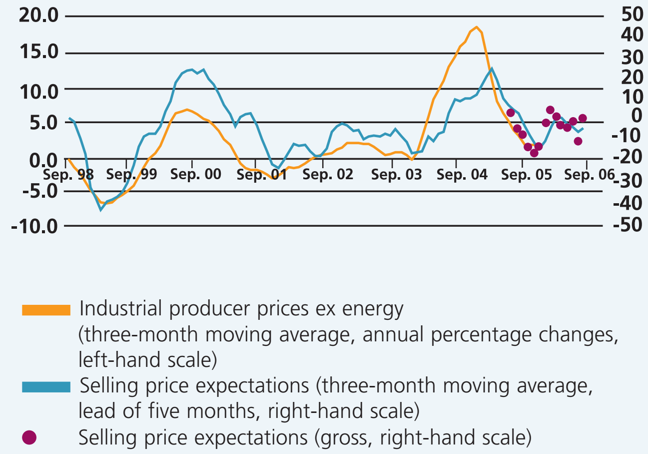
Two factors probably explain these price developments to a large extent. On the one hand, it is likely that the increase in the oil price, from USD 47.7 per barrel in the first quarter of 2005 to USD 56.9 per barrel in the fourth quarter of 2005, has been absorbed in profit margins. On the other hand, world growth has remained steady and is reflected in the volume growth, which has probably partially offset the slightly disappointing price developments.

TABLE 5: INDUSTRIAL PRODUCER PRICES (CHANGES COMPARED WITH THE PREVIOUS PERIOD)

	Shares	2003	2004	2005	05-Q2	05-Q3	05-Q4
Total	1000	1.2	9.0	8.0	-1.0	0.5	1.1
Intermediate goods	675.9	0.8	12.8	10.2	-1.5	-0.6	2.0
Capital goods	109.9	0.7	5.6	0.1	-2.7	2.7	-1.6
Consumer goods	136.3	1.7	0.0	0.9	1.2	0.0	0.0
Energy	77.9	4.6	5.6	10.7	2.5	2.4	2.4

Sources: STATEC, BCL.

CHART 11: INDUSTRIAL PRODUCER PRICES, PAST AND EXPECTED DEVELOPMENTS



Sources: Eurostat, BCL.

The outlook for industrial producer prices has turned more favourable in recent months. While inflation has steadily declined since the end of 2004, a trend inversion in the near future is very likely according to the results of the harmonised business surveys (see chart). These developments imply another increase in the price level after the relatively flat profile that was observed in 2005.

1.2.1.3 Construction prices

Prices of construction services increased by 3.1% in 2005, thus rising faster than the national index of consumer prices. While the contribution of the automatic wage indexation to the nominal wage increase can partly explain these developments, it is likely that these price dynamics also reflect the still vigorous demand for dwellings in a housing market characterised by a structural shortage.

1.2.2 Sectoral developments

1.2.2.1 Industry

In the context of a favourable international environment, the industrial sector expanded for its third consecutive year, and growth was well above that seen in the euro area. Total production and turnover increased at a slower pace in 2005, but growth in production per working day, at 5.9%, was similar to the rate observed in 2004. Although production of intermediate goods has fallen in the context of a weaker steel sector, it remains at a high level. Total production was mainly driven by capital goods and energy components. These branches saw their production levels expand by 11.8% and 22.8% respectively.

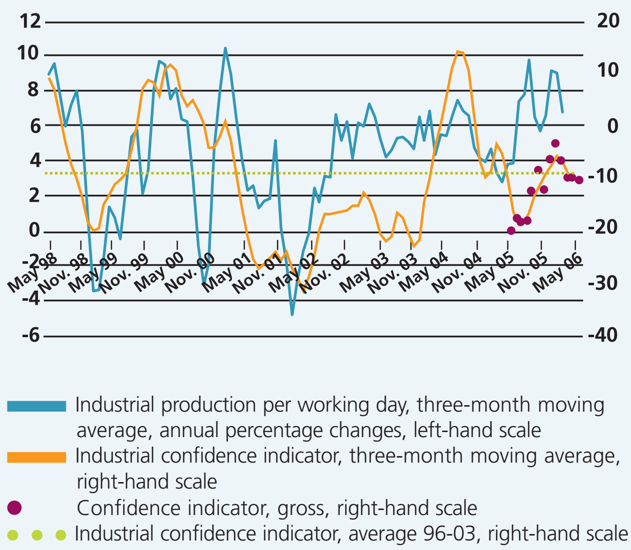
TABLE 6: INDICATORS FOR THE INDUSTRIAL SECTOR (ANNUAL PERCENTAGE CHANGES)

	2003	2004	2005	Q2-05	Q3-05	Q4-05	Q1-06
Turnover	3.0	20.8	2.5	-2.9	4.8	5.3	12.7
Total production	4.9	6.8	3.7	1.5	6.4	5.4	9.5
Production per working day	5.4	5.9	5.9	4.1	10.0	6.8	8.7
Intermediate goods (ppwd)	4.6	6.1	-0.5	-4.6	4.5	3.3	5.7
Capital goods (ppwd)	-0.8	5.6	11.8	9.4	22.8	9.0	5.0
Energy (ppwd)	13.9	14.6	22.8	30.8	22.0	19.9	30.2

Source: STATEC.

On the back of the euro area recovery, the business surveys in the industrial sector point to relatively favourable developments in early 2006. The industrial confidence indicator has gone up compared with the second half of 2005 and remains close to its long-term average level.

CHART 12: CONFIDENCE INDICATORS AND INDUSTRIAL PRODUCTION



Sources: STATEC, BCL calculations.

1.2.2.2 Construction

The construction sector fared much less well than the industrial sector in 2005. Turnover barely increased and production per working day even fell compared with the year 2004. The decline is particularly severe in civil engineering, whereas the building industry, with a 1.7% increase in production per day, is still benefiting from a favourable environment. Most demand-related short-term indicators point to a continuation of this relatively favourable trend. The ECB raised short-term interest rates, but the latter remain at a low level and, at the current juncture, they do not yet seem to be an impediment to credit demands by households for house purchases.

TABLE 7: INDICATORS FOR THE CONSTRUCTION SECTOR (ANNUAL PERCENTAGE CHANGES)

	2003	2004	2005	Q2-05	Q3-05	Q4-05	Q1-06
Turnover - total	6.2	-1.1	1.8	3.0	2.4	6.5	-7.0
Production per working day - total	1.2	-1.2	-0.5	0.0	0.0	4.0	1.6
Production per working day - building industry	0.6	2.9	1.7	2.0	2.5	4.6	2.0
Production per working day - civil engineering	2.6	-14.2	-8.7	-6.7	-8.8	3.0	-0.4
Building permits[1]	11.5	18.2	21.3	34.8	-24.5	64.8	n.a.
Loans for house purchases[2]	24.6	5.7	16.6	16.5	22.5	12.5	n.a.
Mortgage rates	3.8	3.4	3.5	3.5	3.5	3.6	3.7

[1] *Number of dwellings.*

[2] *Total of mortgage loans to residents.*

Sources: STATEC, BCL.

1.2.2.3 Commerce and other sectors

The positive trends observed in 2004 partly continued into 2005. Turnover growth in the wholesale trade and in hotels and restaurants even accelerated when compared with 2004. The latter branch probably benefited to a large extent from the activities related to the European Presidency held by Luxembourg in the first half of 2005. However, expansion in the retail trade is derived mostly from price increases, and volume growth remains anaemic. Car registrations were flat in 2005, which is no surprise given the exceptional increase observed in 2004.

TABLE 8: TURNOVER AND CAR REGISTRATIONS (ANNUAL PERCENTAGE CHANGES)

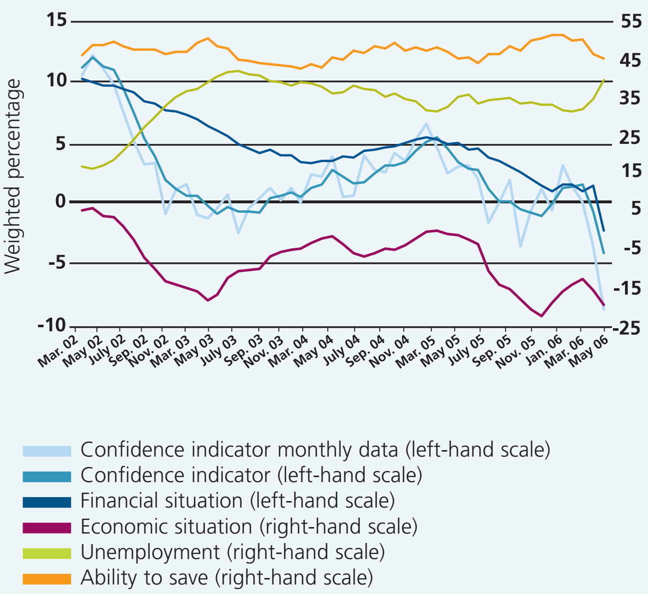
	2003	2004	2005	05-Q2	05-Q3	05-Q4	06-Q1
Car registrations	0.2	10.0	1.6	-3.5	5.7	-3.2	-2.7
Wholesale trade	14.8	4.6	6.6	4.6	6.7	5.4	n.a.
Retail trade	5.1	4.3	2.7	2.1	4.3	0.3	n.a.
Hotels and restaurants	-4.8	0.9	6.0	5.8	4.2	5.0	n.a.

Source: STATEC.

1.2.3 Consumer survey

Consumer confidence declined throughout 2005. Indeed, the three-month moving average of the confidence indicator declined to 0 for the period from October to December 2005, compared with +6 for the period from November 2004 to January 2005. This worsening largely reflected more negative expectations regarding the future development of the general economic situation and, to a lesser extent, less optimistic expectations concerning consumers' own financial situations.

CHART 13: CONSUMER CONFIDENCE INDICATOR AND ITS COMPONENTS (THREE-MONTH MOVING AVERAGES UNLESS OTHERWISE INDICATED)

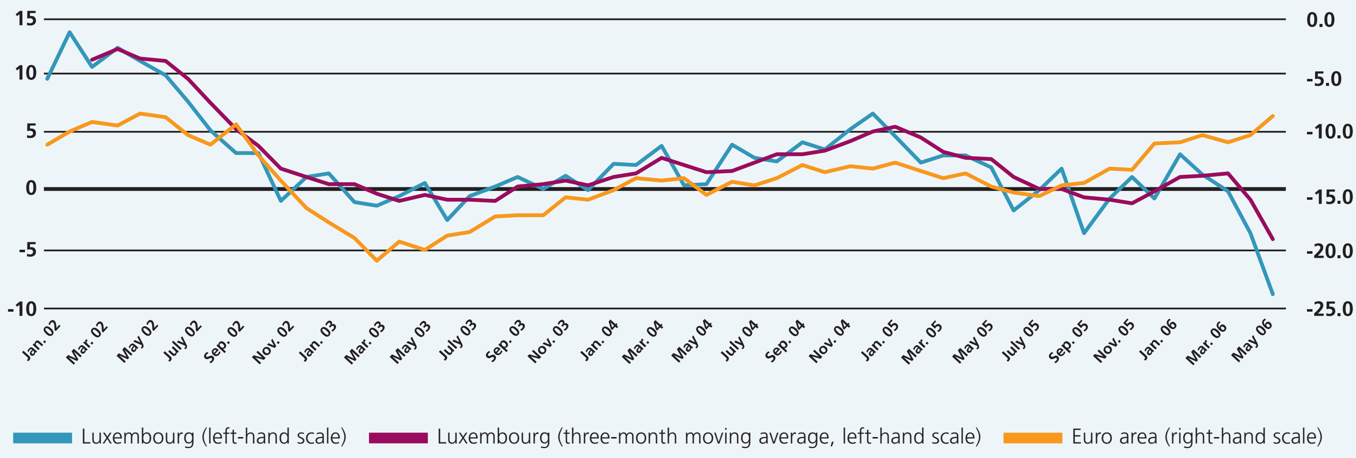


Source: BCL.

The negative trend of consumer confidence continued in early 2006 to reach -9 in May (unsmoothed monthly data). This worsening reflected deteriorations in all of the confidence indicator's components with the exception of the expectations concerning consumers' own financial situations. The decline in consumer confidence in early 2006 could be a reaction to announcements of layoffs at several Luxembourg companies and entities. Uncertainty regarding the discussions on the content of the structural reforms is likely to have contributed to the negative trend in consumer confidence in autumn 2005 and in early 2006.

Luxembourg consumer confidence mirrored developments in euro area consumer confidence until mid-2005, but since then their respective trends have contrasted with each other. Indeed, euro area consumer confidence showed signs of improvement from the second half of 2005 onwards, while a downward trend has been observed for Luxembourg. Domestic factors like those mentioned above seem to have driven developments in Luxembourg consumer confidence since mid-2005, and to have had a greater impact than information originating from the neighbouring countries.

CHART 14: CONSUMER CONFIDENCE INDICATOR AND ITS COMPONENTS (SEASONALLY ADJUSTED DATA)



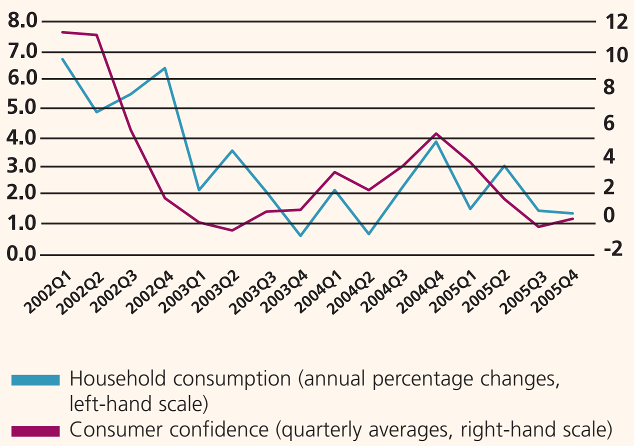
Sources: BCL, European Commission.

Usefulness of consumer surveys for analysing short-term developments in household consumption

Consumer survey data are likely to contribute to the analysis of short-term developments in household spending owing to their high frequency and timeliness. However, the value of such survey data depends on the extent to which they convey reliable information about household consumption. This box focuses on the usefulness of these surveys for assessing real household consumption growth developments in Luxembourg.

The chart below shows a substantial degree of co-movement between year-on-year real household consumption growth (calculated on the basis of the quarterly national accounts) and the consumer confidence indicator in Luxembourg.

CHART 15: CONSUMER CONFIDENCE INDICATOR AND YEAR-ON-YEAR REAL HOUSEHOLD CONSUMPTION GROWTH (SEASONALLY ADJUSTED DATA)



Sources: BCL, STATEC.

The correlation analysis presented below confirms the findings based on the visual inspection of the above graph. The table shows the correlation coefficients for different leads and lags (including contemporaneous correlations) between year-on-year real household consumption growth and the consumer survey data. The second (fourth) column indicates the correlations in cases where the consumer survey data lag (lead) the year-on-year real household consumption growth. The entries in this table that are shown in bold are significant at the 1% level, except for the ability to save, which is significant at the 5% (in t+1). All other entries are not significant.

This analysis indicates that the consumer confidence indicator can be seen as a leading indicator of year-on-year real household consumption growth as the maximum correlation is reached if consumer confidence leads consumption growth by one quarter (column 4). The same conclusion can be drawn for three of the components of the consumer confidence indicator, namely, households' financial situation, unemployment and ability to save.

TABLE 9: CORRELATION BETWEEN CONSUMER SURVEYS AND YEAR-ON-YEAR REAL HOUSEHOLD CONSUMPTION GROWTH

	Consumption in t-1 (lag)	Consumption in t	Consumption in t+1 (lead)
Consumer confidence	0.37	**0.63**	**0.67**
Components of the confidence indicator			
Financial situation	**0.78**	**0.84**	**0.80**
General economic situation	-0.04	0.32	0.31
Unemployment	0.44	**0.65**	**0.67**
Ability to save	0.25	0.11	**0.52**

Sources: BCL, STATEC.

The next table shows that the consumer confidence indicator can at best be characterised as a coincident indicator of quarter-on-quarter real household consumption growth. The entries in the table that are in bold are significant at the 5% level, while all other entries are not significant.

TABLE 10: CORRELATION BETWEEN CONSUMER SURVEYS AND YEAR-ON-YEAR REAL HOUSEHOLD CONSUMPTION GROWTH

	Consumption in t-1 (lag)	Consumption in t	Consumption in t+1 (lead)
Consumer confidence	**0.59**	**0.45**	-0.05
Components of the confidence indicator			
Financial situation	**0.56**	0.38	-0.03
General economic situation	0.33	0.29	-0.15
Unemployment	**0.56**	**0.48**	-0.01
Ability to save	0.23	0.08	0.25

Sources: BCL, STATEC.

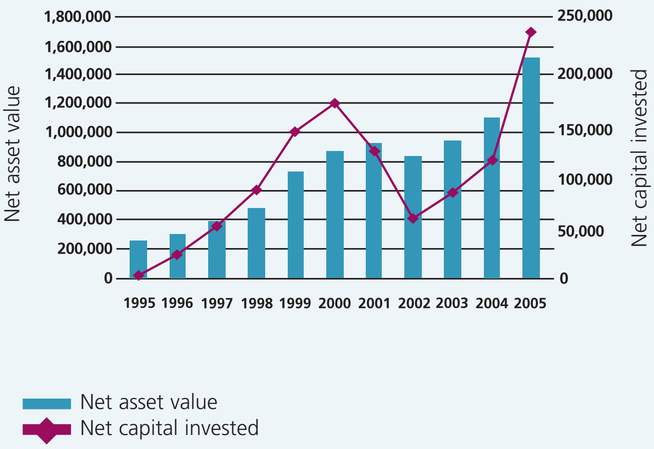
Overall, the above results show that the consumer surveys show a reasonable degree of correlation with real household consumption growth, especially when the latter is measured in year-on-year terms. Hence, consumer surveys convey useful information regarding movements in household spending as the survey results are published before national accounts. However, caution is warranted when trying to extrapolate future developments for household consumption on the basis of the Luxembourg consumer survey data as the latter are only available from 2002.

1.2.4 Financial sector

1.2.4.1 <u>Developments in the financial sector</u>

In 2005, the international financial market climate particularly boosted the mutual fund industry. Their net asset value (NAV) increased by €418,986 million (37.9%), to reach an outstanding amount of €1,525,208 million on 31 December 2005. In addition, the appreciation of the US dollar vis-à-vis the euro was advantageous for those investment funds that invested their assets, in part or completely, in US dollars. During the first quarter of 2006, these positive developments continued. Thus, over this period, the NAV of undertakings for collective investments (UCIs) showed a new surge of €150 million in assets (9.8%), to reach €1,675 million by 31 March 2006.

CHART 16: DEVELOPMENT OF THE NET ASSET VALUE OF MUTUAL INVESTMENT FUNDS (EUR MILLIONS)



Source: BCL.

TABLE 11: DEVELOPMENT OF THE GLOBAL SITUATION OF UNDERTAKINGS FOR COLLECTIVE INVESTMENTS (EUR MILLIONS; OUTSTANDING AMOUNTS AT THE END OF THE PERIOD UNLESS OTHERWISE INDICATED)

	Number of UCIs	Number of sub funds	Net assets	Net capital invested in share/units [1,2]	Variation of financial markets [2,3]	Annual variation in gross terms	Annual change in %	Monthly variation in gross terms	Monthly change in %
2000	1,785	6,995	874,600	168,200	-28,118	140,082	19.1		
2001	1,908	7,519	928,447	121,700	-67,900	53,847	6.2		
2002	1,941	7,806	844,508	57,314	-141,206	-83,939	-9.0		
2003	1,870	7,509	953,302	82,609	26,185	108,794	12.9		
2004	1,968	7,876	1,106,222	10,081	5,299	152,920	16.0		
2005									
March	1,987	7,964	1,194,010	61,320	-3,968	161,238	15.6	14,805	1.3
June	2,025	8,207	1,289,787	36,772	27,220	242,967	23.2	42,380	3.4
Sep.	2,053	8,332	1,423,551	75,901	34,132	364,626	34.4	62,554	4.6
Dec.	2,060	8,497	1,525,208	62,284	27,133	418,986	37.9	50,657	3.4
2006									
Jan.	2,052	8,548	1,583,244	34,110	23,926	436,659	38.1	58,036	3.8
Feb.	2,080	8,626	1,638,106	36,018	18,844	458,901	38.9	54,862	3.5
March	2,091	8,724	1,675,260	36,441	713	481,250	40.3	37,154	2.3

[1] Net capital investment is defined as the difference between net proceeds from shares or units and net payments made in settlement of redemptions adjusted to take into consideration UCIs in liquidation.

[2] Accumulated annual or quarterly figures.

[3] The column variation of financial markets reflects the monthly change in net assets, which is due to the fluctuation of financial markets.

Source: CSSF.

At the level of money market funds, the surge in the aggregate balance sheet reached €18,624 million, or 11.5% in 2005. However, a slight withdrawal was observed during the first quarter of 2006; as at 31 March 2006 the balance sheet reached an outstanding amount of €178,949 million.

In addition, the improvement in the general economic climate as well as the return to a favourable stock market environment allowed credit institutions to increase the volume of their activities. Hence, with an outstanding amount of €792,420 million as at 31 December 2005, the aggregate balance sheet of credit institutions showed once again a historically high level.

TABLE 12: DEVELOPMENT OF THE AGGREGATE BALANCE SHEET OF LUXEMBOURG CREDIT INSTITUTIONS [1, 2]

	Number of banks	Aggregate balance sheet	Annual change in EUR	Annual change in %	Quarterly change in EUR	Quarterly change in %	Monthly change in EUR	Monthly change in %	Yearly average
1999	210	598,459	57,571	10.6					550,008
2000	202	647,749	49,290	8.2					630,065
2001	189	721,000	73,251	11.3					685,944
2002	177	662,618	-58,382	-8.1					687,037
2003	169	655,971	-6,647	-1.0					660,730
2004	162	695,103	39,132	6.0					680,249
2005									
March	162	715,129	39,968	5.9	20,026	2.9	-1,836	-0.3	
June	159	746,480	61,839	9.0	31,351	4.4	12,559	1.7	
Sept.	157	758,314	79,283	11.7	11,834	1.6	5,728	0.8	
Dec.	155	792,420	97,317	14.0	34,106	4.5	5,065	0.6	746,623
2006									
Jan.	156	797,497	87,826	12.3			5,077	0.6	
Feb.	156	821,514	104,549	14.6			24,017	3.0	
March	155	823,028	107,899	15.1	30,608	3.9	1,514	0.2	

[1] *Figures were revised to take the latest information into account. Discrepancies may be due to roundings.*
[2] *For the years 1999 to 2004 columns 2 and 3 report outstanding monthly December figures, but not yearly totals.*

Source: BCL.

The growth dynamic which started in 2003 and 2004, and strengthened in 2005, continued in the first quarter of 2006. As a result, the aggregate balance sheet of Luxembourg banks increased by €30,608 million (3.9%) between 31 December 2005 and 31 March 2006.

On the asset side, interbank credit volume rose by 7.5% between the end of December 2004 and 2005. This increase seems to be rather low compared with annual growth rates generated by loans to non-MFIs[1] and by the securities portfolio. Loans to non-MFIs strongly improved, by 20.9%, rising from €121,307 million at the end of 2004 to €146,640 million one year later. During the first quarter of the current year, they increased by 3.9% to reach €152,291 million. The most important contribution to the increase on the asset side of the aggregate balance sheet was generated by the securities portfolio, which improved strongly by €40,917 million, or 23.4% between 31 December 2004 and 31 December 2005. This continued during the first three months of the current year with a progression of 6.8% or €14,595 million.

TABLE 13: KEY FIGURES RELATING TO VARIOUS ASSET POSITIONS OF THE AGGREGATE BALANCE SHEET AND THEIR DEVELOPMENT (AMOUNTS OUTSTANDING AT THE END OF THE PERIOD)

Assets	Outstanding amounts in EUR millions			Change in EUR millions and in %				Weight in % [1]
	2004/12	2005/12	2006/03	2004/12 - 2005/12		2005/12 - 2006/03		2006/03
				in EUR millions	in %	in EUR millions	in %	
Interbank loans	377,666	405,891	415,888	28,224	7.5	9,998	2.5	50.5
Loans to non-MFIs	121,307	146,640	152,291	25,333	20.9	5,651	3.9	18.5
Securities portfolio	174,522	215,439	230,035	40,917	23.4	14,595	6.8	27.9
Other assets	21,608	24,451	24,814	2,843	13.2	363	1.5	3.0
Total assets	695,103	792,420	823,028	97,317	14.0	30,608	3.9	100.0

[1] *Weighting in % of total assets.*

Source: BCL.

[1] MFI: monetary financial institutions.

On the liability side, most of the rise in the level of activity was due to activities stemming from interbank operations and from refinancing by issuing debt securities. These developments were mainly due to the placement of deposits from non-MFI customers. The latter reached an outstanding amount of €255,580 million as at 31 December 2005. During the first quarter of 2006, this tendency was reversed with respect to the growth of interbank loans insofar as debts towards non-MFI customers increased by 12.6%, or €32,306 million, to reach €287,886 million.

TABLE 14: KEY FIGURES RELATING TO VARIOUS LIABILITY POSITIONS OF THE AGGREGATE BALANCE SHEET AND THEIR DEVELOPMENT (AMOUNTS OUTSTANDING AT THE END OF THE PERIOD)

Liabilities	Outstanding amounts in EUR millions			Change in EUR millions and in %				Weight in % [1]
	2004/12	2005/12	2006/03	2004/12 - 2005/12		2005/12 - 2006/03		2006/03
				in EUR millions	in %	in EUR millions	in %	
Interbank deposits	329,761	386,031	387,060	56,270	17.1	1,029	0.3	47.0
Deposits from non-MFIs	230,903	255,580	287,886	24,677	10.7	32,306	12.6	35.0
Debt securities issued	76,902	89,535	86,198	12,633	16.4	-3,337	-3.7	10.5
Other liabilities	57,537	61,273	61,883	3,736	6.5	610	1.0	7.5
Total liabilities	695,103	792,420	823,028	97,317	14.0	30,608	3.9	100.0

[1] *Weighting in % of total liabilities.*

Source: BCL.

1.2.4.2 Profit and loss account

The solid performance of global financial markets combined with the global economic upswing as well as an outperforming investment fund industry allowed Luxembourg's credit institutions to obtain aggregated gross revenues before taxes and provisions in excess of €4,608 million in 2005. This represents a rise of 12.9% or €699 million compared with 2004. Global expenses (staff costs and other costs) rose by 6.9% during 2005. This increase in staff costs is due to a rise in wages and, in contrast to previous years, to new job creations.

First-quarter 2006 total gross income increased by 42.6% compared with the corresponding period of 2005 and reached €2,868 million. This, combined with strict cost controls, raised aggregated gross revenue before taxes and provisions to €1,862 million, resulting in an increase of 69.9% compared with the first quarter of 2005. This solid growth is due to the exceptional increase of 569%, or €495 million of other net income, from €87 million in the first quarter of 2005 to €582 million at the end of March 2006. Net interest income in the first quarter of 2006 (€1,076 million) rose by 14.2% or €134 million compared with the first quarter of 2004, mainly due to a rise in interest rates. Revenue from commission generated €1,005 million during the first quarter of 2006. This represents growth of 28% compared with the first quarter of 2005. Total expenses (staff costs and other costs) rose by 11.7% during the first quarter of 2006 in comparison with the first quarter of 2005. This is due to the creation of new jobs and a rise in wages resulting from an index tranche that became effective from October 2005.

TABLE 15: AGGREGATED PROFIT AND LOSS ACCOUNT OF THE LUXEMBOURG BANKS AS AT YEAR-END[1]

(in EUR millions) Debit and credit items	2000	2001	2002	2003	2004	2005
Interest receivable and income from securities	51,628	52,790	43,170	35,135	30,014	36,249
Interest payable	47,925	48,332	38,895	31,000	26,045	32,288
Interest margin (1-2)	3,703	4,458	4,275	4,135	3,969	3,961
Other income:						
from securities	322	174	173	288	419	386
from commission	3,216	2,830	2,654	2,552	2,828	3,253
from foreign exchange	312	290	317	282	279	356
other net income	475	399	949	429	7	458
Net income (4+5+6+7)	4,325	3,693	4,093	3,552	3,533	4,453
Gross income (3+8)	8,028	8,151	8,368	7,687	7,502	8,414
Staff costs	1,716	1,804	1,871	1,790	1,858	1,994
Other administrative expenditure	1,483	1,506	1,416	1,370	1,407	1,499
General administrative expenditure (10+11)	3,199	3,310	3,287	3,160	3,265	3,493
Taxes other than tax on income	99	95	51	41	35	40
Write-downs of non-financial fixed assets	320	402	316	293	293	273
Results before provisions (9-12-13-14)	4,410	4,344	4,714	4,193	3,909	4,608
Provisions and write-downs of fixed financial assets	1,682	1,405	1,928	1,241	535	906
Write-back of provisions	794	686	526	590	616	615
Net provisions	888	719	1,402	651	-81	291
Result after provisions (15-18)	3,522	3,625	3,312	3,542	3,990	4,317
Tax on income	969	833	636	665	742	771
Net result (19-20)	2,553	2,792	2,676	2,877	3,248	3,546

[1] *Data has been revised in the light of new information. Discrepancies may arise from rounding.*

Source: BCL.

1.2.4.3 Employment in the financial sector

As at 31 December 2005, the Luxembourg financial sector employed 31,344 persons compared with 29,067, i.e. 2,277 new jobs (+7.8%) compared with the previous year-end. In spite of the extension of the statistical coverage during this period, the surge in financial sector employment is mainly related to the increase in activity in this sector. Initial figures for 2006 confirm that this dynamic development is continuing, since 1,954 jobs were created during the first quarter, a rise of 6.2%. On 31 March 2006, the financial sector employed 33,298 people.

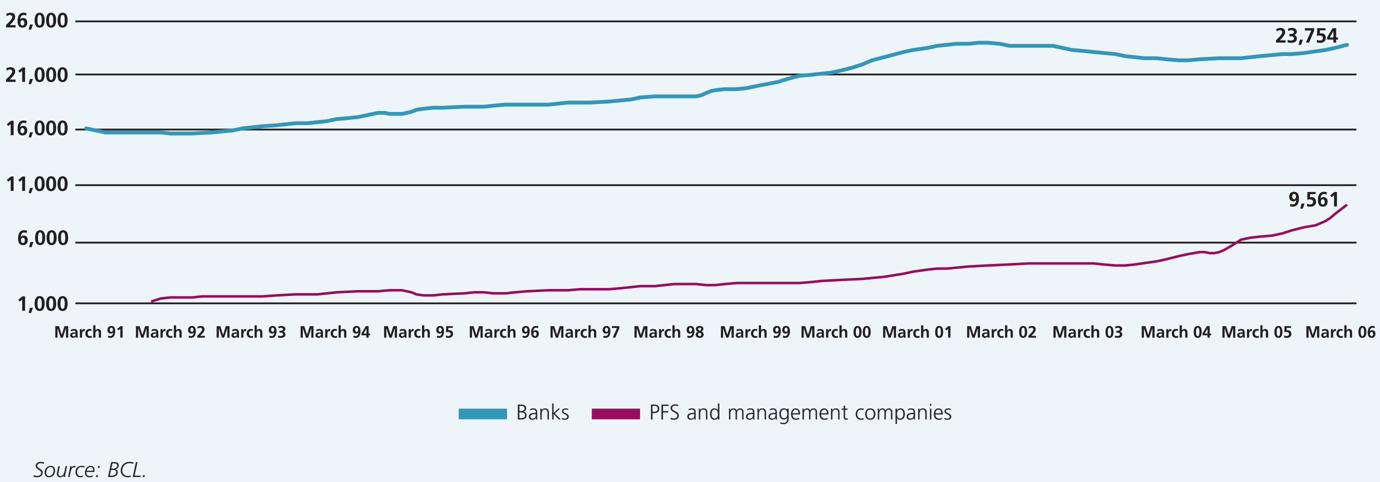
Situation in the banking sector

On 31 December 2005, the Luxembourg banking sector employed 23,224 persons compared with 22,549 on 31 December 2004, an increase of 3.0%, which represents the strongest annual improvement since 2001 (+3.7%). During the first quarter of 2006, 530 new jobs were created, a rise of 2.3%, which brought the number of employees in the banking sector to 23,754 as at 31 March.

Situation in the PFS[2] sector and within management companies

Professionals of the financial sector employed 6,547 people as at 31 December 2005, compared with 6,059 one year earlier, i.e. 488 jobs were created during this period. Employment in the PFS sector has advanced fairly strongly since 2004 due to the expansion of the statistical coverage following the introduction of the law of 2 August 2003[3]. Despite this effect, the 488 new jobs in 2005 are mainly related to the growing volume of business in this sector. As at 31 March 2006, the PFS sector employed 7,799 people, an increase of no fewer than 1,252 jobs or of 19.1%. Management companies[4] hired an extra 1,059 persons between December 2004 and December 2005, a rise of 206%, making a total headcount of 1,572. This increase in 2005 was primarily due to the creation of three entities of considerable size in the reporting population. In addition to this statistical phenomenon, the financial markets benefited from fairly strong economic growth in 2004 and 2005, which supported job creation. In the first quarter of 2006, a further 190 jobs were created, a rise of 12.1%, bringing the total number of employees in this sector to 1,762.

CHART 17: EMPLOYMENT IN THE FINANCIAL SECTOR



Source: BCL.

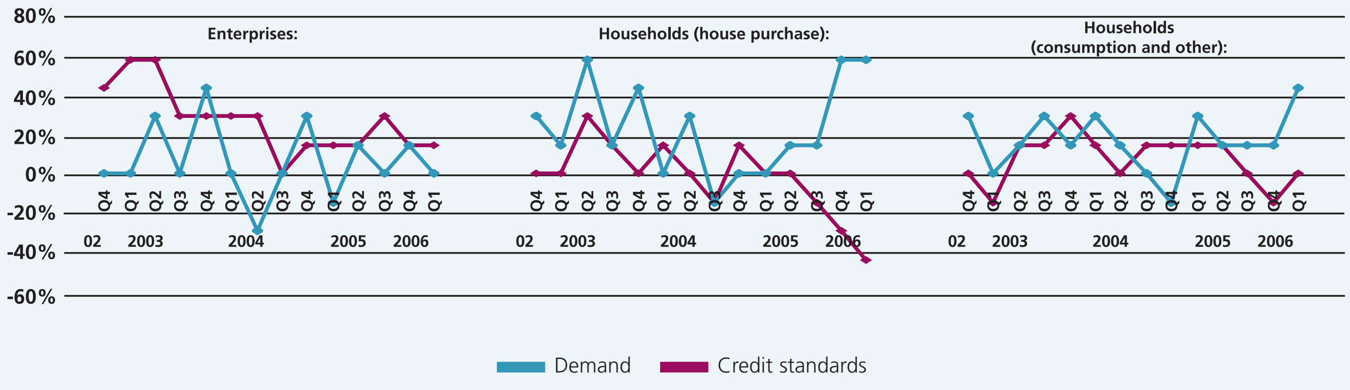
[2] PFS: Professionals of the financial sector.
[3] For more information, see page 42 of BCL Bulletin No 2004/4 (www.bcl.lu).
[4] *Sociétés de gestion*.

1.2.4.4 The Bank Lending Survey

The Bank Lending Survey (BLS) carried out by the Eurosystem assesses credit conditions in the euro area. Every quarter, a questionnaire is sent out to the seven banks from the Luxembourg sample; the survey questionnaire contains a number of questions on the supply of and demand for credit by households and enterprises.

Results are generally expressed in terms of "net percentages". For the questions on credit standards, net percentages refer to the difference between those banks that reported a tightening and those that reported an easing of credit standards. For the questions on credit demand, net percentages refer to the difference between those banks that reported a fall in demand and those that reported a rise.

CHART 18: CREDIT STANDARDS AND DEMAND, NET PERCENTAGES



Source: BCL.

Overall, between early-2005 and the first quarter of 2006, Luxembourg's results were only partly in line with aggregate euro area results. Parallel developments and similar tendencies between the Luxembourg and the euro area samples exist in particular as regards the demand side. In the euro area, net demand from firms and households rose; in Luxembourg, net demand also generally increased, in particular as regards loans for house purchase. As for credit standards, euro area banks generally reported a net easing; in Luxembourg, the net percentages indicate that credit standards applied to loans to enterprises have tightened, while they have eased with regard to loans for house purchase and tightened only slightly with regard to household loans for consumption (and other lending).

In the last five surveys, it has emerged that the tightening of credit standards for loans to enterprises is largely attributable to risk perceptions linked to expectations regarding general economic activity and regarding the industry- or firm-specific outlook, while competition from other banks contributed to an easing of credit standards. The rise in net demand from enterprises was to a large extent due to higher fixed investment.

Credit standards applied to mortgage loans have, on the other hand, eased considerably in terms of net percentages; the latter have in fact become larger and larger over the last few quarters. Since the third quarter of 2005, this result has been attributable to increased competition from other banks, while reduced risks pertaining to housing market prospects have also contributed to a net easing of credit standards applied to mortgage loans. Net demand for loans for house purchase has surged, in particular in the last two surveys, and an upward trend has been discernible for some time now. Increased financing needs linked to housing market prospects have been cited in this regard.

On average, for the entire period under review, a slight net tightening of credit standards for household consumption (and other purposes) has been recorded. While bank competition has been cited as contributing to an easing, especially in the last two quarters, increased risk perceptions pertaining to the creditworthiness of consumers have generally more than outweighed this effect. Net demand for consumer loans (and other lending) has risen, in particular in the latest survey.

1.2.5 Labour market

Slightly contrasting with the acceleration observed throughout 2004 (averaging 2.5%), the annual growth rate of employment in Luxembourg in 2005 appears to have remained broadly stable, but at a higher level (3.2%), reflecting the stabilisation of economic activity. However, from a historical point of view, employment is not growing significantly.

To a large extent, employment growth is reflected in the inflow of non-residents. In 2005, most newly created jobs were still taken up by non-residents (67%). Average growth in cross-border employment reached 5.8% in 2005 after 4.7% in 2004. Among cross-border commuters, 51.6% come from France, 26.9% come from Belgium, and 21.5% from Germany. Despite the rise in employment, the unemployment rate continued to increase further throughout 2005 (4.2% on average after 3.9% in 2004). This development reveals that annual GDP growth has remained insufficient to stabilise the unemployment rate. Moreover, the recent wave of redundancy announcements are expected to affect the unemployment rate in the second and third quarters of 2006, thereby reducing the probability of a reduction.

Impact of the Tripartite Coordination Committee's proposals on the labour market in Luxembourg

After decelerating during the downturn, employment growth has strengthened, whereas the unemployment rate has still been rising. Aware of this dilemma, the Tripartite Coordination Committee - a political forum consisting of government, employers' and trade union representatives - ended with all sides agreeing on a package of reforms that aims to implement an employment security policy, rather than a job security policy on the one hand, and to help tackle unemployment on the other hand. This box presents a summary of these reforms and analyses the relevancy and the feasibility of the proposed measures.

How relevant is the new policy to combat unemployment?

In order to fight the rise in unemployment, the Tripartite Coordination Committee has proposed to offer 1,000 extra apprenticeships and additional work experience opportunities for young people. This policy is expected to induce positive externalities and to reduce the number of young people unemployed. However, the cost and the concrete implementation of these additional apprenticeships are not clearly defined. As a consequence, it is difficult to say if this policy will have a short- or medium-term impact on unemployment. Moreover, the sectors in which the apprenticeships will be created are not mentioned in the agreement.

Another measure consists of a close collaboration between the *Administration de l'emploi (ADEM)*[5] and interim recruitment companies so as to find temporary work for hard-to-place job seekers. Such temporary work arrangements would help to avoid prolonged periods of unemployment. Indeed, employers could interpret such periods as idleness. In this context, a temporary job might be a positive signal, reflecting the job seeker's determination to find work. However, a potential employer might be discouraged by a sequence of temporary jobs on a curriculum vitae, believing that such an applicant might easily resign. 80% of the temporary workers in Luxembourg are cross-border workers that have low-skill jobs and as a consequence receive the minimum wage. The minimum wage can be relatively attractive for lower-skilled non-residents given the fact that minimum wages in the neighbouring countries are lower or do not exist. As a result, non-resident job seekers are very competitive in terms of reservation salary on the temporary job market. Moreover, Luxembourg provides high levels of unemployment benefit when compared with the replacement rate in the neighbouring countries. This intensifies competition between unemployed residents and non-resident job applicants on the temporary job market.

With respect to unemployment benefits, the Tripartite Committee has decided that the relatively generous replacement rate will be maintained but that its duration should be adjusted proportionally to the effective employment period. This measure is in line with a recent OECD study which says that the duration of unemployment benefit plays a significant role in long-term unemployment in OECD countries. For example, if an unemployed person knows that unemployment benefit is to be paid only for a very short period with a high replacement rate, he/she might lower his/her reservation wage and accept a job corresponding to that reservation wage in order to avoid a decline in unemployment benefit.

In the past, the high replacement rate for unemployment benefits in Luxembourg has attracted so-called "social tourists". More specifically, in order to receive unemployment benefit from the Luxembourg employment agency, some former cross-border workers, after losing their jobs, "move" into Luxembourg (giving a false address), as the replacement income provided by unemployment benefit is higher in Luxembourg than in the neighbouring countries. The Tripartite Committee has also decided to fight abuse of the system, by checking whether or not an unemployed person was resident in the country when he/she received his/her notice of dismissal. However, this measure is clearly insufficient if the residence of the unemployed person is not checked.

Finally, the Tripartite Committee decided that young unemployed people have to be offered technical training at the latest after they have been registered as unemployed for six months. The success of this measure depends on *ADEM*'s ability to place young unemployed in private-sector, rather than public-sector, schemes. Past experience shows that placement in the private sector provides better results and a greater likelihood of young people finding a job after their period of training.

How pertinent is the employment security policy?

Over the past few months, the headlines in the Luxembourg press have been dominated by a wave of redundancy announcements. As a consequence, the government decided to adopt an "employment security" policy, which should allow the authorities to better anticipate the process of restructuring in resident firms. In the future, people will have to think in terms of "employment security" rather than "job security". In concrete terms, the social partners will aim to reallocate workers to other jobs - either within the same firm or in another firm - in order to ensure they remain employed instead of being dismissed. However, the success of this measure depends on how well the social partners can re-classify those wage earners affected by large-scale redundancies.

The early retirement scheme will be reformed so that firms have to contribute more to the financing of the scheme. This will help to reduce incentives for firms to replace older workers by lower-paid younger ones and as a consequence it might increase the participation rates for older people.

To conclude, all the measures agreed on by the Tripartite Coordination Committee aim to improve the situation on the labour market, but the success of the reforms depends on their being adapted to Luxembourg's labour market specificities.

[5] A public employment service providing employment services to job seekers and employers in Luxembourg.

1.2.6 External trade

Overall, in the course of 2005, Luxembourg's external trade continued to improve as it did in 2004, ending two years (2002-2003) of consecutive decline. Exports of goods rose by 4.5%, reaching €10 billion. However, as imports of goods grew more rapidly (4.6%), the trade deficit increased by 4.9%, standing at €4 billion in 2005. The rise in imports of goods was driven by higher oil prices as well as by purchases of "machinery and transport equipment". Although exports of goods increased in 2005, steel sector sales, which represent almost one-third of Luxembourg's total exports, dropped by 3.1% as the demand from some trading partners was weaker.

1.2.7 Balance of payments

In 2005, Luxembourg's current account surplus remained stable at €2.85 billion (or 9.7% of GDP in 2005) compared with 2004 data. This stability, however, hides divergent developments in the main components of the current account. The strong rise (23.5%) in the services surplus was offset by a 38% increase in the combined deficit of the goods and income balance, while the current transfer deficit remained unchanged at its 2004 level. The improvement in net services receipts was for the most part driven by favourable developments in the financial sector. The performance of total services also benefited from freight transport by air. The deterioration of 22% in the goods balance was driven by net acquisitions of non-monetary gold and by a faster increase in the imports of general goods over exports. In the income balance, dividend payments abroad and compensations paid to cross-border workers turned the overall balance into a deficit in 2005, whereas there was a surplus in 2004.

In the financial account, Luxembourg's portfolio investments, like those in the rest of the euro area, registered higher net inflows in equity securities. These were largely offset by net outflows in debt securities, in other investments and to a lesser extent in direct investments.

1.2.8 Macroeconomic projections

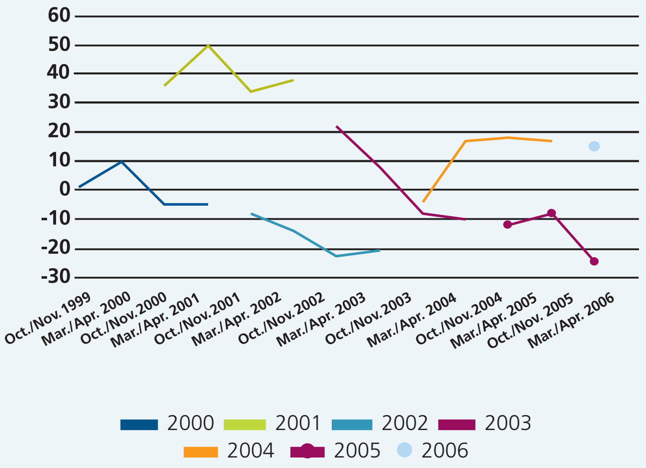
The current projection exercise is based on the revised set of national accounts. Methodological changes that have also been implemented in other countries, i.e. the allocation of the financial intermediation services indirectly measured to the final demand components, have entailed rather significant changes to the level and the growth profile of GDP. The level of nominal GDP has, for example, been revised upwards by 6.6% on average over the 1995-2004 period.

Since the finalisation of the previous projection exercise, the rebound in economic growth from the second quarter of 2005 onwards has been broadly confirmed. Real GDP growth in 2005 is currently estimated at 4.0%, hence slightly above what was expected in December 2005. Furthermore, economic growth at 5.7% on an annual basis was particularly vigorous in the fourth quarter of 2005 and the carry-over effect on annual real GDP growth in 2006 can be estimated at 2.6%.

Short-term indicators published since the end of 2005 broadly confirm our previous scenario and even suggest a slightly better outlook. In the first quarter of 2006, confidence in the industrial sector improved compared with that at the end of 2005 and points, broadly speaking, to trend growth. In the wake of the upward trending equity markets, reduced risk aversion and increased volumes, fees earned by banks other than the interest margin have increased by 28% on a year-on-year basis, compared with an average increase of 14% in 2005. This dynamism has however been tempered somewhat in the second quarter. The rise in the oil price to a level above USD 70 per barrel and an appreciation of the euro with respect to the dollar have probably led to a slight decline in industrial confidence. Furthermore, financial markets were hit in mid-May by increased volatility, followed by a sudden and violent downward correction in equity markets.

Economic growth in Luxembourg has stood up quite well in the recent past, and this in spite of increasing energy costs. It seems that the economy is benefiting more from the expansion of international trade and growth than it is suffering from the rise in oil prices. However, domestic demand, especially private consumption, was quite weak. But, in 2005, a first and significant pick-up in corporate investment was noted. Furthermore, the European Commission's bi-annual investment surveys in the industrial sector suggest that companies have deferred some of their investments planned for 2005 to 2006 (see chart). Companies plan to increase their capital expenditures at roughly the same rate as in 2004.

CHART 19: BI-ANNUAL INVESTMENT SURVEYS IN THE INDUSTRIAL SECTOR (EXPENDITURES AT CURRENT PRICES, ANNUAL PERCENTAGE CHANGES)[1]



[1] *The surveys are carried out in October/November and in March/April of each year.*

Source: European Commission.

Overall, the outlook for the international environment has largely remained unchanged compared with the previous exercise. In the short term, world trade and world GDP should expand somewhat faster than previously expected. World trade is expected to accelerate in 2006 when compared with 2005, whereas world GDP growth should stabilise at a high level. For 2007 however, most international organisations agree on a mild economic slowdown, although growth should remain above its long-term average. The oil price is expected to remain at a level above USD 70 per barrel, a significant upward revision compared with the previous exercise.

As regards the euro area, the strengthening of economic growth that started in the second half of 2005 continued in the first quarter of 2006. Growth was estimated at 0.6% quarter on quarter, hence close to trend growth.

These favourable short-term developments are also reflected in the Eurosystem macroeconomic projections. In June 2006, the Eurosystem revised upwards its real GDP growth projections for 2006, from between 1.4% and 2.4% that prevailed in December 2005 to between 1.8% and 2.4%. In 2007, economic growth is expected to be between 1.3% and 2.3% before rebounding again in 2008. The euro area GDP growth profile might look somewhat volatile, but this is partly attributable to the 3-percentage-point rise in the standard VAT rate in Germany that will take effect on 1 January 2007. It is generally assumed that this measure will affect consumer habits, and bring forward into 2006 some of the consumption planned for 2007.

TABLE 16: PROJECTIONS OF INTERNATIONAL INSTITUTIONS (ANNUAL PERCENTAGE CHANGES; PERCENTAGE POINTS[1])

	2005	2006	2007	2008
World trade (EC)	7.1(+0.2)	8.5 (+1.1)	7.1 (-0.2)	-
World GDP (EC)	4.6 (+0.3)	4.6 (+0.3)	4.3 (+0.1)	-
Euro area GDP (EC)	1.3 ()	2.1 (+0.2)	1.8 (-0.3)	-
Euro area GDP (Eurosystem)	1.4	1.8 - 2.4	1.3 - 2.3	-
World demand for Luxembourg's goods and services	5.5 (+0.4)	7.0 (+1.2)	4.8 (-0.8)	5.5
Oil in USD per barrel[2]	54.4 (-0.6)	70.3 (+10.3)	73.9 (+14.4)	71.9
Exchange rate USD/EUR[3]	1.24 (-0.1)	1.26 (+0.6)	1.27 (0.8)	1.27
Short-term interest rate	2.2	3.1	3.9	4.1
Long-term interest rate	3.4	4.0	4.2	4.3

[1] *Figures between brackets are revisions - expressed in percentage points - relative to the December 2005 projections.*

[2] *Revisions in USD per barrel*

[3] *Revisions in USD per euro*

Sources: European Central Bank, European Commission.

On the back of the changes to the international environment, growth in Luxembourg's export markets has been sharply revised upwards for 2006. World demand is now expected to accelerate from 5.5% in 2005 to 7.0% in 2006 before declining to 4.8% in 2008.

On the basis of this analysis and in the above-mentioned euro area context, it seems appropriate to revise upwards the real GDP growth projections for 2006 to between 4.4% and 5.0%. However, in line with the profile of the foreign demand assumptions, economic growth should decelerate somewhat in 2007. These projections are based on the assumptions that the classical business cycle that started with a rebound in exports in 2004, followed by a pick-up in investment in 2005, will broaden further and spill over into higher private consumption growth over the projection horizon.

Although the recently announced government measures will dent real household disposable income, it is estimated that they are insufficient to cause another slowdown in private consumption growth. Household disposable income will be supported by strong wage income developments. Economic growth has already spilt over into strong employment growth and real wages also increased quite sharply in 2004 and 2005. However, Luxembourg is an open economy, and its growth will largely remain dependent on exports as the main driving force.

TABLE 17: MACROECONOMIC PROJECTIONS AND REVISIONS COMPARED WITH DECEMBER 2005 (ANNUAL PERCENTAGE CHANGES; PERCENTAGE POINTS)

	June 2006				Revisions		
	2005	2006	2007	2008	2005	2006	2007
Real GDP	4.0	4.4 - 5.0	3.4 - 4.4	3.3 - 5.3	+0.2	+0.7	-0.1
HICP	3.8	2.9	2.5	2.1	-	0.5	0.4
HICP energy	14.9	9.5	3.0	-1.0	-0.4	3.4	3.4
HICP excluding energy	2.4	2.1	2.4	2.5	-	0.3	-
NICP	2.5	2.8	2.1	1.8	-	0.6	0.4
Sliding salary scale	2.5	2.1	2.3	2.1	-	0.2	-0.2
Compensation per employee	4.2	3.7	3.5	3.7	0.6	0.6	-0.1
Employees	2.9	3.0	3.0	2.9	-0.3	0.2	0.3
Unemployment rate	4.3	4.6	4.8	5.0	-0.3	-0.2	-0.1

Source: BCL.

As regards wage developments, it seems that wage negotiations are still marked by cautious behaviour by the social partners, probably a consequence of the rising unemployment rate. However, wage moderation is less obvious in the national accounts, which point to a rather significant increase in compensation per employee in both 2004 and 2005. It is likely that any such increases are particularly driven by performance-related bonuses, wages and salaries in kind.

The government has recently announced a programme of corrective measures to address the continuous decline in the cost competitiveness of Luxembourg's economy. Among other measures, the automatic wage indexation mechanism will be temporarily modified. Furthermore, the negotiated wage levels in the government sector will be frozen for the years 2006-2007. This measure is unlikely to imply an improvement in the cost competitiveness of Luxembourg's economy since it is the private sector's cost developments that matter. However, if the measure leads to wage moderation that spills over into the private sector, then it can fulfil its objectives. Such dynamics cannot, at the moment, be observed. The minimum wage will be increased by around 2% from January 2007 onwards.

Stronger economic growth has already led to strong job creation on a fairly broad basis and this process is likely to continue. But as the share of non-residents in total employment increases further, the unemployment rate is unlikely to reverse its current trend soon and should even approach 5% by 2008. The downward revision of the unemployment projections is solely due to a backward adjustment to the historical series, itself motivated by a change in the definition of the narrow unemployment rate. However, due to the recent announcements of closures of firms and production sites, the scenario is bleaker than anticipated in December.

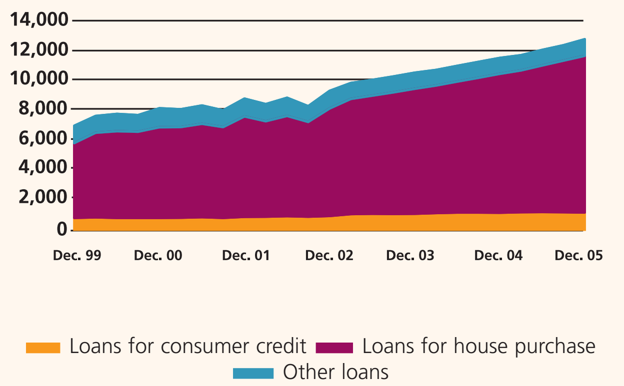
In the short run, inflation dynamics will be driven by increases in the oil price beyond the USD 70 per barrel level and the rises in administered prices observed in early 2006. The contribution of energy to headline inflation will remain positive in 2006 and 2007. The NICP excluding energy should accelerate from 1.7% in 2005 to around 2% over the projection horizon and remain above the HICP excluding energy inflation in the neighbouring countries. This acceleration is essentially due to high services inflation and a gradually increasing pass-through of higher energy costs to consumer price inflation. Compared with the previous exercise, the inflation projections have been adjusted upwards significantly.

Household indebtedness in Luxembourg

For some time now, resident banks have been proposing extended loan maturities of 25 and even 30 years for mortgage contracts, mainly in response to the steady increase in house prices. Moreover, in order to meet their mortgage repayments, it is often the case that both partners in a household need a job. Are these the first signs of excessive household indebtedness?

Indebtedness of resident households

CHART 20: DEBT OF RESIDENT HOUSEHOLD SECTOR



Sources: CPEP and BCL.

From December 1999 to December 2005, indebtedness of resident households increased from €6,919 million to €12,673 million. This represents an increase of 83% in respect of total loans; loans for consumer credit rose by 46% and loans for house purchase[6] by 109%, while other loans dropped by 3%. Throughout the first quarter of 2006, loans granted to resident households kept on rising and totalled €12,985 million by the end of March.

Demographic developments,[7] rising house prices and an increase in households' disposable income contributed to this rapid accumulation of household debt. In addition, historically low interest rates have been a key driver of credit demand. From June 2003 to December 2005, the Governing Council of the ECB left the minimum bid rate on the main refinancing operations unchanged at 2%. In the categories "Loans for house purchase" (84%) and "Other loans" (98%), the share of variable interest rate loans was dominant.

Indebtedness of resident households to disposable income

The disposable income is an indicator which makes it possible to evaluate if the increased household debt is sustainable. However, in the Luxembourg national accounts, data on households' disposable income is not directly available. An approximation has been obtained by adding together the compensation paid to resident employees and social transfers to households, and by deducting from that amount social contributions and taxes on households' income.[8] This estimate does not take into account the income of self-employed persons and income from capital.[9] Thus, disposable income in the household sector is probably somewhat understated.

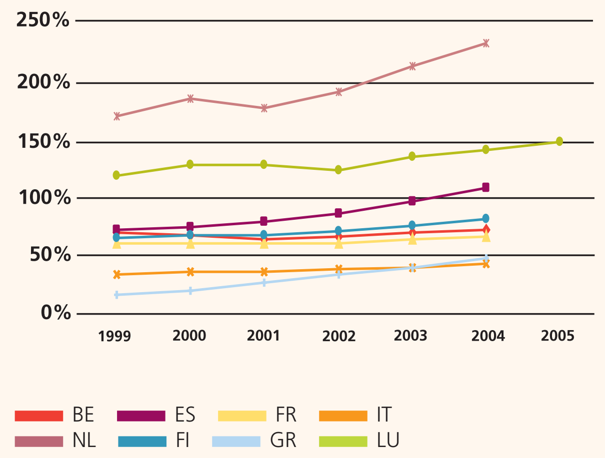
6 This amount includes loans for house purchase granted by the *Caisse de pension des employés privés (CPEP)*.

7 From 1994 to 2004, the population of Luxembourg increased by 50,700 inhabitants, which corresponds to an annual population growth of 4,610 people. From 1999 to 2004, the population grew by 22,400 people, reaching a total of 451,600 inhabitants. This development is explained by a positive difference between the number of births and the number of deaths, but most of all by positive net immigration flows during the entire period.

8 In order to take account of the important share represented by cross-border commuters, the amounts of social contributions and taxes have to be adjusted on the basis of the assumption that the commuters' share in total compensation paid to employees is identical to their share in social contributions. The proportion of the social benefits that is paid to non-residents has also been subtracted. Also, the compensation received by residents working for the European institutions needs to be added due to the fact that they are treated as if they were working outside the national territory, given that the institutional units they are working for are considered to be non-resident. For Luxembourg, the application of the European System of Accounts (ESA 95) is important, given the significant number of these residents compared with the rest of the population as well as their high purchasing power.

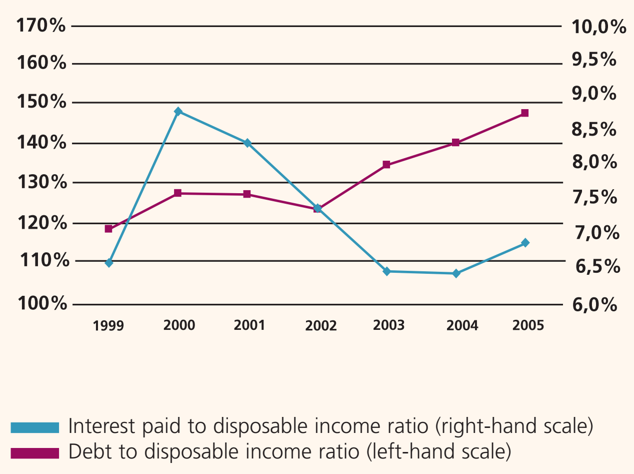
9 According to the information contained in the PSELL panel, capital income amounted to 4.8% of total household income in 1999 and to 4.6% in 2000. (*CEPS, Population & Emploi* 4/2001 et 1/2002).

CHART 21: RESIDENT HOUSEHOLDS' DEBT (END OF PERIOD) TO NET DISPOSABLE INCOME



Sources: Eurostat, STATEC, CPEP and BCL. BCL estimates.

CHART 22: CHANGES IN RESIDENT HOUSEHOLDS' DEBT-TO-DISPOSABLE-INCOME RATIO AND INTEREST PAID BY HOUSEHOLDS AS A SHARE OF DISPOSABLE INCOME



Sources: CSSF, CPEP and BCL. BCL estimates.

TABLE 18: ANNUAL VARIATIONS IN THE INDICATORS

	2000	2001	2002	2003	2004	2005
Per capita debt	15.16%	6.63%	4.66%	12.00%	8.61%	9.8%
Per capita disposable income	6.95%	6.82%	7.93%	2.58%	4.24%	4.17%
Household debt-to-disposable-income ratio	7.68%	-0.18%	-3.03%	9.18%	4.19%	5.41%

Sources: STATEC, CPEP and BCL. BCL calculations.

The household debt-to-disposable-income ratio reveals a rather high level of indebtedness, making households more vulnerable to economic shocks and affecting disposable income and interest rates. The annual variations in the specific indicators shown in Table 18 allow a comprehensive analysis for Luxembourg.

After a strong rise in 2000, the indebtedness of resident households slowed down in 2001 and 2002 before growing again at faster pace in the years thereafter. Reasons for this behaviour might have been the uncertainty of financial markets in the aftermath of the burst of the speculative bubble and the 9/11 terrorist attacks in 2001, both of which weighed on economic growth and on the general economic outlook.

In 2004, the annual rate of growth of loans to households[10] increased on average by 8.7% in Europe, after 6.2% in 2003. By end-2004, per capita debt reached €16,337 in the European Union. At €25,313, 55% above the EU 15 average, Luxembourg ranked fourth, closely behind the United Kingdom.

[10] In Bulletin No 144 of December 2005, the Banque de France published the results of a comparative study on household indebtedness in Europe. The survey was conducted by the *Observatoire de l'épargne européenne (OEE).*

In 2005, credit demand by households rose by 10.87%, compared with 9.41% in 2004, whereas the 5.18% increase in households' disposable income was roughly the same as in 2004 (5.01%). Consequently, interest payments by national households as a share of disposable income increased slightly, to 6.75%. This development also reflects an adaptation of credit conditions by resident banks for new business in anticipation of a rise in the minimum bid rate on the main refinancing operations by the ECB, which in fact occurred at end-2005.

In comparison with the tendency observed in the preceding periods, the increase in the indicator may reflect a possible reversal. In fact, in 2000, the household sector needed 8.79% of its disposable income to meet interest payments on total debt.[11]

Thereafter, this share kept on decreasing and stabilised in 2003 and 2004 at a level of about 6.4%.[12] Despite the continuous growth of household indebtedness, this development was mainly due to the drop in the minimum bid rate on the main refinancing operations after May 2001. These monetary policy decisions impact directly on the ratio as the share of variable interest rate loans compared with total debt is considerable. From 1999 to 2000, the significant rise in the indicator may be explained by a sharp increase in household debt, by 16.8%, as well as by a rise in the minimum bid rate on the main refinancing operations of 1.75 percentage points, to 4.75%.

Conclusion

Two distinctive features of the indebtedness of resident households can be identified. In 2004, the debt-per-capita ratio of Luxembourg ranked second in the euro area, with an upward tendency. The share of disposable income used by households for interest payments progressed at relatively moderate levels; it appears however strongly dependent on the development of the minimum bid rate on the main refinancing operations. It is set to increase under the combined effect of an increase in household indebtedness – in terms of the level and relative to households' disposable income – and of the ongoing normalisation of interest rates in the euro area.

[11] The methodology used for the compilation of the relevant time series does not allow for an estimation of principal repayments.

[12] Not all households are indebted. For those households that do have a loan, the interest payment burden is considerably higher than is implied by macroeconomic data.

1.2.9 Public finance

1.2.9.1 Budgetary policy overview

The period between October 2005 and May 2006 was marked by three fiscal policy milestones. First, the central government budget was presented in October and adopted by Luxembourg's Parliament, the Chamber of Deputies, in December 2006. The stance of this budget could be considered quite expansionary. Total expenditure by central government *sensu stricto*, irrespective of the expenditure of extra-budgetary funds, will indeed increase by close to 9% in 2006. According to the more exhaustive presentation of the central government accounts elaborated by the BCL in its opinion on the 2006 budget, central government expenditure would grow by more than 15% from 2004 to 2006, namely by close to 8% per year on average over this two-year period.

TABLE 19: KEY FIGURES IN THE 2006 CENTRAL GOVERNMENT BUDGET (EUR MILLIONS, UNLESS OTHERWISE INDICATED)

	2005 budget	2006 budget	Increase in nominal terms
Revenue	**6,902.5**	**7,328.0**	**+6.2%**
Current revenue	6,828.7	7,223.7	+5.8%
Capital revenue	73.8	104.3	+41.4%
Expenditure	**7,009.2**	**7,629.3**	**+8.8%**
Current expenditure	6,303.1	6,852.2	+8.7%
Capital expenditure	706.1	777.1	+10.1%
Balance	**-106.7**	**-301.3**	**--**
of which current balance	525.6	371.5	--
of which capital balance	-632.3	-672.8	--

Sources: 2005 and 2006 budget laws.

By contrast, the second and third milestones marked a shift towards a more rigorous stance. The second milestone was the seventh update of the Luxembourg Stability Programme, under which the government committed itself to bringing the general government deficit down to 1% of GDP in 2007 and to 0.2% of GDP in 2008. In addition, the medium-term budgetary objective targeted on this occasion was a deficit equal to 0.8% of GDP in cyclically adjusted terms. This gradual transition to a more balanced budgetary position would mark a reversal of the trend towards higher deficits observed from 2001 to 2005. However, the measures that would underpin such a break with the recent past were only outlined in the update.

The third milestone dispelled this uncertainty. New, specific consolidation measures were announced by the Prime Minister on 2 May 2006 in his address on the economic, social and financial situation of the country. As explained in the box below, these measures aim to improve the general government balance by about 1% of GDP from 2007 onwards. The government also renewed the commitments made in the update of the Stability Programme.

Impact of the consolidation measures announced by the Prime Minister on 2 May 2006

Several measures have been agreed between the social partners making up the Tripartite Coordination Committee (representatives of employers, employees and the government). The Prime Minister announced these measures as well as several additional measures on 2 May on the occasion of the traditional declaration on the social, economic and financial situation of the country.

Only clearly specified measures have been taken into account in the projections. For nearly all such measures, the BCL made a specific assessment of the budgetary impact, as illustrated in the table below. The effective impact could of course turn out to be different. For instance, the BCL's estimates rely on the assumption that the decision to increase excise duties on diesel and petrol will have no adverse volume effects. In addition, the budgetary impact of higher taxes on self-propelled vehicles was especially difficult to assess. Furthermore, the decision to freeze public sector wages in the next public sector agreement in 2007 and 2008 may be difficult to implement, as the major public sector trade union (*CGFP*[13]) has announced that it does not agree with this decision.

Several other measures were announced by the Prime Minister (e.g. the authorities will endeavour to curb tax fraud and to cap growth of central government expenditure to 4% a year in nominal terms in 2007 and 2008). They have not been considered in the projections because they are not precise enough at this stage.

All in all, sufficiently specific measures would contribute to improving the fiscal balance by about 1% of GDP from 2007 onwards, as indicated in the table.

[13] *Confédération Générale de la Fonction Publique (CGFP).*

TABLE 20: ESTIMATED FISCAL IMPACT OF THE QUANTIFIABLE CONSOLIDATION MEASURES ANNOUNCED ON 2 MAY 2006 (IMPACT ON THE RESPECTIVE BUDGETARY ITEM COMPARED WITH THE BASELINE SCENARIO; EUR MILLIONS UNLESS OTHERWISE INDICATED)

	2006	2007	2008
1. Measures on the revenue side	**+0**	**+187**	**+224**
Higher "solidarity" levy on households (3.5% on personal income tax instead of 2.5%)		+20	+22
Higher "solidarity" levy on enterprises (5% on *Impôt sur le revenu des collectivités instead* of 4% before)		+12	+13
Contribution *assurance dépendance* (long-term care) up from 1% of gross income to 1.4%		+67	+71
Higher excise duties on diesel and petrol in January 2007 and on diesel in January 2008		+36	+64
VAT rates for services provided by self-employed professionals up from 12% to 15%		+30	+31
Higher taxes on self-propelled vehicles		+22	+23
2. Measures on the expenditure side	**-7**	**-139**	**-176**
Pensions in the private sector regime: changes in the adjustment to the development of real wages [1]		-38	-13
Lower government investment		-58	-96
Real wages negotiated in the public sector: +0.0% in 2007 and 2008 [2]		-21	-43
Suspension of the indexation of family allowances to prices from 2006 to early 2008 [3]	-7	-22	-24
3. Impact on the budgetary balance (=1.-2.)	**+7**	**+326**	**+400**
Impact on balance as a percentage of GDP	**+0.02%**	**+0.97%**	**+1.12%**

[1] *Two adjustments in July 2007 (the first half) and July 2008 (the second half) instead of one single adjustment in January 2007, as initially planned.*
[2] *Compared with a situation in which real wages would have been adjusted upwards by 0.8% in 2007 and 2008, in line with the situation observed in 2006.*
[3] *On the assumption that indexation will restart in March 2008.*

Sources: State budgets, Prime Minister's declaration, IGSS, Groupement Pétrolier Luxembourgeois, STATEC, BCL calculations.

1.2.9.2 General government revenue

The revenue ratio went down in 2005 for the fourth consecutive year, by 0.6% of GDP. This was due to the conjunction of three factors. First, indirect taxes were subdued because of exceptionally large VAT refunds. Second, social contributions declined as a percentage of GDP as the tax base - basically the wage bill - grew at a slower pace than GDP. Third, interest receivable (in "other revenue") amounted to 0.7% of GDP in 2005 compared with 0.9% one year earlier due to the deteriorating general government asset position. These three factors were partly offset by strong direct taxes. Direct taxes on corporations went down as a percentage of GDP as a result of the lower collection of taxes related to previous exercises. However, direct taxes on households were particularly buoyant in 2005, as they increased by 15.7% in nominal terms compared with 2004. Very strong *impôts sur les revenus de capitaux*, collected inter alia on dividends, played a large role here. Direct taxes on households were also enhanced by the introduction in July 2005 of withholding taxes on interest incomes in connection with the EU Savings Directive 2003/48/EC.

According to BCL projections, the revenue ratio will go up in 2006 owing to the full-year impact of the withholding taxes on non-residents, to higher energy taxes, to the payment of an exceptionally high dividend by the Arcelor company and to exceptional payments in connection with corporate taxes. The revenue ratio will decline thereafter, however, as the impact of the tax-increasing discretionary measures described in the box above will be more than offset by three factors. First, the collection of corporate taxes relating to previous years ("back taxes") will decrease. Second, the tax bases of indirect taxes and – albeit to a lesser extent – of social contributions are expected to grow below GDP. Third, it is assumed in the projections that Arcelor will no longer pay exceptional dividends in 2007 and 2008.

TABLE 21: GENERAL GOVERNMENT REVENUE (AS A PERCENTAGE OF GDP, UNLESS OTHERWISE INDICATED)

	Official data March 2006						BCL projections spring 2006		
	2000	2001	2002	2003	2004	2005	2006	2007	2008
Direct taxes	14.9	15.2	15.2	14.7	13.2	13.4	13.8	13.5	13.4
payable by households	*8.0*	*7.9*	*7.2*	*7.3*	*7.4*	*7.9*	*8.1*	*8.3*	*8.4*
payable by corporations	*7.0*	*7.3*	*8.0*	*7.4*	*5.8*	*5.5*	*5.7*	*5.2*	*5.1*
Indirect taxes	14.0	13.5	12.8	12.6	13.8	13.5	13.4	13.5	13.3
Social contributions	10.9	11.8	11.7	11.7	11.7	11.5	11.5	11.7	11.6
Other revenue	4.2	4.0	3.9	3.5	3.5	3.2	3.4	3.3	3.3
Total revenue	**44.0**	**44.5**	**43.6**	**42.5**	**42.2**	**41.6**	**42.1**	**41.9**	**41.7**
Nominal increase in total revenue (%)	***13.2***	***3.7***	***4.3***	***4.2***	***4.7***	***6.6***	***8.3***	***6.1***	***6.1***
Revenue ratio in the Stability Programme					***42.2***	***41.8***	***41.6***	***41.2***	***41.4***

Note: The revenue ratios in the seventh update of the Stability Programme are somewhat different from other revenue ratios displayed in the table. This discrepancy reflects different data vintages and the fact that the official ESA 95 data and corresponding BCL projections as they appear in the table include some transactions with European Union institutions, which is not the case in the Stability Programme.

Sources: IGF, IGSS, STATEC, UCM, seventh update of the Luxembourg Stability Programme 2004-2008, BCL calculations.

1.2.9.3 General government expenditure

The expenditure ratio increased steadily from 2000 to 2004. By contrast, it stabilised in 2005 due to high GDP growth rather than to expenditure restraint. The growth rate of total general government expenditure accelerated in 2005 (8.5% nominal growth in 2005, compared with 8.0% in 2004). The composition of expenditure hardly changed in 2005. Social transfers decreased somewhat as a percentage of GDP, but government investment rose.

The expenditure ratio will be broadly stable in 2006 but will decline thereafter as a percentage of GDP. Higher interest payments brought about by a rising debt ratio are expected and the Kyoto Protocol is likely to lead to additional costs in 2008. However, government investment is projected to grow below GDP over the projection period, in line with the consolidation package announced on 2 May 2006. The decision to freeze wages in the public sector should also contribute to this result.

In spite of the consolidation measures announced in May, total expenditure would exceed the level targeted in the seventh update of the Stability Programme by a wide margin in 2007 and 2008, which highlights the need for additional measures. The government announced on 2 May that the rate of growth of central government expenditure would not exceed 4% in nominal terms in 2007 and 2008. However, this decision was not included in the BCL's projections, because the underlying measures have not been spelled out so far. As illustrated in the next section, the strict implementation of this rule would improve the general government balance in a significant way.

TABLE 22: GENERAL GOVERNMENT EXPENDITURE (AS A PERCENTAGE OF GDP, UNLESS OTHERWISE INDICATED)

	Official data March 2006						BCL projections spring 2006		
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Social transfers	18.2	19.6	20.4	20.9	21.3	21.1	21.0	21.0	20.9
Government investment	3.8	4.3	4.8	4.6	4.4	4.6	4.7	4.5	4.4
Consumption expenditure [1]	10.8	11.1	11.3	11.5	11.6	11.7	11.7	11.6	11.5
Subsidies [2]	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Other expenditure [3]	3.7	1.9	3.4	3.6	4.4	4.3	4.4	4.4	4.6
Total expenditure	**38.2**	**38.6**	**41.6**	**42.3**	**43.4**	**43.4**	**43.5**	**43.2**	**43.1**
Nominal increase in total expenditure (%)	***6.2***	***8.8***	***9.5***	***8.6***	***8.0***	***8.5***	***7.0***	***5.7***	***6.5***
Expenditure ratio in the Stability Programme [4]					***43.3***	***43.9***	***43.3***	***42.2***	***41.6***

Notes:

[1] *Compensation of employees and intermediate consumption.*

[2] *Excluding capital transfers.*

[3] *The expenditure ratio recorded in 2001 was negatively affected by a one-off transaction, namely the sale of a licence to SES Global, a satellite company. This explains the marked decrease in the "Other expenditure" item in 2001. The nominal growth rates displayed in the penultimate line of the table do not allow for this transaction, which amounted to 1.9% of the 2001 GDP.*

[4] *The expenditure ratios in the seventh update of the Stability Programme are somewhat different from the other ratios. The discrepancy reflects different data vintages and the fact that the STATEC ESA 95 data and the corresponding BCL projections as they are displayed in the table include some transactions with European Union institutions. A different presentation was adopted in the Stability Programme.*

Sources: IGF, IGSS, STATEC, UCM, seventh update of the Luxembourg Stability Programme 2004-2008, BCL calculations.

1.2.9.4 General government net lending or borrowing and asset position

The general government deficit increased sharply from 1.1% of GDP in 2004 to 1.9% in 2005. The relatively favourable revenue developments (+6.6% in nominal terms) were outweighed by an even more significant increase on the expenditure side. The implementation of several large infrastructure projects together with strong intermediate consumption and higher social payments explain this development.

In spite of the new consolidation measures announced by the Prime Minister on 2 May, the general government deficit is projected to remain quite significant over the projection period. The balance will improve significantly in 2006 owing especially to high Arcelor dividends and exceptionally strong corporate tax payments by a few companies. It will further improve in 2007 due to the implementation of new consolidation measures, but will deteriorate in 2008, reflecting unfavourable developments in corporate "back" taxes, stagnating interest receivable and the additional costs related to the Kyoto Protocol.

TABLE 23: GENERAL GOVERNMENT NET LENDING (+) OR NET BORROWING (-) (AS A PERCENTAGE OF GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Actual balances									
	Official data March 2006						BCL projections spring 2006		
General government	**5.9**	**5.9**	**2.0**	**0.2**	**-1.1**	**-1.9**	**-1.4**	**-1.2**	**-1.4**
of which central government	2.8	2.8	-0.4	-1.6	-2.6	-3.2	-2.7	-2.7	-2.8
of which local governments	0.5	0.1	0.1	0.0	-0.1	-0.3	-0.2	-0.3	-0.4
of which social security	2.6	2.9	2.3	1.8	1.6	1.6	1.5	1.8	1.8
Stability Programme					**-1.2**	**-2.3**	**-1.8**	**-1.0**	**-0.2**
Cyclically adjusted balances									
Spring 2006 BCL estimate [1]	5.4	5.5	1.2	0.0	-1.1	-1.8	-1.3	-1.1	-1.4
Stability Programme estimate [2]	--	--	--	--	-1.0	-2.0	-1.6	-1.1	-0.6

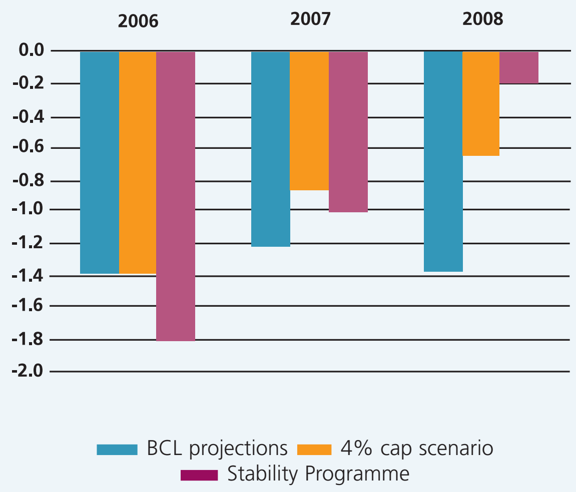
Notes : [1] These cyclically adjusted balances are estimated based on a disaggregated Hodrick-Prescott approach.

[2] Calculated on the basis of a production function approach.

Sources: STATEC, seventh update of the Luxembourg Stability Programme 2004-2008, BCL calculations.

The November 2005 update of the Stability Programme foresees a significant reduction in the general government deficit, from 1.8% of GDP in 2006 to 1% in 2007 and 0.2% in 2008. These objectives are compatible with those presented by the Prime Minister on 2 May, namely a 1% deficit in 2007 and a balanced situation in 2009. These targets are highly commendable and should be strictly adhered to. The consolidation package presented by the Prime Minister is a significant step in this direction, as it would improve the fiscal balance by about 1% of GDP according to BCL estimates. However, in spite of these measures, the budgetary situation projected by the BCL for 2007 and especially for 2008 is less favourable than the one envisaged in the November 2005 update of the Stability Programme. The main reason is that only well-defined policy measures have been taken into account in BCL projections. Several of the measures presented by the Prime Minister in May, in particular the decision to cap the nominal growth of central government expenditure at 4% in 2007 and 2008, are not yet fully spelled out at this stage and are therefore not considered in the projections. As illustrated in the chart below, a strict implementation of the 4% expenditure cap would result in a marked improvement of the general government balance, which would then be much closer to the targets embedded in the seventh update. This highlights the paramount importance of compliance with the 4% cap.

CHART 23: GENERAL GOVERNMENT BALANCE UNDER SEVERAL ASSUMPTIONS



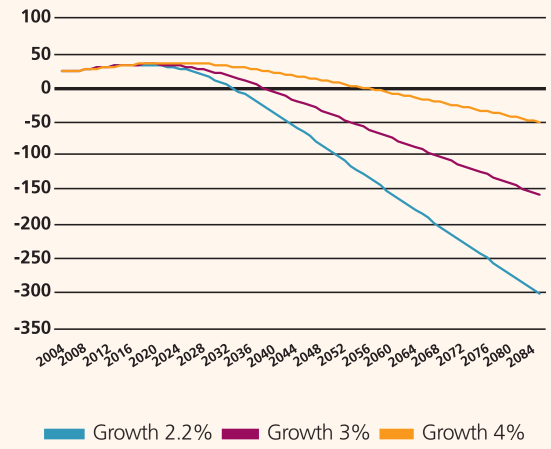
Sources: STATEC, seventh update of the Stability Programme, BCL calculations.

The seventh update of the Stability Programme also establishes a medium-term structural deficit objective of 0.8% of GDP. Nevertheless, several factors of fiscal instability should be taken into account; they make it advisable to set a target for a government surplus in the medium term, in order not to undermine compliance with the 3% of GDP reference value. First, the Luxembourg economy exhibits high cyclical volatility. Second, Luxembourg faces many non-cyclical sources of fiscal volatility, especially on the revenue side. Fiscal drag could easily occur with regard to direct taxes on corporations or VAT. Third, public finance statistics are frequently revised. In addition, further room for manoeuvre is required in order to deal with several challenges presented by the Prime Minister on 2 May (as regards research, education, child-care centres, housing, public transport, public safety and other matters) and to address long-term sustainability issues, in particular in the pension and healthcare systems. As explained in the box below, the sustainability of the pension system is indeed far from guaranteed at the current juncture.

Reflections on the possible transition from pay-as-you-go to funding in Luxembourg's private sector pension system

Luxembourg's private sector pension system (*régime général de pension*) is at the crossroads. On the one hand, the current budgetary situation of the system appears extremely favourable. On the other hand, projections based on reasonable assumptions suggest that the pension regime is not sustainable over the long term (see chart below). Pension benefits are bound to increase steeply when large groups of cross-border and immigrant employees retire. For the moment, these employees are contributing to substantial surpluses of about 2% of GDP.

CHART 24: NET RESERVES (+) OR LIABILITIES (-) OF THE PRIVATE SECTOR PENSION REGIME (UNCHANGED POLICY ASSUMPTION; AS A PERCENTAGE OF GDP)



Notes: the most salient underlying assumptions are: 2008-2085: 1.9% inflation, rate of growth of wages equal to productivity gains (i.e. 2% per year); 4,000 immigrants a year from 2008 to 2085; number of cross-border employees in line with GDP growth (residual variable); mortality rates in line with the ILO (2000) assumptions; labour force participation rates would increase in a gradual way for women and be stable for men.

Sources: IGSS, ILO, STATEC, BCL calculations.

As explained in Bouchet (2006), a solution proposed by Modigliani and Muralidhar (2004), where pensioners are gradually transferred from pay-as-you-go (PAYG) to a public fund in accordance with the "defined benefit" principle, would be suitable for Luxembourg's situation.

A baseline funding scenario designed in a stepwise manner and under reasonable return assumptions illustrates how fruitful such a solution could be in Luxembourg, provided that a significant pre-funding effort takes place at the beginning of the transition period. In the steady state, this scenario would lead to very comfortable reserves and budgetary surpluses with no cost in terms of long-term, equilibrium contribution rates. These very favourable results would be achieved in spite of a continuously increasing pension cost ratio induced by ageing and by the gradual retirement of large groups of cross-border workers. Another particularly attractive feature of the baseline funding scenario presented in the paper - especially in the context of a small and very open economy - is that it would mitigate in an effective way the impact on the pension regime of adverse GDP growth developments. By contrast, PAYG does not seem to provide a sound basis for a social security scheme, as contributions are very sensitive to small changes in the key macroeconomic variables. Finally, the baseline funding scenario is reasonably resilient to alternative return or demographic assumptions. However, even the funding system would have to be monitored in a rigorous way and at pre-set, regular intervals.

To sum up, the currently favourable situation of the private sector pension regime should be considered as a "window of opportunity" during which the pension system should set aside the large assets required in order to cover future pension liabilities. This would mark the onset of a virtuous circle, with increasing assets and the related property incomes offsetting the rising cost of pension benefits. At the same time, it would mitigate adverse macroeconomic developments.

Bibliographical references

Bouchet (2006), *The transition from PAYG to funding: application to the Luxembourg private sector pension system*, Cahier d'études No 23, Banque centrale du Luxembourg.

IGSS (2006), *Bilan technique de la période de couverture 1999-2005*.

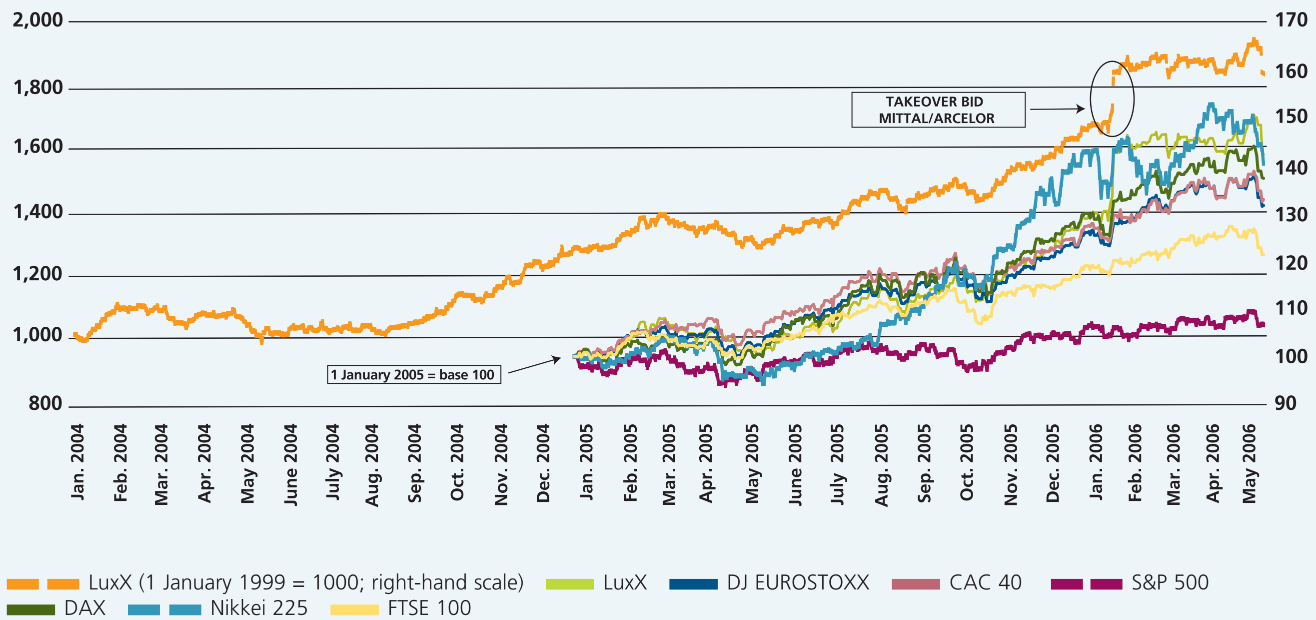
ILO (2000), *Evaluation actuarielle et financière du régime général d'assurance pension du Grand-Duché de Luxembourg*, Rapport remis au Ministère de la Sécurité Sociale.

Modigliani, Franco and Muralidhar, Arun (2004), *Rethinking Pension Reform*, Cambridge University Press.

1.2.10 Luxembourg Stock Exchange

In 2005, the Luxembourg stock price index generally moved in tandem with other major international stock markets. However, following Mittal's takeover bid for the steelmaker Arcelor, the Luxembourg index has been outperforming most other indices since January 2006; Arcelor has a weighting coefficient of 20% in the Luxembourg index.[14] The LuxX progressed by 26.7% in 2005, finishing the year at 1,636.98, and by 8% between January and end-May 2006, finishing the review period at 1,767.01.

CHART 25: LUXX AND MAJOR INTERNATIONAL EQUITY INDICES (INDEX: 1 JANUARY 2005 = 100 UNLESS OTHERWISE INDICATED; DAILY DATA)



Source: Bloomberg.

[14] The weightings date from 31 December 2005.

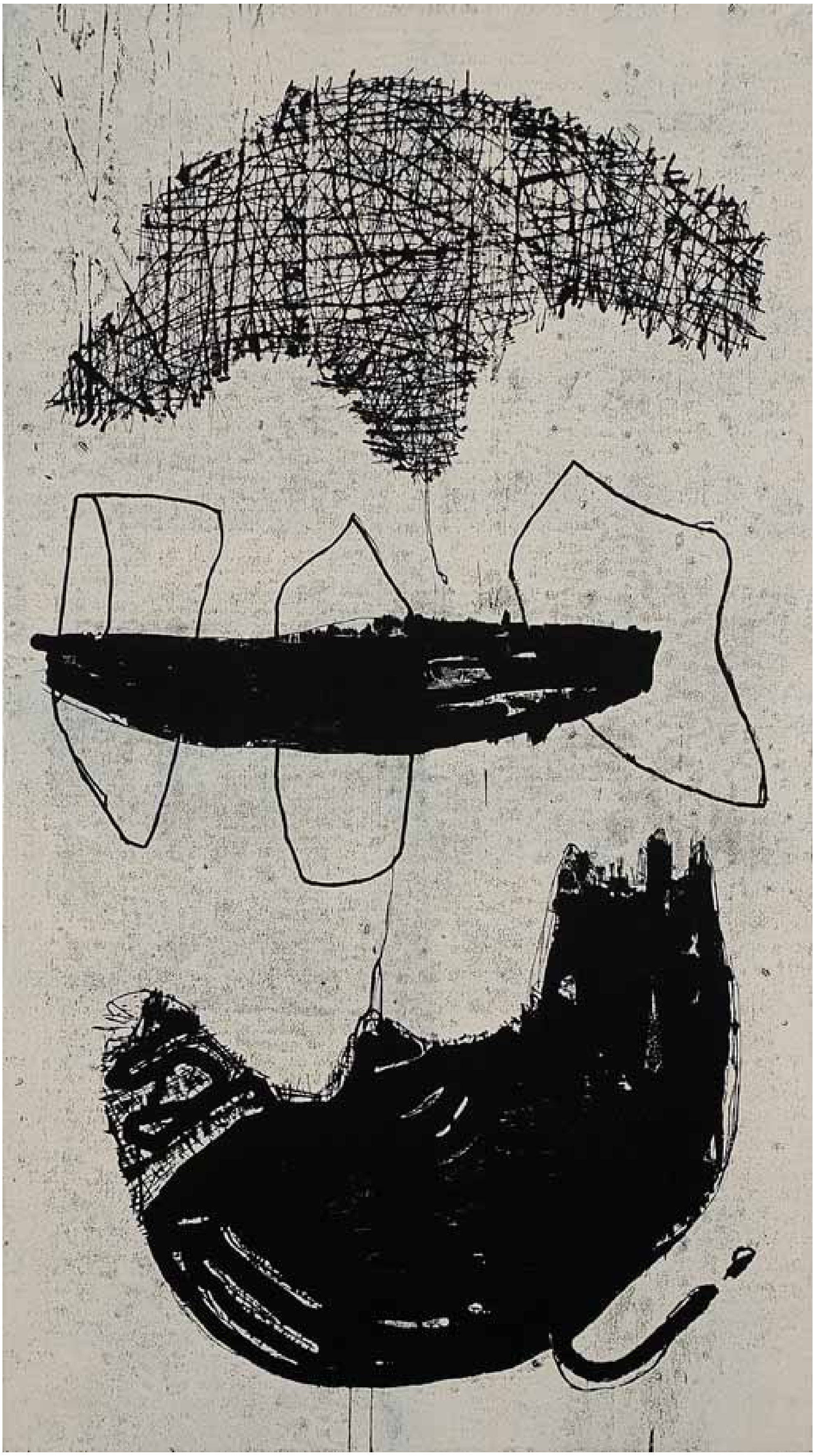
Most other equity members that form the Luxembourg stock price index made substantial progress in 2005. The composition of the index has also been reviewed: since Kredietbank SA Luxembourgeoise and Banque Degroof Luxembourg SA withdrew from the LuxX in July and December 2005 respectively, the index has consisted of Fortis, DEXIA, KBC Group and Audiolux.

Turnover (by volume) increased by 86.3% in 2005; bond turnover was especially vibrant and increased by 230%. The composition of turnover by volume changed considerably from 2004 to 2005, with the bond segment rising steeply at the expense of shares, warrants and UCIs. In fact, bond turnover represented almost 90% of total turnover in 2005, up from just under 50% in 2004.

At end-2005, the total number of listings stood at 36,054, up by over 9%; there is a strong bias towards bonds in terms of turnover and bonds make up almost three-quarters of total listings.

An alternative market called "Euro MTF" was created in July 2005 following the coming into force of Luxembourg's "Prospectus Law". This market is governed by the rules and regulations of the Luxembourg Stock Exchange, rather than by European directives, hence the requirements of the EU Prospectus and Transparency Directives are not applicable. Euro MTF is monitored by the CSSF.

The e-file application, which permits all the steps required for launching a UCI or for listing a security to be performed in a virtual environment, was also implemented in 2005.



Artist: Dani Neumann
Title: Drei Elemente
Material: Oil on canvas
Format: 180 x 100 cm
BCL collection

2. THE BCL'S OPERATIONS

2.1 Monetary policy

In Luxembourg, the BCL is responsible for implementing monetary policy as formulated by the ECB for the whole of the euro area. Refinancing operations, also called open market operations, provide liquidity against collateral to counterparties, i.e. the credit institutions in Luxembourg.

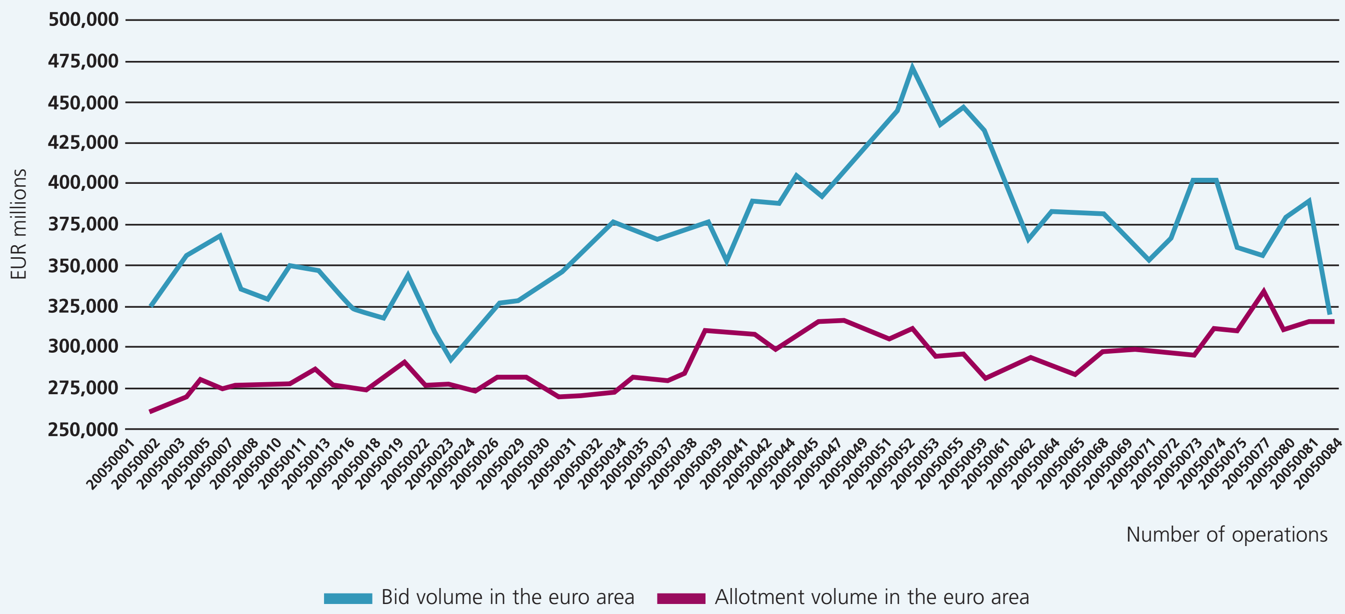
Open market operations are divided into:

- main refinancing operations (MROs), which are conducted regularly through weekly standard tenders, with a maturity of one week, and
- longer-term refinancing operations (LTROs), which are conducted regularly through monthly standard tenders, with a maturity of three months.

Main refinancing operations (MROs)

The main refinancing operations of the Eurosystem are conducted as variable rate tenders, using the multiple rate auction procedure.

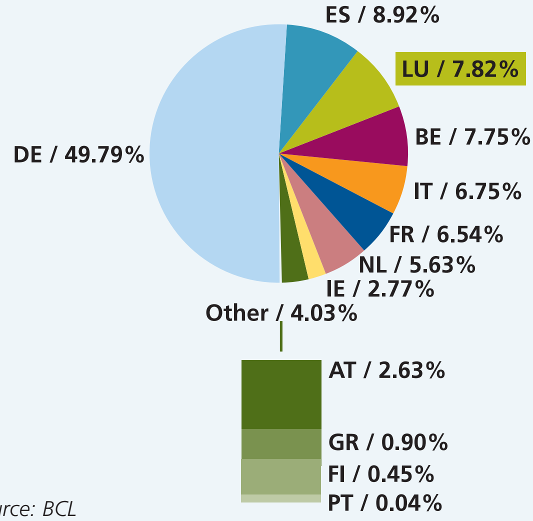
CHART 1: MROs IN 2005 - BID AND ALLOTMENT VOLUME IN THE EURO AREA



Source: BCL

In 2005 Luxembourg ranked third in the allotment volume behind Germany and Spain with, on average, 7.8% of the total euro area volume. This ranking was confirmed during the first quarter of 2006, when Luxembourg's allotment volume amounted to 8.4%.

CHART 2: MROS IN 2005 - AVERAGE ALLOTMENT SHARE IN THE EURO AREA



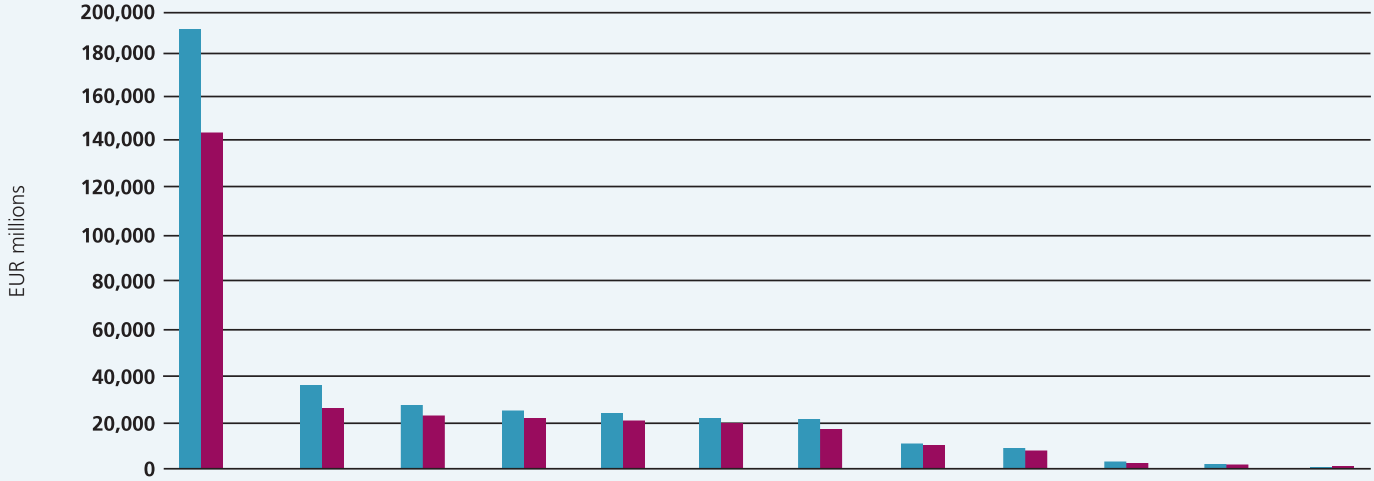
Source: BCL

Compared with 2004, the average percentage allotted in Luxembourg decreased from 8.6% to 7.8%.

In 2005, the number of counterparties participating in MROs remained stable in Luxembourg, with an average of 20 banks in comparison with 19 in 2003 and 18 in 2002. In the euro area, the number of participating counterparties rose, on average, from 339 in 2004 to 351 in 2005, reversing the declining trend observed between 1999 and 2003. This increase in the euro area could be explained by the reduction in the maturity from two weeks to one week and by the simplification of the new framework in 2004.

During the first quarter of 2006, the average number of participating counterparties in MROs rose to 23 banks in Luxembourg and 392 banks in the euro area.

CHART 3: MROs IN 2005 - AVERAGE BID AND ALLOTMENT VOLUME IN THE EURO AREA



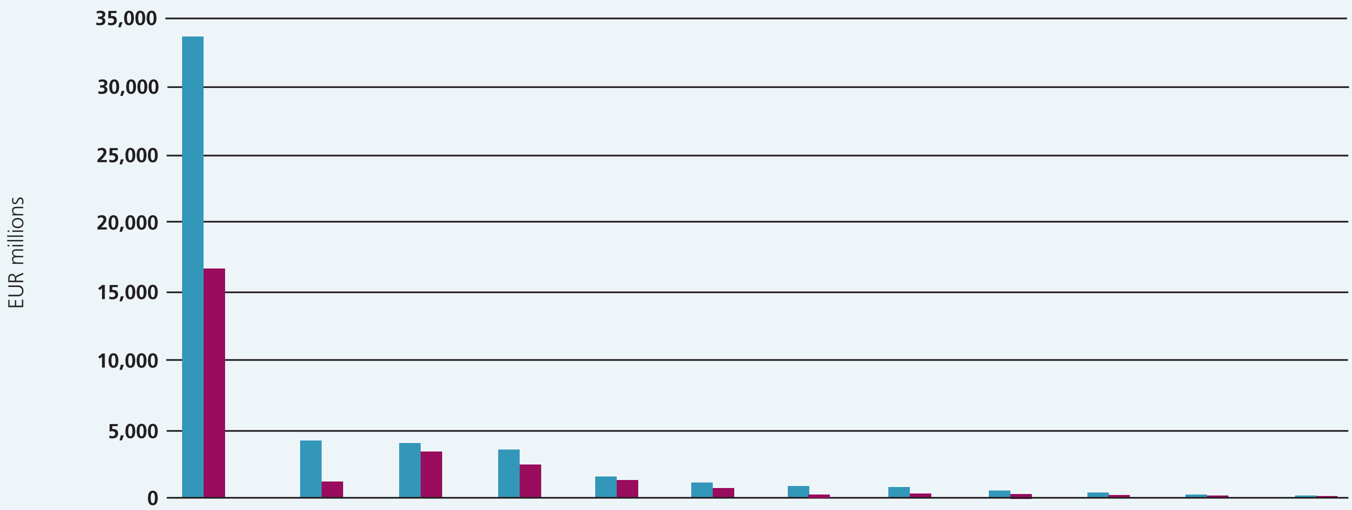
	DE	ES	BE	LU	FR	IT	NL	AT	IE	GR	FI	PT
Bid	190,218.0	32,969.2	26,893.2	26,236.0	23,971.3	22,990.3	22,745.7	9,593.4	8,660.1	3,057.3	1,408.8	146.0
Allotment	144,456.0	25,883.6	22,483.3	22,693.6	18,982.7	19,590.1	16,346.8	7,639.9	8,028.6	2,621.1	1,316.8	102.0

Source: BCL

Longer-term refinancing operations (LTROs)

With regard to the allotment volume for LTROs in the euro area, Luxembourg ranked, on average, third in 2005 (with 7.6% of the allotment volume in 2005). The average number of participating counterparties, seven, remained broadly unchanged in 2005 but rose to nine in the first quarter of 2006.

CHART 4: LTROs IN 2005 - AVERAGE BID AND ALLOTMENT VOLUME IN THE EURO AREA



	DE	AT	IE	LU	PT	ES	NL	FR	IT	BE	FI	GR
Bid	33,393.54	4,493.08	4,152.23	3,244.23	1,792.19	1,300.08	1,115.38	1,084.62	811.88	634.62	234.62	130.85
Allotment	16,845.36	1,074.67	3,436.52	2,100.02	1,618.39	832.00	297.07	511.16	248.12	431.89	198.29	98.82

Source: BCL

In December 2005, the ECB's Governing Council decided to raise the allotment amount from €30 billion to €40 billion for each LTRO, starting in January 2006.

Fine-tuning operations

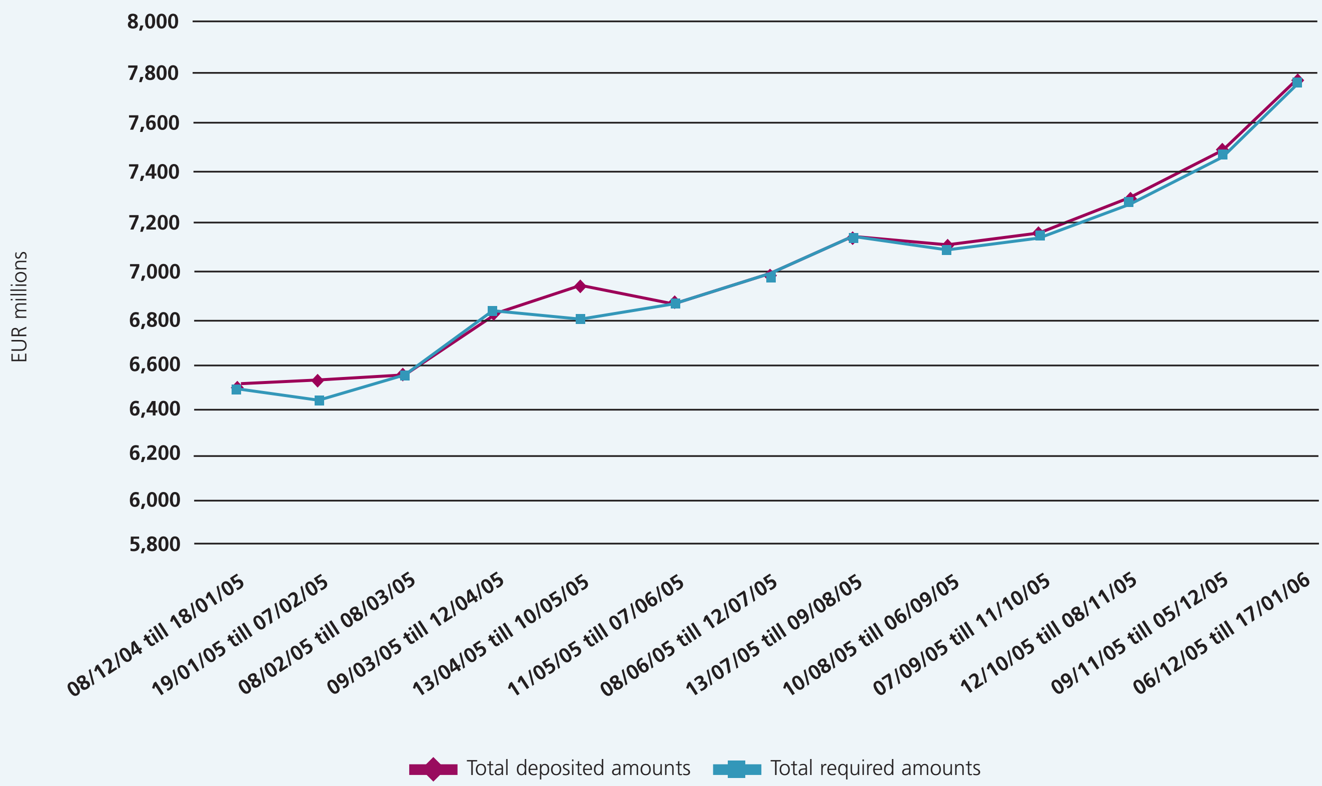
Short-term rate fluctuations increased during the final days of the reserve maintenance periods. This reflects the fact that, as the allotment of the last MRO during a reserve maintenance period now occurs eight days before its end, the risk of a liquidity imbalance is thereby increased. In order to restore neutral liquidity conditions, the ECB carried out several fine-tuning operations on the last day of the reserve maintenance period whenever it expected a significant imbalance. Eight fine-tuning operations were conducted in 2005 (in comparison with three in 2004).

In the first quarter of 2006, the ECB conducted four fine-tuning operations. The ECB also improved its communication by announcing these operations and their estimated amounts beforehand.

Minimum reserve system

From 8 December 2004 until 17 January 2006, the average amount of minimum reserves held by credit institutions in Luxembourg was estimated at €7.015 billion. The deposited amounts are remunerated at the average MRO rate of the ECB during the reserve maintenance period.

CHART 5: DEVELOPMENT OF THE AVERAGE REQUIRED AND DEPOSITED MINIMUM RESERVES



Source: BCL

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

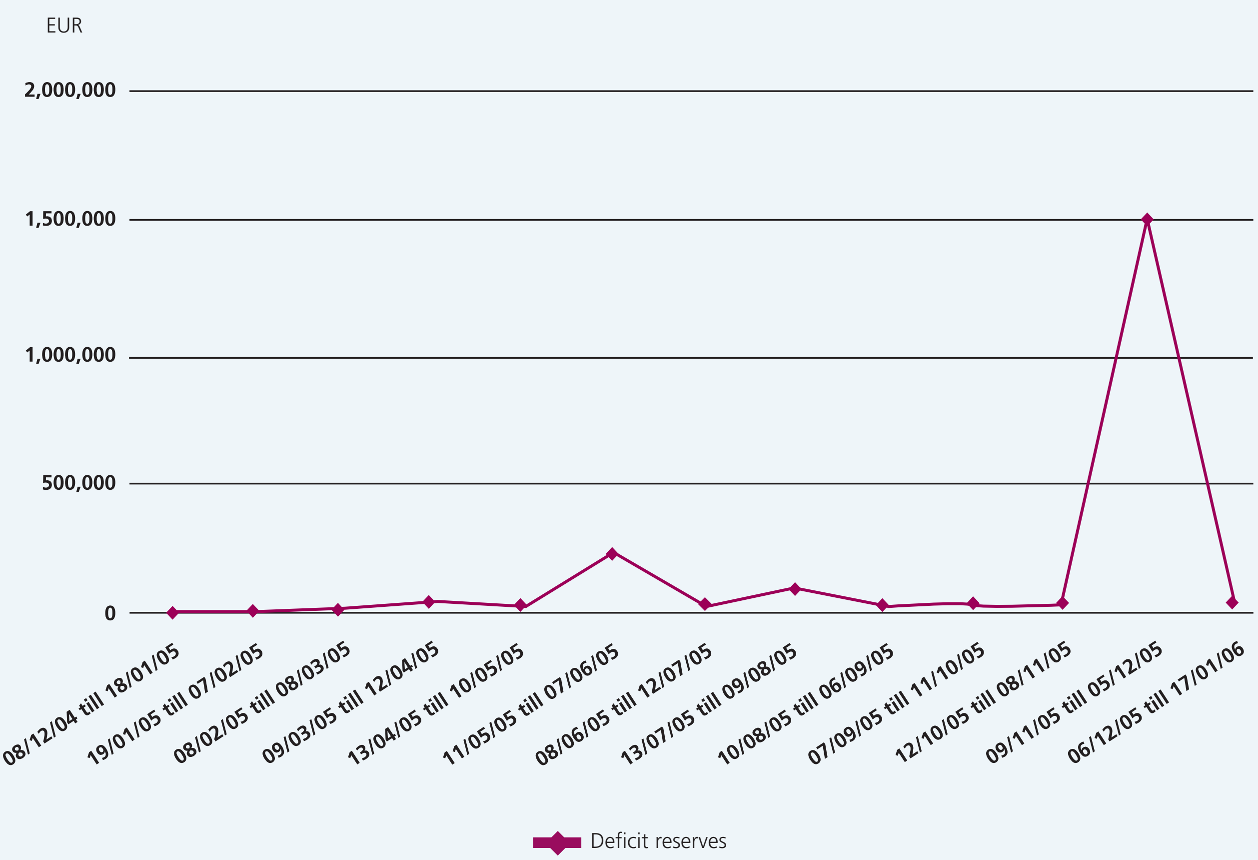
Changes in the remuneration rate in 2005

The rates at which minimum reserves were remunerated increased from 2.07% to 2.29% in 2005.

Periods	08/12/04 18/01/05	19/01/05 07/02/05	08/02/05 08/03/05	09/03/05 12/04/05	13/04/05 10/05/05	11/05/05 07/06/05	08/06/05 12/07/05	13/07/05 09/08/05	10/08/05 06/09/05	07/09/05 11/10/05	12/10/05 08/11/05	09/11/05 05/12/05	06/12/05 17/01/06
Rate (%)	2.07%	2.06%	2.05%	2.05%	2.05%	2.05%	2.05%	2.05%	2.05%	2.06%	2.06%	2.07%	2.29%

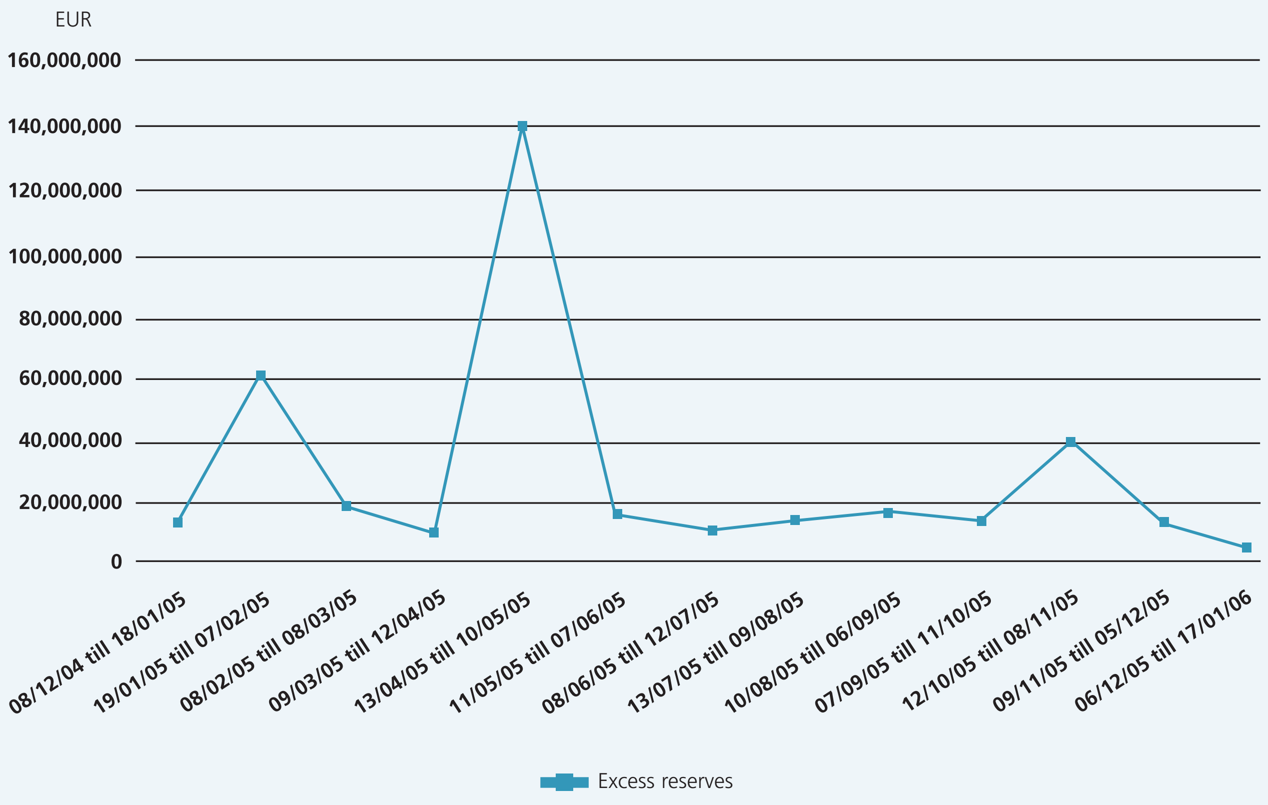
Counterparties paid five sanctions for not respecting minimum reserve requirements in 2005, compared with seven in 2004.

CHART 6: DEVELOPMENT OF AVERAGE DEFICIT RESERVES



Source: BCL

CHART 7: DEVELOPMENT OF AVERAGE EXCESS RESERVES



Source: BCL

Excess of minimum reserves, which by definition are not remunerated, remained at a high level throughout the year.

2.2 Foreign exchange reserves management by the BCL

In accordance with the Statute of the Eurosystem and in line with its share in the ECB's capital key, the BCL transferred €74.6 million in foreign exchange assets to the ECB, an amount which corresponded to 0.1492% of the capital key as at 31 December 2003.

The ECB's foreign exchange reserves have been managed in a decentralised way by the national central banks since January 1999. Since 1 May 2004, following the adjustment of the weightings, which takes place every five years, and the EU's enlargement on 1 May 2004, the BCL's share in the ECB's capital key has been 0.1568%; an additional €12.6 million has been transferred to the ECB. As at 31 December 2005, the total market value of the ECB's reserves (including accrued interest) managed by the BCL corresponded to €92.4 million.

One goal of the foreign exchange reserves management of the ECB is to ensure that the ECB has sufficient liquidity available to intervene in the foreign exchange markets if need be. Security and liquidity are therefore basic requirements in managing these reserves.

A tactical benchmark is set up for each currency by taking into account the strategic benchmark. This tactical benchmark reflects the ECB's risk/return medium-term preference as regards market conditions. A change in the tactical benchmark may affect different risk categories (for example, modified duration or liquidity risk). The modified maturity of the tactical benchmark may differ from that of the strategic benchmark in the context of fluctuation margins announced in advance by the ECB.

In the management of this portfolio, the prime task of the BCL is to invest the foreign exchange reserves on behalf of the ECB within the prescribed fluctuation bands and fixed risk limits with the objective being return maximisation. The amount of actively managed assets in gold is specified by the ECB, taking account of strategic considerations and market conditions.

The BCL manages a US dollar portfolio on behalf of the ECB.

2.3 Management of the BCL's assets

2.3.1 Institutional structure

Asset management is based on a five-level intervention structure, in addition to risk control:

- The Council (level 1),
- The Board of Directors (level 2),
- The Asset and Liability Management Committee (ALCO) (level 3),
- The tactical committees (level 4),
- The portfolio managers (level 5).

- **Level 1:** The Council

The Council approves the guidelines of the asset management framework. Thus, the Council has granted the BCL the possibility to provide asset management services to third parties and to hold own funds asset portfolios in order to diversify the Bank's income. The guidelines also include mitigation of the risk framework applied to asset management. This framework comprises two kinds of risk mitigation: institutional mitigation and operational mitigation.

- **Level 2:** The Board of Directors

The Board of Directors defines the risk management framework. Thus, it determines the maximum risk allowance (MRA) in the management of the Bank's own assets. It also specifies the risk management measures, like the Value at Risk (VaR) method and the application of stress-testing scenarios. The Board of Directors also sets warning thresholds, which can lead to the calling of emergency meetings for assessment and arbitrage purposes.

The Board of Directors sets the limits of the framework annually.

- **Level 3:** The Asset and Liability Management Committee (ALCO)

ALCO determines the **strategic benchmark** according to the framework fixed annually by the Board of Directors by examining the impact of each risk profile (market, credit and liquidity risk) which would result from the proposed investment policies, in respect of both the overall balance sheet and the profit and loss account of the BCL. During the year, ALCO regularly assesses the results of the investment policy.

- **Level 4:** The tactical committees

The tactical committees monitor the evolution of the portfolios on a shorter-term basis and work out proposals for **tactical benchmarks** that comply with the limits laid down by the strategic benchmark.

The tactical committees are as follows:

- The *Comité de gestion*, for the BCL's own funds,
- The *Comité réserves de change* for the pooled reserves of the ECB,
- The *Comité tactical benchmark* for the pension fund of the BCL.

- **Level 5:** The portfolio managers

In conclusion, the portfolio managers implement the decisions of the tactical committees within the limits of the approved investment policy. The transactions are executed in strict compliance with the limits set, covering both the overall and specific investment limits.

Risk control

In addition, the important role played in the asset management framework by the Organisation and Risk Management unit (OR) and the Internal Audit unit (IA) should be mentioned.

The OR unit[1] monitors the positions of all the portfolios in order to assess risks and to verify compliance with the pre-defined limits. This monitoring is carried out daily, independently of the Front Office. The IA unit complements the monitoring structure with specific missions at different levels of the organisation. In addition, the Middle and Back Offices also take part in the monitoring process.

2.3.2 Conceptual framework

The investment policy objectives:

The main objectives are to generate a high income on a regular basis and to ensure a total return over the long term by taking into account considerations such as capital safety, stability of securities and liquidity. In order to achieve these goals and in accordance with the principle of risk diversification, the BCL implements a coordinated, progressive and pro-active investment policy based on modern portfolio theory.

The investment approach takes into account:

- the analysis of economies and international financial markets;
- the asset allocation decisions by assessing the returns on different international markets;
- the drawing-up of a clearly defined strategy;
- the capital value preservation of the assets under management by a policy of risk diversification and the application of specific qualitative requirements with regard to investments;
- the application of strict risk control measures.

Investment decisions are based on:

- technical and fundamental analyses, as well as on quantitative assessments;
- market risks (interest rates, exchange rates, equity prices, commodity prices);
- credit risks (minimum credit ratings criteria by international rating agencies);
- liquidity risks (limits by sector, by issuer, by issue and by geographic diversification).

Performance measurement

The quality of the investment decisions is measured by comparing the performance with the external benchmarks of leading investment banks. This permits a given performance to be assigned to a decision level (strategic, tactical) as well as to daily management.

[1] The risk manager is a member of the OR unit.

2.3.3 Structure of portfolios

The bulk of the BCL's own funds are invested in fixed-income securities denominated in euro. The strategic orientation permits a diversification into other asset categories.

The BCL manages five kinds of portfolio: Investment Portfolio, Liquidity Portfolio, Domestic Reserves Portfolio, Pension Fund Portfolio and Institutional Portfolios.

Investment Portfolio (Portfolio 1)

This portfolio consists of assets (equity and bonds) which can be deemed to represent its own funds (with a longer-term investment profile). The main goal of the portfolio is to maximise the return by taking into account the above-mentioned risk constraints (see section 2.3.2). As at 31 December 2005, the total market value (including accrued interest) amounted to €980.5 million.

In 2005 a significant proportion of the funds was invested in long-term bonds, as market conditions for that kind of investment were favourable. However, towards the end of the year the underlying duration of the portfolio was reduced.

The securities included in this portfolio are widely diversified not only geographically but also in terms of sector and issuer.

Liquidity Portfolio (Portfolio 2)

This portfolio comprises the other assets that are largely attributable to a Eurosystem arrangement (Agreement on Net Financial Assets) and mirror TARGET accounts and other liabilities. This portfolio, whose liability profile covers certain liquidity needs, also aims to maximise income. The instruments used are mainly fixed-income short-term bonds, variable rate bonds and certificates of deposits (eurocommercial paper), provided that they comply with strict and predefined rating criteria. As at 31 December 2005, the total market value (including accrued interest) amounted to €2,821 million.

Domestic Reserves Portfolio

This portfolio aims to maintain an intervention portfolio in addition to the pooled foreign exchange reserves transferred to the ECB. Thus, the main requirements for this portfolio are security and liquidity. As at 31 December 2005, the total market value (including accrued interest) of this portfolio in foreign currencies amounted to €125 million.

Pension Fund Portfolio

The management of this fund is described further in section 4.2.4 of this report.

Institutional Portfolios

The BCL provides discretionary management services to institutional clients (central banks and international organisations).

Since 1 January 2005 the Bank has acted as a Eurosystem service provider. Six central banks within the Eurosystem offer institutional clients (central banks, public authorities and international organisations) a comprehensive range of services for managing euro-denominated reserve assets under a new framework of harmonised services defined by the ECB.

TABLE 1: ALLOCATION AS AT 31 DECEMBER 2005

Maturity	Portfolio 1	Portfolio 2
0-1 year	45%	81%
1-3 years	22%	10%
3-7 years	24%	9%
> 7 years	9%	0%

2.4 Banknotes and coins

Euro banknotes are produced to meet all the NCBs' banknote requirements, which are aggregated by the ECB. The production of one denomination is assigned to, at most, two NCBs. In 2005, the BCL was responsible for producing 4.8 million €500 banknotes for its own requirements. The production of these banknotes was entrusted to the *Oesterreichische Banknoten- und Sicherheitsdruck GmbH*, a security printing company in Vienna, Austria.

According to an agreement with the Luxembourg government, the BCL is in charge of the production of Luxembourg's euro coins, in addition to the task conferred on it by its Founding Law of 23 December 1998 to put the euro coins into circulation. Following an invitation to tender, the BCL put the *Rahapaja Oy (Mint of Finland)* in charge of the production in 2005 of 45.6 million coins for its own requirements. Following a renewed invitation to tender, the BCL signed an agreement with the Mint of Finland at the end of September 2005 for the production of 31.3 million Luxembourg euro coins dated 2006 in order to satisfy the demand for coins in 2006.

2.4.1 Circulation of banknotes and coins

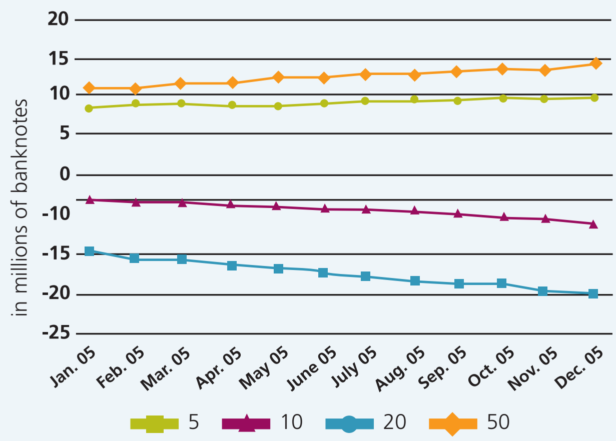
2.4.1.1 Euro banknotes and coins

The volume of euro banknotes and coins put into circulation by the BCL exceeds, in the case of certain denominations, the volume effectively in circulation in Luxembourg, i.e. those used in the payment systems of Luxembourg, because of the movement of banknotes and coins inside the euro area.

The total net volume of euro banknotes put into circulation by the BCL in 2005 amounted to 20.88 million notes, compared with 23.22 million banknotes in 2004, a decrease of 10.1%. The volume of €10 and €20 denominations lodged with the BCL exceeds the volume issued. Credit institutions, which are BCL clients, deposited more banknotes than they withdrew from the BCL. This phenomenon can be explained by the fact that tourists and cross-border workers brought in these denominations in large quantities for their everyday expenditures in Luxembourg.

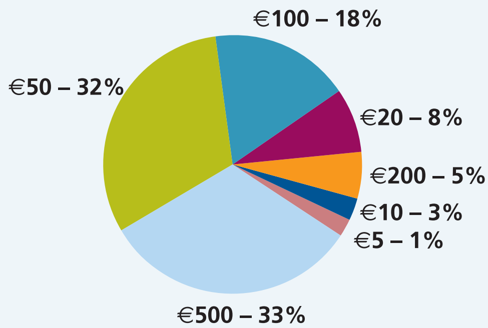
The chart below shows the change in the number of euro banknote denominations used for everyday expenditures.

CHART 8: CHANGE IN THE NUMBER OF EURO BANKNOTES USED FOR EVERYDAY TRANSACTIONS PUT INTO CIRCULATION BY THE BCL



In comparison with other national central banks in the euro area, the BCL increased its contribution to the total volume of banknotes put into circulation by the Eurosystem from 0.93% at end-2004 to 1.10% in December 2005. In Luxembourg and in the rest of the euro area, the year 2005, like 2004, was marked by a steady demand for higher denominations used mainly for saving and precautionary purposes, a sign of increased trust in the euro. The total value of euro banknotes put into circulation by the Eurosystem increased by 12.76% and amounted to €565.22 billion at the end of 2005, with the following value breakdown by denomination:

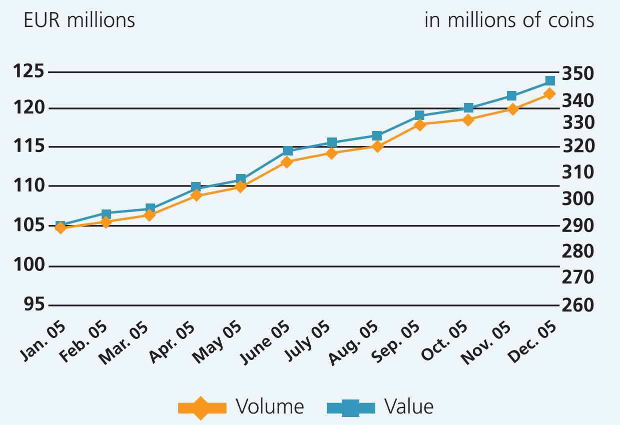
CHART 9: BREAKDOWN BY DENOMINATION OF EURO BANKNOTES PUT INTO CIRCULATION BY THE EUROSYSTEM



Public demand for euro coins issued by Luxembourg has remained strong. The total value of the coins put into circulation increased by 19.1% in 2005, compared with 27.5% in 2004. The total value rose from €103.65 million to €123.41 million. The volume of Luxembourg's euro coins issued increased by 54.57 million coins (more than 260 tonnes of metal), a rise of 19.2%, and amounted to 338.14 million coins at the end of 2005. This volume is equivalent to a total weight of 1,639 tonnes, i.e. 3.6 kg or around 735 coins, with a value of €268, for each inhabitant of Luxembourg. As in previous years, the country's coins continued to be much sought after by collectors.

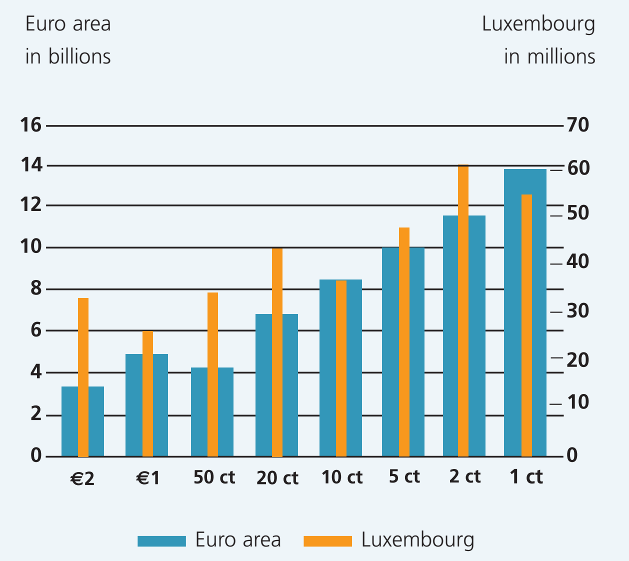
The average monthly volume of coins in circulation rose to 312.43 million. The following chart shows the changing volume and value of Luxembourg's euro coins in circulation throughout 2005. The demand for coins grew steadily in the year under review.

CHART 10: TOTAL VOLUME AND VALUE OF LUXEMBOURG EURO COINS IN CIRCULATION



Compared with the other euro area countries, Luxembourg increased its contribution to the total number of coins put into circulation by all the participating Member States from 0.50% in 2004 to 0.54% in 2005; Luxembourg contributes 0.74% of the total value issued by all the issuing authorities of the euro area. The average value of its euro coins in circulation amounts to 36.5 cent in comparison with an average of 26.4 cent for the other euro area coins. The following chart compares the volume of the different coin denominations put into circulation by Luxembourg with the volume corresponding to the rest of the euro area.

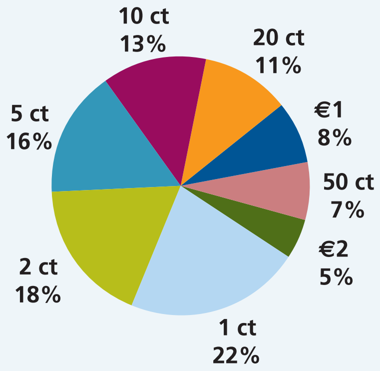
CHART 11: COMPARISON OF THE CIRCULATION VOLUME OF THE DIFFERENT EURO COIN DENOMINATIONS IN LUXEMBOURG TO THAT OF THE EURO AREA



Concerning Luxembourg's coins, the 2-cent denomination remained the most common in 2005. Compared with 2004, the ranking according to volume remained unchanged in 2005, confirming the public's preference for denominations with a face value starting with 2. In descending order, the sequence is as follows: 2 cent, 1 cent, 5 cent, 20 cent, 10 cent, 50 cent, €2, €1. The corresponding ranking for the euro area as a whole is: 1 cent, 2 cent, 5 cent, 10 cent, 20 cent, €1, 50 cent, €2.

The total value of euro coins put into circulation by the Eurosystem increased from €15.35 billion at the end of 2004 to €16.64 billion at the end of 2005, whereas the total volume of coins reached 62.98 billion. The following chart shows the volume breakdown by denomination:

CHART 12: BREAKDOWN BY DENOMINATION OF THE VOLUME OF COINS OF THE EURO AREA IN CIRCULATION



2.4.1.2 Luxembourg franc banknotes and coins

In 2005, the total value of Luxembourg francs not yet exchanged fell by 2.2%, from LUF 452 million to 442 million. This decline was due exclusively to the return of franc banknotes, the franc coins having ceased to be exchangeable at the end of December 2004. The volume of 5,000-Luxembourg-franc banknotes not yet returned underwent the most pronounced decline (- 9.1%), while that of 1,000-franc banknotes fell by 2.7%. The volume of unreturned 100-franc banknote only decreased by 1.1%. These figures show that collectors prefer the lower denominations. The return of banknotes in 2005 took the form of a nearly linear curve with a very marked fall in December 2005. The table below shows the total value of unreturned Luxembourg franc banknotes for the five last years.

TABLE 2: TOTAL VALUE OF UNRETURNED LUXEMBOURG FRANC BANKNOTES BETWEEN 2001 AND 2005

in LUF

End of period	LUF 5,000	LUF 1,000	LUF 100	LUF banknotes withdrawn abroad	Total
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%**
2003	80,720,000	79,038,000	82,003,000	0	**241,761,000**
variation*	-14.0%	-5.6%	-2.1%		**-7.5%**
2004	75,625,000	76,702,000	81,592,200	0	**233,919,200**
variation*	-6.3%	-3.0%	-0.5%		**-3.3%**
2005	68,750,000	74,651,000	80,670,900	0	**224,071,900**
variation*	-9.1%	-2.7%	-1.1%		**-4.2%**

* compared with the preceding year.

The total volume of unreturned Luxembourg banknotes decreased by 91.9% between end-2001 and end-2005.

At the end of 2005, a total volume of 895,110 Luxembourg banknotes and 63.1 million coins, with a total value of LUF 408.7 million, had still not been exchanged. Numismatic products and collector coins still not exchanged amounted to LUF 33.5 million.

Nearly 900 Luxembourg franc banknotes were returned to the BCL by financial institutions, whereas just over 1,600 Belgian franc banknotes were returned.

Luxembourg and Belgian franc banknotes can still be exchanged at the counters of the BCL.

2.4.2 Handling of banknotes and coins

The number of euro banknotes returned by financial institutions to the BCL – 56.81 million – remained nearly unchange compared with the previous year. The volume of returned notes involved more than 1,760 lodgement operations registered and managed by the Cash Department. Furthermore, the number of withdrawals of euro banknotes by financial institutions exceeded 3,900 operations. These were likewise registered and managed by the Cash Department, and represented a decrease of 11% compared with 2004.

The public also made use of the services offered by the BCL over its counters to exchange banknotes and coins which were unfit for circulation as well as to buy numismatic products. Nearly 9,000 transactions were conducted over the counter in 2005, i.e. an average of 35.5 operations per working day. Some 200 transactions for professional numismatists were also carried out, a field of activity more actively pursued by the Bank in 2005. All in all, the Cash Department registered and managed over 14,800 transactions concerning notes, coins and numismatic products.

The number of euro banknotes processed by sorting machines rose noticeably, by some 7%, from 54.23 million notes in 2004 to 57.96 million in 2005. The sorting machines carry out both authenticity tests and soiling tests. Nearly 16.2 million notes of all denominations had to be destroyed as they were unfit for circulation. The reject/destruction rate fell from 33% in 2004 to 28% of the total number of euro baknotes sorted, due to a slight improvement in the quality of certain denominations (€10, €50 and €200) lodged with the BCL. Moreover, this percentage varied greatly from one denomination to another: 5% for the €200 banknote to 55% for the €5 note.

In the field of counterfeit monitoring, the BCL continued to work closely with the ECB and the national authorities in analysing discovered counterfeits.

2.4.3 Numismatic issues

The BCL took the opportunity in 2005, as in 2004, to issue a €2 commemorative coin with a distinctive national side, thus maintaining the interest of collectors in numismatic products put on sale by the BCL. The coin, which shows Grand Duke Henri and Grand Duke Adolphe, marks the former's 50th birthday and the fifth anniversary of his accession to the throne, as well as the 100th anniversary of the death of Grand Duke Adolphe.

The BCL issued the following numismatic products in Luxembourg in 2005:

- The "2005 BU set" comprises Luxembourg's euro coins (1 cent to €2, including the €2 commemorative coin with a distinctive national side), struck in "Brilliant Uncirculated" quality and dated 2005. The mintage is limited to 20,000 sets.

- The "2005 Benelux set" contains the 2005 series of eight euro coins of the three Benelux countries struck in "Brilliant Uncirculated" quality. It also includes a silver medal specially designed for the 50th anniversary of the Benelux Parliament – the theme of this set.

- The "2005 Proof set" features Luxembourg's eight euro coins (ranging from 1 cent to €2) and the €2 commemorative coin, all struck in "Proof" quality and dated 2005. The mintage amounts to 1,500 sets.

- The silver coin "Council of the European Union", issued in January 2005 to mark Luxembourg's Presidency of the Council and with a mintage of 10,000, is the country's third collector coin in silver in the series "European institutions". This coin has a face value of €25 and is minted with a silver fineness of 925. Its diameter is 37 mm and its weight 22.85 g.

Collector coins in precious metal issued by a euro area Member State are only legal tender in the issuing country.

2.5 Developments in the area of statistics

2.5.1 Monetary and financial statistics

The BCL publishes monthly and quarterly aggregated balance sheet statistics on Luxembourg's credit institutions and money market funds. It also publishes monthly statistics on interest rates applied by credit institutions on loans and deposits for households and non-financial corporations in Luxembourg and the rest of the euro area. The BCL additionally publishes various statistics on investment funds and other professionals of the financial sector as well as data on employment in the country's financial sector.

In 2005, the BCL started work on the development of new statistical requirements for other financial intermediaries such as investments funds. This work will be finalised by the adoption of an ECB Regulation.

2.5.2 Balance of payments and international investment position

The BCL publishes quarterly statistics on Luxembourg's balance of payments as well as on the international investment position and reserve assets on its website and in its quarterly bulletin. Furthermore, the BCL and the *Service central de la statistique et des études économiques* (*STATEC*) provide, in a joint press release, information on the main developments in the balance of payments when publishing new data.

In 2005, the BCL started developing a new system for collecting statistical data relating to portfolio investments. A considerable amount of work is required here in order to comply with the European Central Bank Guideline ECB/2004/15 dated 16 July 2004. This new compilation system will be based on a security-by-security collection method and should become operational in January 2008.

2.5.3 Financial accounts

The BCL and *STATEC* have performed a detailed stock-taking exercise of the information needed and defined a common plan for compiling financial accounts for Luxembourg. The government has entrusted *STATEC* with the compilation of financial accounts and requested it to liaise with the BCL in this area.

2.5.4 The IMF Special Data Dissemination Standard

In 1996, the IMF introduced its Special Data Dissemination Standard (SDDS), which aims to improve the production and publication of a large set of macroeconomic statistics.

In 2005, Luxembourg's institutions continued to adapt their statistical framework to fit this standard. The BCL has in particular made available to all interested parties statistics on the analytical accounts of the BCL, the MFI sector, the balance of payments (jointly with *STATEC*), the international investment position, and on the external debt and reserve assets, within the periods required by the SDDS.

2.6 Payment and securities settlement systems

2.6.1 Real-time gross settlement systems

The number of participants in LIPS-Gross[2], Luxembourg's real-time gross payment system, remained unchanged in 2005 at 31.

2.6.1.1 LIPS-Gross activity in 2005

Domestic payments[3]

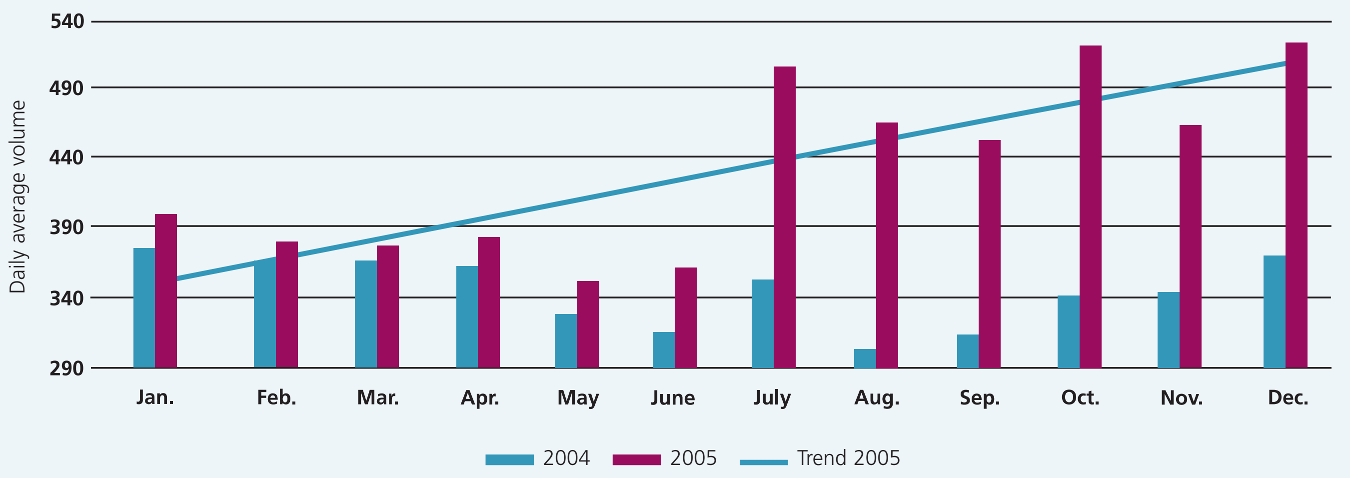
In 2005, LIPS-Gross participants exchanged a total of 109,567 payments (89,128 in 2004) for a total value of €2,736 billion (€2,258 billion in 2004). In comparison with 2004, the volume increased by 23% and the value exchanged rose by 21%. The average value per payment was €25 million.

The following charts show the daily average volume as well as the daily average value of domestic payments.

Compared with 2004, domestic traffic rose strongly in the second half of 2005. This increase was generated by a limited number of participants.

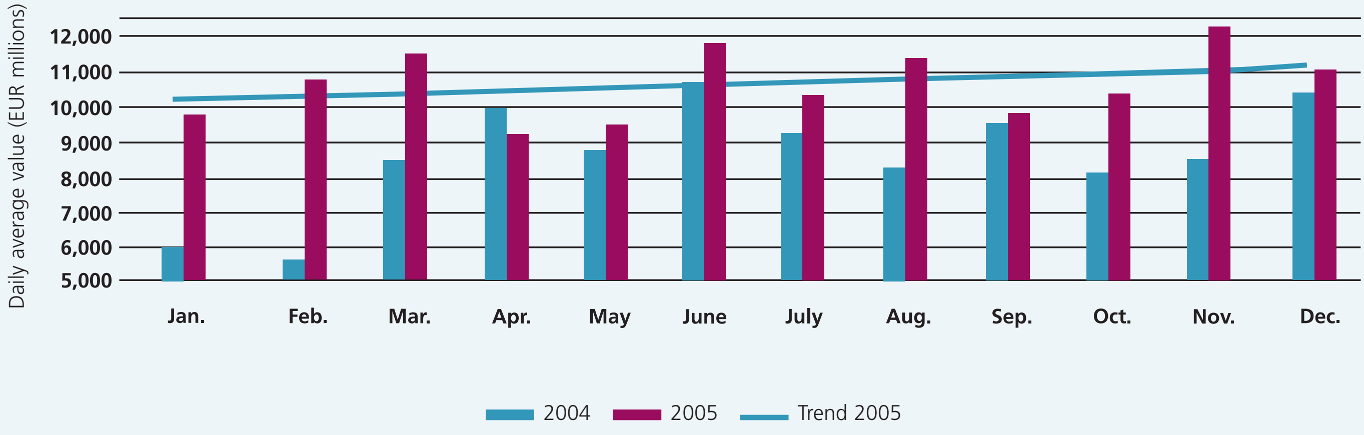
The amounts exchanged in January and February 2005 were much higher than in the corresponding period of 2004, mainly because of a change[4] in the tender procedure for the Eurosystem's MROs, for which the maturity was shortened from two weeks to one week.

CHART 13: DOMESTIC PAYMENTS: DAILY AVERAGE VOLUME



[2] Real-Time Gross Settlement System (RTGS)
[3] Domestic payment: payment exchanged between two LIPS-Gross participants.
[4] The new procedure came into force in February – March 2004.

CHART 14: DOMESTIC PAYMENTS: DAILY AVERAGE VALUE

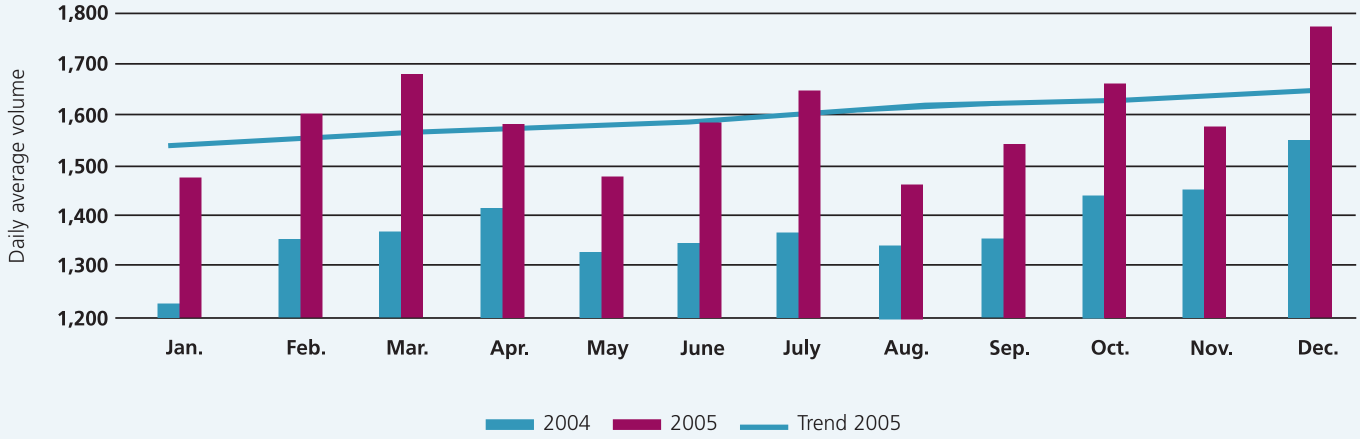


Cross-border payments[5]

In 2005, LIPS-Gross participants sent 407,375 payments to other countries in the European Union (357,317 in 2004) for a total value of €3,902 billion (€3,241 billion in 2004). In return, the participants received 382,732 cross-border payments (321,711 in 2004) for a total value of €3,907 billion (€3,242 billion in 2004). The average value per payment sent was €9.6 million (an increase of 5.6%). The average value per payment received is €10.2 million (an increase of 1.3%).

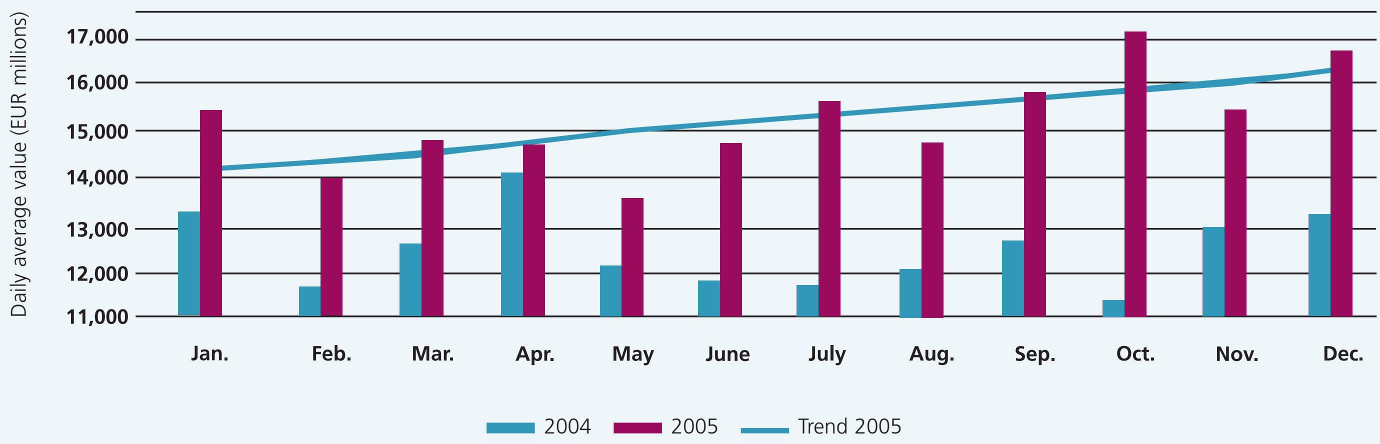
The following charts show the daily average volume and value of cross-border payments by Luxembourgish participants.

CHART 15: CROSS-BORDER PAYMENTS SENT: DAILY AVERAGE VOLUME



[5] Cross-border payment: payment exchanged between a LIPS-Gross participant and a TARGET participant.

CHART 16: CROSS-BORDER PAYMENTS SENT: DAILY AVERAGE VALUE



In 2005, the volume of cross-border payments increased by 14% and the value by 20%. Around ten banks contributed to this development.

CHART 17: DISTRIBUTION OF CROSS-BORDER PAYMENTS SENT (IN VOLUME)

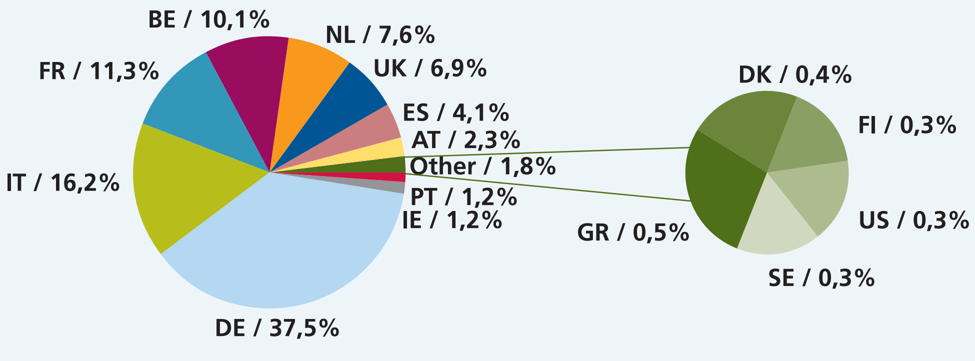
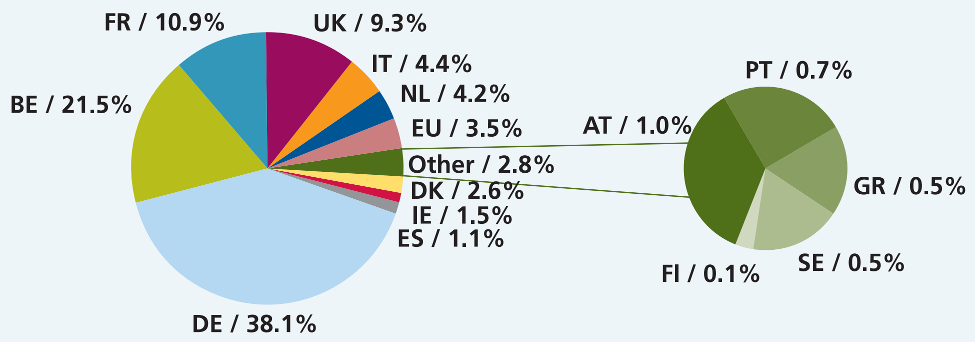


CHART 18: BREAKDOWN BY VALUE OF CROSS-BORDER PAYMENTS SENT



Whether in volume or in value, more than 80% of cross-border payments are sent to five countries, three of which are direct neighbours of Luxembourg.

Aggregated figures for domestic and cross-border payments

The total number of payments processed by LIPS-Gross in 2005 amounted to 922,370, with a peak of 5,327 transactions on 30 June.

The following table provides an overview of daily average volumes and values exchanged per year. Overall, volumes as well as values exchanged continued to increase.

TABLE 4: VALUE (IN EUR MILLIONS) OF PAYMENTS (DAILY AVERAGE)

	Domestic Payments		Cross-border sent		Cross-border received		**Total sent and received**
	Volume	(% volume sent)	Volume	(% volume sent)	Volume	(% total volume)	
2003	5,932	(31.81%)	12,715	(68.19%)	12,760	(40.63%)	**31,407**
2004	8,717	(41.06%)	12,515	(58.94%)	12,519	(37.09%)	**33,752**
2005	10,686	(41.21%)	15,243	(58.79%)	15,260	(37.05%)	**41,189**
Variation 2005-2004	**+23%**		**+22%**		**+22%**		**+22%**

TABLE 3: VOLUME OF PAYMENTS (DAILY AVERAGE)

	Domestic Payments		Cross-border sent		Cross-border received		**Total sent and received**
	Volume	(% volume sent)	Volume	(% volume sent)	Volume	(% total volume)	
2003	379	(25.18%)	1,125	(74.82%)	1,205	(44.49%)	**2,708**
2004	344	(19.96%)	1,380	(80.04%)	1,242	(41.88%)	**2,966**
2005	428	(21.20%)	1,591	(78.80%)	1,495	(42.54%)	**3,514**
Variation 2005-2004	**+24%**		**+15%**		**+20%**		**+18%**

The change in the trend which started in 2004 continued in 2005: the members of the RTGS-L GIE received fewer cross-border payments than they sent. Nevertheless, the value of cross-border payments received still exceeds the value of cross-border payments sent.

LIPS-Gross compared with other systems connected to TARGET

In 2005, all the national RTGS systems processed a total of 58.5 million domestic payments (52.4 million in 2004) for a value of €324,089 billion (€297,857 billion in 2004). With 109,567 national payments for a total amount of €2,736 billion, Luxembourg accounted for 0.19% of the total volume and 0.84% of the total value.

In addition, 17.7 million cross-border payments (16.8 million payments in 2004) were processed during the year for a total value of €164,812 billion (€146,137 billion in 2004). Luxembourg contributed 2.23% to this volume and 2.37% to the value exchanged.

Availability of TARGET

The overall availability of TARGET reached 99.83% in 2005 (99.80% in 2004). TARGET's average availability figure during its six years of existence has been 99.69%.

The overall availability of LIPS-Gross declined from 99.97% in 2004 to 99.94% in 2005 because of a minor technical problem. However, it was 100% available for 11 months out of 12 in 2005. LIPS-Gross' average availability figure during its six years of existence has been 99.69%, identical to TARGET's.

2.6.1.2 TARGET2

Work on the development and implementation of TARGET2 continued in 2005 at the BCL and at other European central banks.

On 24 November 2005, the BCL invited the representatives of credit institutions in order to discuss important decisions taken by the Governing Council of the ECB, notably its endorsement of the technical specifications and its setting of the go-live dates for the system, which will become operational in phases.

Luxembourg will be part of the first wave of migration on 19 November 2007. The Governing Council finally determined the pricing, which will consist of two components: an annual fee and a transaction fee. In order to prepare for the migration of Luxembourgish participants, the BCL organised several meetings of a technical nature in 2005.

2.6.2 The interbank netting system LIPS-Net

13 credit institutions are connected to the network. This figure has remained unchanged since 2004.

Transactions in 2005

In terms of volumes of payments exchanged, the total number of transactions increased by 3.73% in 2005 to 13.74 million. The total value exchanged in 2005 amounted to €62.28 billion, a 10% increase relative to 2004.

The daily average volume of transactions went up to 54,572. The highest volume (121,817) was registered on 3 May.

TABLE 5:

	2004	2005	Variation
Number of **credit transfers**	13,043,626	13,585,880	4.16%
Value of credit transfers (EUR millions)	45,846	50,551	10.26%
Average value per credit transfer (EUR)	3,515	3,791	5.86%
Number of **cheques**	174,396	124,694	-28.50%
Value of cheques (EUR millions)	2,567	2,372	-7.60%
Average value per cheque (EUR)	14,719	24,577	29.24%
Number of transactions related to the **settlement of balances of debit and credit cards**	28,951	30,363	4.88%
Value of transactions related to the settlement of balances of debit and credit cards (EUR millions)	8,363	9,352	11.82%
Average value per transaction related to the settlement of balances of debit and credit cards (EUR)	267,775	350,126	6.62%
Total number of operations	**13,246,973**	**13,740,937**	**3.73%**
Total value of operations (EUR millions)	**56,776**	**62,275**	**9.69%**
Average value per operation (EUR)	**4,286**	**4,607**	**5.74%**

Credit transfers

As in previous years, the seasonal trend was confirmed: the volumes exchanged in August and September were quite low, whereas the month of December showed the most activity.

In 2005, the average number of credit transfers exchanged per day in the national compensation amounted to 53,956 transactions with a daily average amount of around €201 million. The total value of credit transfers exceeded €50 billion in 2005 (a 10.3% increase compared with 2004).

CHART 19: CREDIT TRANSFERS: DAILY AVERAGE VOLUME

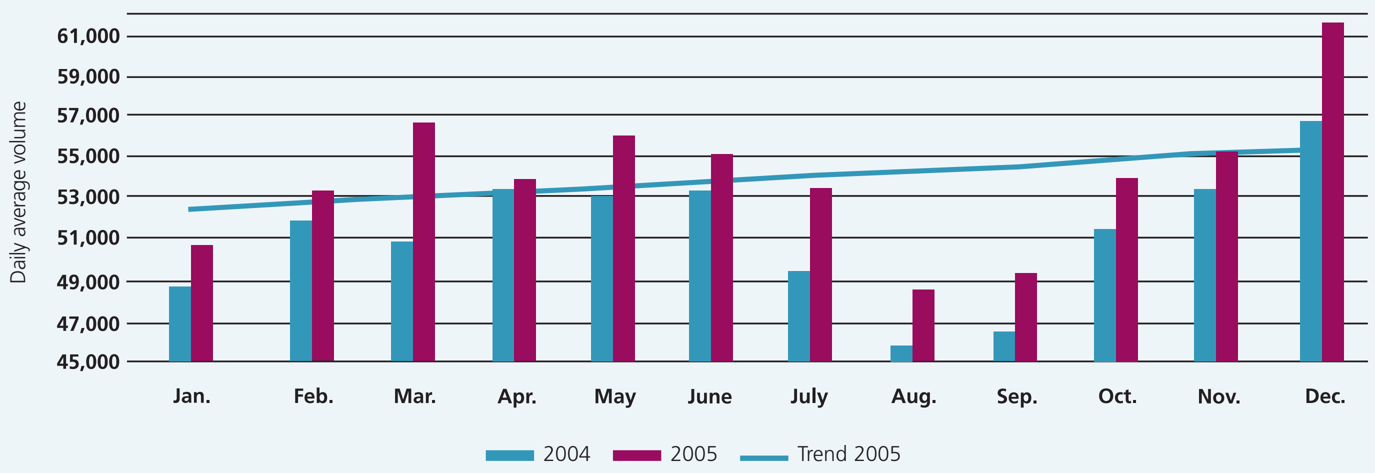
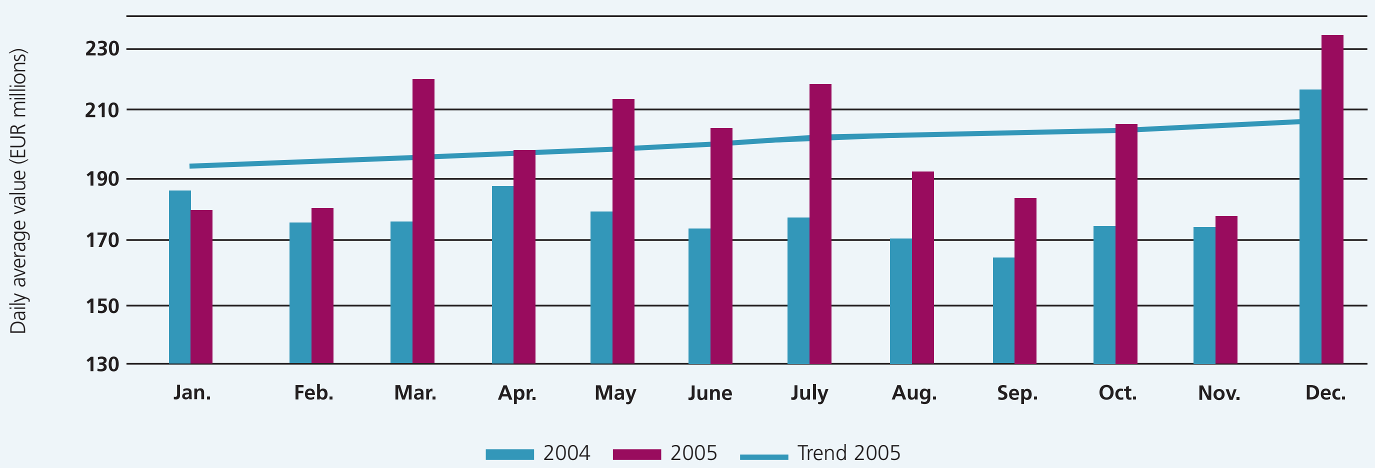


CHART 20: CREDIT TRANSFERS: DAILY AVERAGE VALUE



Cheques

The declining trend in cleared cheques which started in 2001 with the disappearance of the Eurocheque guarantee slowed down in 2005 (-29% compared with -37% the previous year). The total value of cheques also decreased in 2005, but to a smaller extent (-7% compared with 2004). The average value of cheques exchanged in the compensation sharply increased, to €19,022 in 2005, up from €14,719 in the preceding year. In 2005, the average daily number of cheques exchanged amounted to around 500 transactions and the daily average value rose to around €9.5 million.

Debit and credit cards

In May 2003, the settlement of credit card balances was integrated into the clearing system, a step already taken in respect of debit cards. As a result, balance settlement operations between card issuers have strongly increased since then. In contrast to customer payment operations (credit transfers and cheques), interbank settlement operations are less numerous (less than 1% of the volume) but represent a not inconsiderable part of the values exchanged in the compensation (15%). Within LIPS-Net, the proportion (both in terms of volume and value) of balance settlement operations for debit and credit cards has remained stable.

Evolution of the LIPS-Net system

The development of the LIPS-Net system in the early 1990s required substantial investments. Considering the limited scope for increasing its activity, insufficient economies of scale as well as integration prospects at the European level[6], the managers of the SYPAL-GIE, the owner of the system, have decided to terminate its operations in October 2006 and to transfer its credit exchange activity to the pan-European STEP2 platform operated by the Euro Banking Association (EBA). Luxembourgish participants will thus be able to benefit from economies of scale and from the coverage of a European system for retail payments. The exchange of cheques will in future be organised on a bilateral basis between the participants.

2.6.3 General framework of eligible collateral in the Eurosystem credit operations

2.6.3.1 List of eligible assets

All credit operations of the ECB and the national central banks are performed "on the basis of adequate collateral"[7]. Consequently, each counterparty of the Eurosystem guarantees the credit received from a Eurosystem central bank by providing assets as collateral. These assets have to fulfil specific eligibility criteria defined by the Eurosystem, which are detailed in a publication entitled "The implementation of monetary policy in the euro area" available on the ECB's website.

In 2005 the Eurosystem continued to work towards replacing its two categories of eligible assets[8] by a single list of eligible assets applicable for the whole of the euro area.

This single list will be progressively implemented. Following the decision to accept credit claims as collateral for central bank credit as from January 2007 throughout the euro area, the Eurosystem is working on the procedures and systems necessary for handling these assets. In this context, the Governing Council has accepted, among others, the following key elements:

- between 2007 and 2012 each national central bank will apply its own threshold for credit claims. As from 2012, a common minimum threshold of 500,000 will be applied by the whole of the Eurosystem.
- the debtors of the claims provided as collateral have to be financially sound. The Eurosystem will assess the financial soundness of the debtors according to the Eurosystem Credit Assessment Framework (ECAF), which details the rules governing the Eurosystem's credit quality requirements. In this context, the Eurosystem also published its minimum rating threshold in 2005. This threshold is set at a rating of at least A-, or by means of a probability of default no higher than 10 basis points.

The BCL filed with the government a pre-draft law which envisages the registration of credit claims at the central bank and establishes a regime for the pledging of credit claims which is like those offered in neighbouring countries.

Another significant change in 2005 was the acceptance of debt securities denominated in euro and issued in the euro area by those G10 members outside the European Economic Area (United States, Canada, Japan and Switzerland).

[6] Achievement of the Single Euro Payment Area (SEPA).

[7] Article 18 of the Statute of the ESCB and the ECB, Article 22 of the Founding Law of the BCL.

[8] These are the tier one assets (debt instruments fulfilling uniform euro area-wide eligibility criteria specified by the Eurosystem) and tier two assets (additional assets that are of particular importance to national financial markets and banking systems).

2.6.3.2 Eurosystem as a user of securities settlement systems

Selection of depositories[9] at the domestic level

In order to meet the requirement of "adequate collateral"[10], the Eurosystem also assesses against specific safety criteria depositories that are safekeeping securities used in the framework of central bank credit operations. Thus, a national depository is eligible if it obtains, after verification of its compliance with the Eurosystem user standards, the formal approval of the Governing Council.

Cross-border use of collateral

Besides using eligible domestic securities settled via the national depository, which for Luxembourg counterparties is Clearstream Banking Luxembourg (CBL), all Eurosystem counterparties may receive credit from their local national central bank by using collateral issued by a depository located elsewhere in the euro area. The Eurosystem foresees two ways for such cross-border use of collateral. Counterparties may use

- the CCBM[11]; and
- links established between securities settlement systems.

Currently, two types of links are eligible: direct links and relayed links. In a given securities settlement system located in a country of the euro area, direct links make available securities issued by a system of another euro area country, thanks to bilateral accounts that the two systems maintain with each other. Relayed links enable the transfer of securities between two systems without bilateral accounts by using a third system with which the first two systems have bilateral accounts. The possibility of using relayed links was approved by the Governing Council in 2005. Links have to be approved by the Governing Council before being used for the collateralisation of central bank credit operations. In 2005, Luxembourg counterparties used the direct links between CBL and Clearstream Banking Frankfurt A.G., Euroclear, the National Bank of Belgium, Monte Titoli (Italy), OeKB (Austria), and Euroclear Netherlands.

2.6.4 Correspondent Central Banking Model (CCBM)

In the framework of the CCBM, each NCB acts on behalf of the other central banks as a custodian for securities held at the national depository. This procedure involves a central bank called a correspondent central bank (CCB), which differs from the central bank granting the credit to the counterparty. The CCB holds the account at the depository in which the securities deposited are registered. The home central bank (HCB) grants the credit to its counterparty on the basis of confirmations received by the CCB.

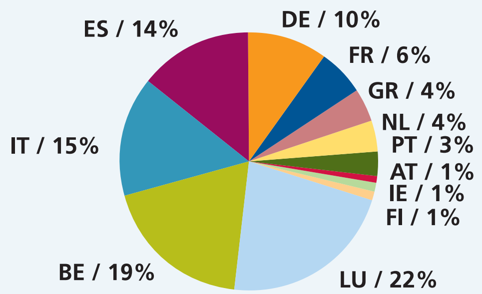
The CCBM has been a success with the counterparties and, as it remains the main channel for the cross-border mobilisation of collateral, the Governing Council has decided to continue the CCBM until 2007. The efficiency of the model has been further increased by the decision to limit the maximum processing time to one hour for each operation.

Across the euro area, usage of the CCBM has remained very uneven. The most active correspondent central banks have been those from Luxembourg (22%), Belgium (19%), Italy (15%), and Spain (14%).

The most active home central banks have been those from Germany (59%), the Netherlands (10%), France (7%) and Ireland (6%).

As in previous years, the cross-border use of tier two assets has remained marginal.

CHART 21: CORRESPONDENT CENTRAL BANKS IN 2005



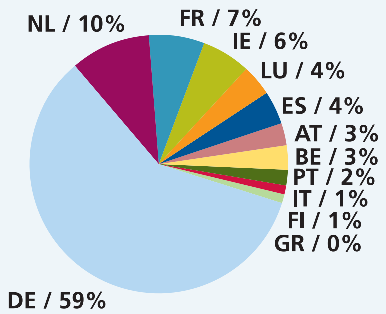
Source: ECB

[9] A depository is an institution that operates a securities settlement system.

[10] Article 18 of the Statute of the ESCB and the ECB, Article 22 of the Founding Law of the BCL.

[11] Correspondent Central Banking Model, see section 2.6.4.

CHART 22: HOME CENTRAL BANKS IN 2005



Source : ECB

2.6.5 Night-time link with Clearstream Banking Luxembourg

Night-time link (NTL) is a complementary service introduced by the BCL and CBL in 2002. It enables banks in Luxembourg to improve the use of their cash and securities deposited with the BCL, while at the same time increasing the financial safety of the night-time securities settlement operated by CBL.

The NTL procedure is divided into two parts:

1. A customer of CBL can use its cash and collateral available at the BCL to guarantee credit granted by CBL for the clearing process taking place at night. The guarantee is issued by the BCL in favour of CBL on behalf of the customer.
2. At the end of the night-time processing, reimbursement of credit granted by CBL is automatically made by the BCL on behalf of the customer.

The BCL considers that the night-time link, by offering new collateralisation possibilities to the banking community, contributes to improving the safety of securities transactions. This procedure also enables banks to manage their liquidity in a more centralised way.

2.6.6 Committee of Payment Systems and Securities Settlement Systems

The Committee of Payment Systems and Securities Settlement Systems (CSPRT) has continued its work on Luxembourg's level of preparation for any large-scale technical and operational risks. A working group, the Large-Scale Disruption Task Force (LSDTF), has been established by the BCL, the *Commission de Surveillance du Secteur Financier* (*CSSF*), and institutions from Luxembourg's financial sector, in order to analyse in detail the country’s situation as a financial centre in this respect. The results of the work were published in the BCL's *Revue de Stabilité Financière* (financial stability review) in April 2006.

2.7 Financial stability

2.7.1 Macro-prudential surveillance

In 2005 the BCL continued to perform its macro-prudential surveillance of Luxembourg's banking sector, based on a set of macro-prudential indicators complemented by a monitoring of the activities and results of systemically important credit institutions. This analysis has in turn been supported by a monitoring of structural, regulatory and prudential developments that may affect financial stability.

In addition, the BCL intends to step up its stress-testing of the banking sector and its studies in this field.

Macro-prudential indicators for 2005 show a rise in income, balance sheet assets and own funds of credit institutions under Luxembourg law. The share of the interest margin in total revenues is decreasing while the share of commission revenues is rising. Moreover, operating costs linked to the banking product remain favourable compared with the European average.

Net value adjustments in the books of banks subject to Luxembourg law have been reduced, both in terms of volume and in respect of their own funds. The relative proportion of collateralised loans in total loans slightly declined. Intra-group activities remained important, especially for large credit institutions. The hunt for higher return has increased credit institutions' to risk countries. Credit to the non-financial corporate sector has grown positively for the first time since 2001. Credit to households has continued to rise, albeit representing only a small part of Luxembourg credit institutions' exposures, which are mainly concentrated on financial institutions. The share of non-performing loans in total exposures has stabilised at a low level. Net foreign currency positions remained modest in relation to own funds. The degree of concentration of banking activities, as measured by the Gini coefficient, remained stable despite the steady decline in the number of banks.

Overall, based on the macro-prudential analysis in 2005, Luxembourg's banking sector seems to be sound and well positioned to face potential instability risks given comfortable liquidity and solvency ratios combined with asset quality and earnings ratios indicating no major threats to financial stability.

An in-depth analysis of recent financial stability developments was published in the BCL's *Revue de Stabilité Financière* in April 2006.

In addition to publishing national macro-prudential indicators at the national level, the BCL actively participates in producing indicators at the level of the ECB and the IMF.

At the level of the European System of Central Banks (ESCB), the BCL contributes to the work of the Banking Supervision Committee, which brings together the central banks and EU supervisors and, among other tasks, analyses the macro-prudential situation and structural developments in the European banking sector from a financial stability point of view.

The BCL also participates in the work of the Committee of European Banking Supervisors (CEBS) set up by the European Commission.

At the national level, the BCL has proposed the establishment of a financial stability committee, in the context of a draft bill revising the BCL's Founding Law which was sent to the government in February 2006.

It is intended that this committee, under the coordination of the BCL, will operate as a forum for cooperation and organise the dialogue between the different supervisory authorities and the BCL. It will contribute to the implementation of Memoranda of Understanding adopted at the European level between competent authorities and deal with inter-sectoral issues as well as serve as a forum for reflection on issues of general interest related to the stability of the global financial system. In addition, the committee will organise a regular exchange of qualitative and quantitative information on individual credit institutions, infrastructures and market developments, and operate in the field of crisis prevention as well as crisis management. It can also serve, under the leadership of the BCL as the authority responsible for liquidity provision, as the organiser of crisis simulation exercises.

2.7.2 Oversight of payment and securities settlement systems

The BCL's oversight of payment and securities settlement systems derives from its mission to contribute to financial stability. It focuses on operators and technical agents of Luxembourg's two major payment systems, i.e. LIPS-Gross, the real-time gross settlement system, and LIPS-Net, the retail net settlement system, as well as the securities settlement system operated by Clearstream Banking Luxembourg.

The oversight activity, which aims to ensure the smooth functioning and efficiency of payment and securities settlement systems and thus to contribute to financial stability, is performed in accordance with the requirements defined by the BCL in its policy and procedures document of December 2001. In this context, operators and technical agents subject to oversight supplied in 2005 a set of information of a general, statistical and financial nature which has been followed up on a regular basis.

The BCL also contributes to the work of the Payment and Settlement Systems Committee and its sub-groups at the level of the European System of Central Banks (ESCB). The Committee's objective is to help the ESCB promote the smooth functioning of payment systems, notably in the field of oversight. Thus, parallel to the oversight performed at the national level, the LIPS-Net and LIPS-Gross payment systems are subject to a harmonised common oversight stance carried out by the ESCB central banks, based on the Core Principles for Systemically Important Payment Systems. In this context, an assessment of retail payment systems was undertaken in 2005 and concluded that LIPS-Net fully complied with the principles.

The two national payment systems, LIPS-Net and LIPS-Gross, are currently restructuring. In 2005 LIPS-Net's operator decided to close its payment system on 6 October 2006. Banks will exchange their retail payment orders through STEP2, the system operated by the Euro Banking Association and overseen by the ECB. Moreover, LIPS-Gross will cease operating at the end of 2007, when TARGET, the ESCB's real-time gross settlement system, of which LIPS-Gross forms the Luxembourg part, will be replaced by TARGET2, operating on a shared single platform. As far as oversight is concerned, even though key aspects of TARGET2 will be subject to joint oversight by the participating central banks, the BCL will keep its competence in assessing the new system's decentralised aspects.

The BCL also helped to draw up standards for clearing and securities settlement systems in the EU via a joint task force involving the ESCB and the Committee of European Securities Regulators (CESR).

Artist: Tina Gillen
Title: Camion
Material: Acrylic on canvas
Format: 120 x 85 cm
BCL collection

3. EXTERNAL ACTIVITIES

3.1 Activities with the International Monetary Fund and other international organisations

The BCL handles Luxembourg's financial transactions with the International Monetary Fund (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. As at 31 December 2005, Luxembourg's quota, recorded in full on the BCL's 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 14.56% of Luxembourg's quota.

The IMF's operational budget defines the currencies to be made available to its members on a quarterly basis and the distribution of reimbursements among its members. During 2005, the BCL was instrumental in granting credits of €2.4 million related to IMF operations and was reimbursed to the tune of €61.1 million.

At the end of 2005, Luxembourg held 67.4% of its SDR allocation (58.0% in 2004) following the accumulation of net interest received on the SDR account and on the reserve position. As at 31 December 2005, the amount recorded on the SDR account was SDR 11.4 million.

One BCL staff member is on secondment to the IMF.

The BCL also attended the meetings of several working groups at the Organisation for Economic Cooperation and Development (OECD) and at the Bank for International Settlements (BIS), contributing in particular to the work of the OECD's Financial Markets Committee (FMC) and that of the BIS' Committee on the Global Financial System (CGFS).

3.2 European activities

3.2.1 European Constitution

On 10 July 2005, a majority of Luxembourg citizens supported the adoption of the European Constitution. 56.52% of them answered "yes" to the question "*Are you in favour of the treaty establishing a constitution for Europe, signed in Rome on 29 October 2004*?".

The referendum in Luxembourg was of a consultative, non-binding nature only, but the national Parliament, the Chamber of Deputies, announced it would fully respect its outcome. Luxembourg became the 13th country to ratify the European Constitution. The relevant acts, such as the draft law dated 25 November 2005 aiming at approving the Treaty establishing a European Constitution, Protocols attached to the Treaty establishing a European Constitution, and Annexes I and II of the Final Treaty, signed in Rome on 29 October 2004, were published on 9 December 2005 in *Mémorial A, Recueil de Législation* No 197 (page 3170).

3.2.2 Enlargement of the European Union

The Accession Treaty between the members of the European Union, Bulgaria and Romania was signed in Luxembourg on 25 April 2005. On 25 November 2005, Draft Law No 5515 aiming at approving the Accession Treaty was lodged with Luxembourg's Chamber of Deputies. The accession of Bulgaria and Romania completes the fifth enlargement of the European Union, which started in 1993 and saw ten new Member States joining on 1 May 2004.

Negotiations on the accession of Croatia and Turkey to the European Union got under way in Luxembourg on 3 October 2005.

3.2.3 Stability and Growth Pact

Following technical discussions to reform the Stability and Growth Pact (SGP) which had been ongoing since mid-2004, the Pact was considerably revised in 2005.

Under Luxembourg's presidency, the ECOFIN Council issued a report on 20 March 2005 to the European Council aiming to improve the Pact's implementation. The European Council endorsed this report, approving its proposals and conclusions, at its meeting on 22 and 23 March 2005.

As a result, the Council of the European Union adopted on 27 June 2005 inter alia (EC) Regulations No 1055/2005 and No 1056/2005 amending (EC) Regulations of the Council No 1466/97[1] and No 1467/97[2]. The ECOFIN Council also endorsed a revised code of conduct[3] on 11 October 2005.

The reform of the SGP had implications for its preventive and corrective arms, such as the definition of country-specific medium-term budgetary objectives and their adjustment paths, the definition of relevant factors to take into account if a deficit exceeds the reference value of 3% of GDP as well as the deadlines applicable to the excessive deficit procedure.

Throughout the discussions to reform the Pact, the Governing Council of the ECB considered it to be appropriate in its initial form, not requiring an amendment of its rules. The Governing Council did however acknowledge that the Pact's preventive measures could be improved. The Governing Council expressed on several occasions its concerns about making a formal change to the SGP, notably the measures relating to the excessive deficits, and recommended a rigorous and coherent implementation of this procedure.

Even though the ECB is not a signatory to the Pact and does therefore not play an active part in defining and implementing the Pact's procedures, the Governing Council was involved in the debate on the reform and issued various opinions on the new legal framework as well as a statement on the reform[4]. The Governing Council regularly draws attention to the fact that sound fiscal policies and a monetary policy based on price stability are fundamental for the success of the Union. Those are prerequisites for macroeconomic stability, growth and cohesion in the euro area.

It is essential that the Member States, the European Commission and the Council of the European Union implement the reformed pact in a strict and coherent way conducive to prudent fiscal policies.

3.2.4 The Economic and Financial Committee

A BCL representative participates in meetings of the Economic and Financial Committee (EFC). The Committee is composed of representatives from the finance ministries and central banks of EU Member States, the European Commission and the ECB. According to the Treaty on European Union, one of the tasks of 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 the compliance of Member States' economic policies with the broad economic policy guidelines and with the Stability and Growth Pact. The EFC also works on economic policy issues discussed at informal ECOFIN meetings, which are attended by the BCL's Governor.

The EFC meets six times a year in plenary composition but also meets in restricted composition. It is worth noting that the ECB participates in the Eurogroup Working Group, where it represents the Eurosystem.

3.2.5 The Committee on Monetary, Financial and Balance of Payments Statistics

In relation to the missions of the Statistical Office of the European Communities (Eurostat), the Committee on Monetary, Financial and Balance of Payments Statistics provides the European Commission with opinions on the development and the coordination of the various statistical areas. Central banks are represented on this Committee together with national statistical institutes. The BCL contributed to the activities of the Committee's working groups and task forces in 2005.

[1] (EC) Council Regulation No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies;

[2] (EC) Council Regulation No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure;

[3] "Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of the Stability and Convergence Programmes" (Code of Conduct), replacing the existing code of conduct as approved by the Council on 10 July 2001.

[4] *ECB Opinion of 3 June 2005 (CON/2005/17) on proposal for a Council regulation amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure; ECB Opinion of 3 June 2005 (CON/2005/18) on a proposal for a Council regulation amending Regulation (EC) No 1466/97 on the strengthening of the surveillance of the surveillance of budgetary positions and the surveillance and coordination of economic policies; press release dated 21 March 2005.*

3.2.6 Consultative Committees

3.2.6.1 The Statistics Committee

The Statistics Committee has been set up by the BCL to ensure a constant dialogue between the financial sector organisations that are subject to statistical reporting requirements and the main users of these data.

3.2.6.2 The Monetary and Financial Statistics Consultative Commission

The Monetary and Financial Statistics Consultative Commission has been set up by the BCL to enhance the dialogue between reporting agents and the central bank. The Commission also ensures the efficiency of the reporting procedures in the area of monetary and financial statistics.

3.2.6.3 The Balance of Payments Consultative Commission

The Balance of Payments Consultative Commission, established in 2001, assists the BCL in its mission to collect statistical data for the compilation of balance of payments and international investment position data. It seeks to ensure an efficient organisation of the collection procedures, taking into account the responsibilities borne by the declarants.

In 2005 the Commission was consulted extensively within the framework of activities aiming to set up a new collection system for portfolio investments.

3.3 National activities

3.3.1 Legal developments

During the year, the BCL followed the legal and regulatory developments falling within its field of competence as well as other important texts for Luxembourg.

In particular, the following texts are noteworthy:

3.3.1.1 Monetary law

In 2005 a silver coin was issued by the BCL to commemorate Luxembourg's Presidency of the Council of the European Union.

The coin, with a face value of €25, has been legal tender since 24 January 2005 according to a Grand-Ducal Regulation of the same day (published in *Mémorial A*, No 7 of 25 January 2005).

Draft Law No 5439 was tabled by the government on 8 February 2005 to implement the Council Framework Decision of 28 May 2001 combating fraud and counterfeiting of non-cash means of payment. The objectives of the Framework Decision are to ensure that fraud and counterfeiting of these means of payment, at least when they are provided with a special form of protection against imitation or abuse, are recognised as criminal offences and are subject to effective, proportionate and dissuasive sanctions in all Member States. These measures are aimed in particular at electronic payment cards.

Luxembourg's Penal Code does not specifically provide for protection against fraud and counterfeiting of electronic means of payment.

3.3.1.2 Financial law

Financial collateral arrangements

The law of 5 August 2005 relating to financial law arrangements implementing the Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements was published in the *Mémorial A*, No 128 of 16 August 2005.

The Opinion of the ECB on the draft law was published on 25 May 2005 (CON/2005/12). The Luxembourg legislator has duly taken account thereof.

The ECB welcomes the fact that the draft law does not avail itself of any opt-out possibilities provided for in the Directive and endorses the grouping of the provisions on different kinds of financial collateral arrangements into a single law. It is important to provide for simple and reliable methods of collateralisation, which include efficient enforcement methods. This is particularly important for the smooth functioning of the single monetary policy of the Eurosystem.

The ECB also welcomes the fact that the scope of application of the draft law goes beyond the obligations provided for in the Collateral Directive. In respect of pledges, the draft law will apply irrespective of the quality of the parties to the financial collateral arrangements.

The ECB expresses its view on the material scope of application of the law. Assets being defined as financial instruments and claims, the ECB understands that credits granted in the form of bank loans would be covered by the draft law. For the sake of clarity, the ECB recommends defining the concept of netting agreements.

Furthermore, the draft law extends the list of issues that may be governed by the conflict-of-law rule provided for in the Collateral Directive. As the Hague Convention on the Law applicable to Certain Rights in respect of Securities held with an Intermediary provides for a different conflict-of-law rule, the ECB points out that if the Hague Convention were to be ratified subsequently by the Community, it would not be possible to apply the conflict-of-law rule established by the draft law in the light of the Convention.

Most of the ECB's comments relate to the statutory lien granted to the depositories principally operating a securities settlement system (the "depositories"), particularly in respect of the lien granted to the BCL, the ECB and the ESCB central banks by Article 4 (paragraph 4) of BCL's Founding Law.

Point 8 of the ECB Opinion reads as follows: "The statutory lien granted to the depositories on the assets of a participant's clients held in relation to the system which they operate increases, in terms of scope, the risk of potential conflicts between the statutory lien of the depositories and the lien of the BCL and the ESCB central banks. It is noted in this respect that the lien of the BCL and the ESCB central banks has, in large part, been introduced into the law in Luxembourg in order to reinforce the BCL's financial position, thereby assisting the BCL and the Eurosystem in performing their central banking tasks. In this regard the ECB takes note of the particular situation of the BCL within the Eurosystem. The risks stemming from the BCL's operations with the financial sector are of systemic relevance in view of the relative importance of the financial market in Luxembourg. The BCL is the third largest national central bank within the Eurosystem in terms of liquidity granted to credit institutions and the amount of collateral used for monetary policy operations. A substantial part of the assets used to collateralise Eurosystem credit operations on a cross-border basis originates in Luxembourg. Furthermore, the Standards for the use of EU Securities Settlement Systems in ESCB credit operations, published in 1998, are relevant from the perspective of the Eurosystem as a user of a central securities depository operating an SSS. Standard 1 states that an SSS must provide adequate protection of the rights of the NCBs and the ECB in respect of securities held on their accounts in such systems. Against this backdrop, the ECB would strongly prefer a statutory lien granted to the depositories that does not prejudice the legal position of the BCL and the ESCB central banks in performing their central banking functions. The ECB hopes that the relevant provisions of the draft law can be amended accordingly in order to fully secure the legal position of the BCL and the ESCB central banks."

The Luxembourg law has been amended on this point (Article 25.4).

Taxation of savings income

The law of 21 June 2005 implementing Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments entered into force in Luxembourg on 1 July 2005 (*Mémorial A*, No 86 of 22 June 2005).

In principle, according to the Directive, each Member State shall inform the other Member States concerning interest payments to individuals having their residence in another Member State. However, three countries, one of which is Luxembourg, benefit from a transitional period during which a withholding tax levied by the relevant States will apply to the interest payments.

The law introduces a withholding tax on savings income in the form of interest payments from Luxembourg in favour of beneficial owners being private individuals having residence for tax purposes in another Member State of the European Union. Except for the cases provided for in the law, the withholding tax is fixed at a rate of 15% during the first three years and 20% during the following three years. The rate will increase to 35% thereafter.

The revenue raised by this tax will be shared with the Member State of residence of the beneficial owner of the interest.

A grandfathering clause exists in favour of payments resulting from negotiable debt securities meeting specific issuance criteria.

For depositors having their residence in Luxembourg, the Founding Law of 23 December 2005 relating to the introduction of a withholding tax in full discharge on certain interests produced by personal savings should be mentioned. The law introduces a withholding tax in full discharge of 10% on interests generated by saving products owned by private individuals residing in Luxembourg. Exemptions are provided in relation to a traditional savings account up to a threshold fixed by the law. Derogations are also foreseen for income deriving from UCIs and specific negotiable debt securities. Furthermore, the law abolishes the wealth tax on private individuals having their residence in Luxembourg or not. The law entered into force on 1 January 2006 (*Mémorial A*, No 124 of 28 December 2005).

3.3.2 External Committees

3.3.2.1 The Economic Committee *(Comité de conjoncture)*

The Economic Committee, established in 1975, acts on the basis of the legislation which authorises the government to take measures to stabilise employment and growth. Thus, the Committee provides a framework for examining business cycle fluctuations in the country's economy and for monitoring economic policy issues as they arise. The BCL belongs to the Economic Committee for two reasons: it collects information on Luxembourg's cyclical position and it contributes to the Committee's work by monitoring and commenting on the latest developments in the monetary domain and in the financial sector.

3.3.2.2 The Consumer Price Index Commission (*Commission de l'indice des prix à la consommation)*

The BCL has observer status at the meetings of the Consumer Price Index Commission, which is in charge of advising and assisting *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 the compliance of this index with national and European regulations.

3.3.3 BCL committees

The BCL has a number of committees on whose expertise it relies, namely:

The Information Technology Committee

The Legal Committee

The Fiduciary Money Committee

The Market Operations Committee

The Statistics Committee

The Settlement and Clearing Systems Committee

The Balance of Payments Consultative Commission

The Monetary and Financial Statistics Consultative Commission

The work of these committees is described in the corresponding sections of this annual report.

3.3.4 Training at the BCL

The BCL organises internal training on subjects within its competence, including: economic and monetary union and the BCL; monetary policy-strategy and instruments; monetary policy operations; payment and clearing systems. These courses may, under certain conditions, be given outside the BCL.

The BCL is a shareholder of the *Agence de Transfert de Technologie Financière* (*ATTF*, agency for the transfer of financial technology). The *ATTF*, founded in 1999, aims to share Luxembourg's financial expertise with developing countries as specified by the Luxembourg government. As in the past, the BCL participated in *ATTF* seminars for bankers and officials from third countries. In 2005, the BCL welcomed delegations from China, Egypt, El Salvador, Kazakhstan, Mongolia, Tunisia, and Uzbekistan.

3.3.5 External events

3.3.5.1 Conferences and international meetings

In March 2005, the Governor of the Banque centrale du Luxembourg joined a panel of central bankers at the European Banking & Financial Forum in Prague. His speech was entitled *Financial Stability from the Perspective of Luxembourg's Financial Sector.* The Governor attended the 13th annual meeting of central bank governors from French-speaking countries organised by the central bank of Morocco from 9-12 May 2005. Mr Mersch gave a speech on the conditions required for a successful liberalisation of the capital account.

Professor Axel Weber, President of the Deutsche Bundesbank, gave a lecture on the competition between financial systems entitled *Finanzsysteme im Wettbewerb* at the BCL on 28 April 2005.

On 11 October 2005, Mr Jacques de Larosière, Honorary Governor of the Banque de France, former Managing Director of the International Monetary Fund and former President of the European Bank for Reconstruction and Development, was the speaker at the third Pierre Werner Lecture organised since 2003 by the BCL. His speech, *Fiscal policy: A challenge for the European Monetary Union*, was produced as a brochure.

On 8 and 9 November 2005, the BCL and the Islamic Financial Services Board jointly organised the *Islamic Financial Services Forum: the European Challenge*. This international forum, being held for the first time in Luxembourg, gave its attendees an opportunity to better comprehend the characteristics of Islamic finance.

The BCL was also represented at the second Euro-Mediterranean seminar organised jointly by the Banque de France and the ECB. The seminar brought together the Eurosystem central banks and those from Mediterranean countries outside the euro area. The BCL also took part in the second high-level seminar involving the Eurosystem and the Bank of Russia in St Petersburg, and in the second high-level seminar between the Eurosystem and the *Executives' Meeting of East Asia-Pacific Central Banks* (EMEAP) in Frankfurt.

The BCL is also contributing to academic activities, with its Governor participating in the 35th Symposium of the University of St Gallen and in events organised by the Universities of Princeton and Oxford. The BCL also gave a presentation on the Eurosystem which was organised by the ECB in Frankfurt for students from Miami University (Ohio).

The Governor of the BCL is also President of the *Bridge - Forum Dialogue*, an association which brings together high-level executives of European institutions in Luxembourg with leaders from the Luxembourg financial, economic and legal community. The Bridge Forum serves as a platform for interdisciplinary discussion and in 2005 three conferences were organised at the initiative of the BCL. Mr Philippe Maystadt, President of the European Investment Bank, spoke about public and private partnerships, and Sir Tim Lankester, President of Corpus Christi College, Oxford, and Mr Rolf Tarrach, Rector of the University of Luxembourg, held a debate, chaired by Mr Yves Mersch, entitled *Higher Education in Europe: Can we be equal and excellent too?* Mr Mersch was also in the chair when other speakers were invited, including the President of Mali, Mr Amadou Toumani Touré, who gave a talk entitled *Afrique - Europe - Quel partenariat?* (Africa - Europe: What kind of partnership?).

3.3.5.2 Bilateral events

In 2005, the BCL continued to strengthen its links with other central banks.

A delegation from the National Bank of Cambodia, headed by its Governor, Mr Chea Chanto, paid a working visit to Luxembourg from 28-30 June 2005. On this occasion, the Governors of both central banks signed an agreement to step up cooperation in respect of operations and training.

Also in 2005, the BCL welcomed representatives from the financial sector and from the main trade unions.

In October 2005 Mr Mersch went to Slovakia for an exchange of views with the Governor of *Národná banka Slovenska* (National Bank of Slovakia), Mr Ivan Šramko, on the preparations for the introduction of the euro in Slovakia.

3.3.5.3 Other meetings in Luxembourg

The BCL received a number of official delegations, notably a high-level one from Bhutan which included a member of the royal family, the Director General of the Finance Ministry as well as the Deputy Director General of the *Royal Monetary Authority*, Bhutan's central bank.

On 4 April 2005, Mr Mersch welcomed a delegation from the Finance Commission of the German Parliament, accompanied by Mr Roland Lohkamp, the German Ambassador, for a meeting. Their discussion covered in particular the financial and banking situation in Europe, including the reform of the Stability and Growth Pact.

The Budget Committee (BUCOM) of the ECB met on 16 and 17 June 2005 at the BCL. The tasks of the committee consist of assisting the Governing Council to evaluate the budgetary proposals made by the Executive Board of the ECB. The meeting in Luxembourg was of an informal nature and focused on the following topics:

- zero-based budgeting;
- financial monitoring of ongoing projects;
- monitoring of research and development activities concerning banknotes.

In September 2005, the BCL gave a presentation to 30 Indian senior executives during their visit, which was jointly organised by the *Administrative Staff College of India* and the *Maastricht School of Management*.

At the invitation of Mr Mersch, Governor of the BCL, Mr Jaime Caruana, Governor of the Banco de España and President of the Basel Committee on Banking Supervision, paid a working visit to Luxembourg on 15 and 16 September 2005. Mr Caruana held a speech during a conference entitled *Basel II and Financial Stability*, which was jointly organised by the BCL, the European Investment Bank, PRMIA (Professional Risk Managers' International Association) and Ernst & Young.

3.3.5.4 Death of Willem F. Duisenberg, first President of the ECB

Dr Willem F. Duisenberg, the first President of the ECB, passed away at the end of July 2005. He was a former Finance Minister of the Netherlands, former Governor of De Nederlandsche Bank, and President of the ECB from 1998 to the end of 2003, and played a decisive part in the establishment of the Monetary Union and in the successful introduction of the new currency, the euro.

Mr Duisenberg visited the BCL on several occasions, e.g. in May 2001 for the official inauguration of the Bank and, for the last time, in July 2002 for the 100th meeting of the Governing Council of the ECB.

On hearing of Mr Duisenberg's unexpected death, the Governor expressed his personal sorrow as well as that felt by the other Council members and the staff of the BCL.

Willem F. Duisenberg and Yves Mersch in October 1998 outside the Banque centrale du Luxembourg.

3.4 Communication activities

3.4.1 Periodical bulletins

In 2005, the BCL published three bulletins, one of which was on financial stability. In addition to providing news as well as economic and financial reports on the economy of Europe and of Luxembourg, the BCL's bulletins (in French or German) were as follows:

Bulletin No 2005/1, *Revue de stabilité financière*

- The financial environment
- Luxembourg's financial sector in 2004
- The insurance sector
- The BCL's position on measures relating to the reorganisation and winding-up of credit institutions

Bulletin No 2005/2

- *Sektorale Spezialisierung und Produktivität der Luxemburger Wirtschaft im internationalen Vergleich*
- Estimating the real natural interest rate for the euro area and Luxembourg
- Price rigidity. A study of macroeconomic data on consumer prices in Luxembourg
- Cape Verde's exchange rate policy and its alternatives

Bulletin No 2005/3

- Index calculation of the monetary conditions for the euro zone and Luxembourg
- Global exterior position of Luxembourg
- *Das Preissetzungsverhalten im Euroraum*
- Price-setting behaviour: results from a survey of Luxembourg companies
- *L'identité de Fisher et l'interaction entre inflation et la rentabilité des actions: l'importance des régimes sous-jacents aux marchés boursiers*

3.4.2 Working papers

In its working papers, the BCL publishes the results of research conducted by its staff. Five such papers were published in 2005:

No 13: *Les déterminants du solde de la balance des transactions courantes au Luxembourg*, by Abdelaziz Rouabah, February 2005

No 14: *Nominal rigidities and inflation persistence in Luxembourg: a comparison with EU15 member countries with particular focus on services and regulated prices*, by Patrick Lünnemann and Thomas Y. Mathä, April 2005

No 15: *Estimating the natural interest rate for the euro area and Luxembourg*, by Ladislav Wintr, Paolo Guarda and Abdelaziz Rouabah, June 2005

No 16: *Cape Verde's exchange rate policy and its alternatives*, by Romain Weber, October 2005

No 17: *Consumer price behaviour in Luxembourg: evidence from micro CPI data*, by Patrick Lünnemann and Thomas Y. Mathä, November 2005.

3.4.3 The website

The BCL's website, www.bcl.lu, provides information about the Bank's activities and services, and about its internal organisation. It also contains links to other central banks in the European Union and to the ECB's website.

Overhauled in 2004, the website offers its visitors a powerful search engine, a configurable web mailing list and clearly arranged information for the different groups served by the BCL: financial professionals, journalists, university students, researchers, coin collectors, etc.

The website will play an increasing role in the diffusion of the BCL's publications. It exists in English and French, while the documents it offers are in their original language version (English, French or German).

All BCL publications can be viewed and downloaded from the Publications section at www.bcl.lu. Hard copies are available from the BCL on request, as long as stocks last.

3.4.4 The library

In 2005, the BCL opened its new library. With the support of the National Library of Luxembourg, the BCL has joined the country's library network and uses the Aleph library management system, as do a number of other central banks. The library currently offers 9,000 publications on monetary, financial, economic and legal affairs within the euro area issued by organisations such as the World Bank, the IMF, the OECD, the BIS and the European Commission, and by other central banks. The library also has many CD-ROMs (specialist publications, studies, statistics, laws and regulations) and provides access to databases.

Members of the public can use the library by sending a request by e-mail to bibliotheque@bcl.lu or by fax to +352 4774 4910.

Artist: Jean-Marie Biewer
Title: Paintings or Paint-Things
Material: Oil on canvas
Format: 110 x 110 cm
BCL collection

4. THE BCL AS AN ORGANISATION

4.1 Structure of the BCL

4.1.1 The Council and the Audit Committee

The Council

Article 6 of the Founding Law of 23 December 1998 defines the powers of the Council of the Bank. In 2005, the Council consisted of the following members:

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

During 2005, the Council held five meetings. Within the framework of **monitoring the financial situation** of the Bank, the Council approved the financial accounts as at 31 December 2004, the budgetary trends and subsequently, the budget and the organisation chart of the Bank for the 2006 financial exercise.

The Council also observed and commented on economic and financial developments on a national and international basis and was kept informed of the decisions taken by the Governing Council of the ECB, concerning for instance the future of the national payment systems.

Within the framework of the **state budget procedure**, the BCL has given an opinion to the Financial Commission of the Chamber of Deputies. The draft opinion was previously presented to the members of the Council for their comments.

Finally, the Council appointed the members of the Audit Committee for the 2006 financial exercise.

The Audit Committee

At its meeting on 8 December 2005, the Council renewed the mandates of the non-executive members of the Audit Committee for 2006: Messrs. Pit Hentgen, Mathias Hinterscheid and Nico Reyland. Mr Mersch is an *ex officio* member in his function as Governor of the Council.

The Audit Committee held three meetings in 2005.

4.1.2 The Board of Directors

The Board of Directors is the superior executive authority of the BCL. It takes the decisions and draws up the measures necessary for the Banque centrale du Luxembourg to carry out its tasks.

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

The Board of Directors consists of a Director-General and two Directors.

Director-General: Yves Mersch
Directors: Andrée Billon et Serge Kolb

4.1.3 Supervisory mechanisms

Various supervisory mechanisms have been set up by the BCL in order to ensure the efficient functioning of its operations in a secure environment and while respecting its budget allocations.

Internal supervisory mechanisms

The BCL's internal supervisory system is based on general rules and regulations, which are widely accepted as standards by the financial sector, and it also takes the BCL's specific needs as a central bank into consideration. The principles of internal supervision and the assignment of various responsibilities in this area are laid down in internal circulars and in the Bank's handbook of procedures.

An initial internal supervisory system concerning the general management of the BCL has been put in place by the Board of Directors. The senior management of the BCL and their staff are responsible for the proper functioning of this supervision. Some functional checks are carried out by specific administrative units, ensuring a separation of the tasks to be carried out by the BCL.

The management of financial risks is performed by the organisation and risk unit, which tracks all the portfolio positions of the BCL on a daily basis, independently of the front office. Daily reports on movements in portfolio positions that affect performance and risk exposure are sent to staff specialists and heads of unit.

The BCL's strategic orientations are defined on the basis of performance measurement according to the Balanced Scorecard method and of the principles laid out in the *Positionnement de la Banque*, a document describing the Bank's positioning which has been approved by the Council and published on the BCL's website.

In order to obviate any risk of money laundering, a compliance officer has been supervising the BCL's banknote and coin transactions in the interest of the general public and of professionals of the financial sector since 2005.

A second level of internal supervision is provided by the internal audit unit, which analyses and evaluates on the basis of predefined objectives and a precise methodology the appropriateness and efficiency of the existing supervision. Internal audit is a supervisory unit independent of the BCL's other administrative units and it reports directly to the Governor.

The head of internal audit may also be involved in the work of the Audit Committee. Generally speaking, the internal audit unit pursues the objectives and follows the reporting procedure of the ESCB.

External supervisory mechanisms

An initial external supervision of the BCL's activities, namely the checking of its accounts, is carried out by the Bank's independent external Auditor, who is nominated yearly in a proposal sent by the Council of the Bank to the government.

At the request of the Council, the independent Auditor carries out specific complementary checks and analyses during the year. At the European level, the Auditor of the Bank is approved by the Council of Ministers upon the recommendation of the Governing Council of the ECB. In this context, the Auditor is given responsibility for particular missions with regard to the Eurosystem.

The Statute of the ESCB and of the ECB states that the central banks shall act in accordance with the guidelines and instructions of the ECB. The Governing Council of the ECB monitors respect for those provisions at the European level and may also request additional information.

4.1.4 Financial reports, annual accounts and annual budget

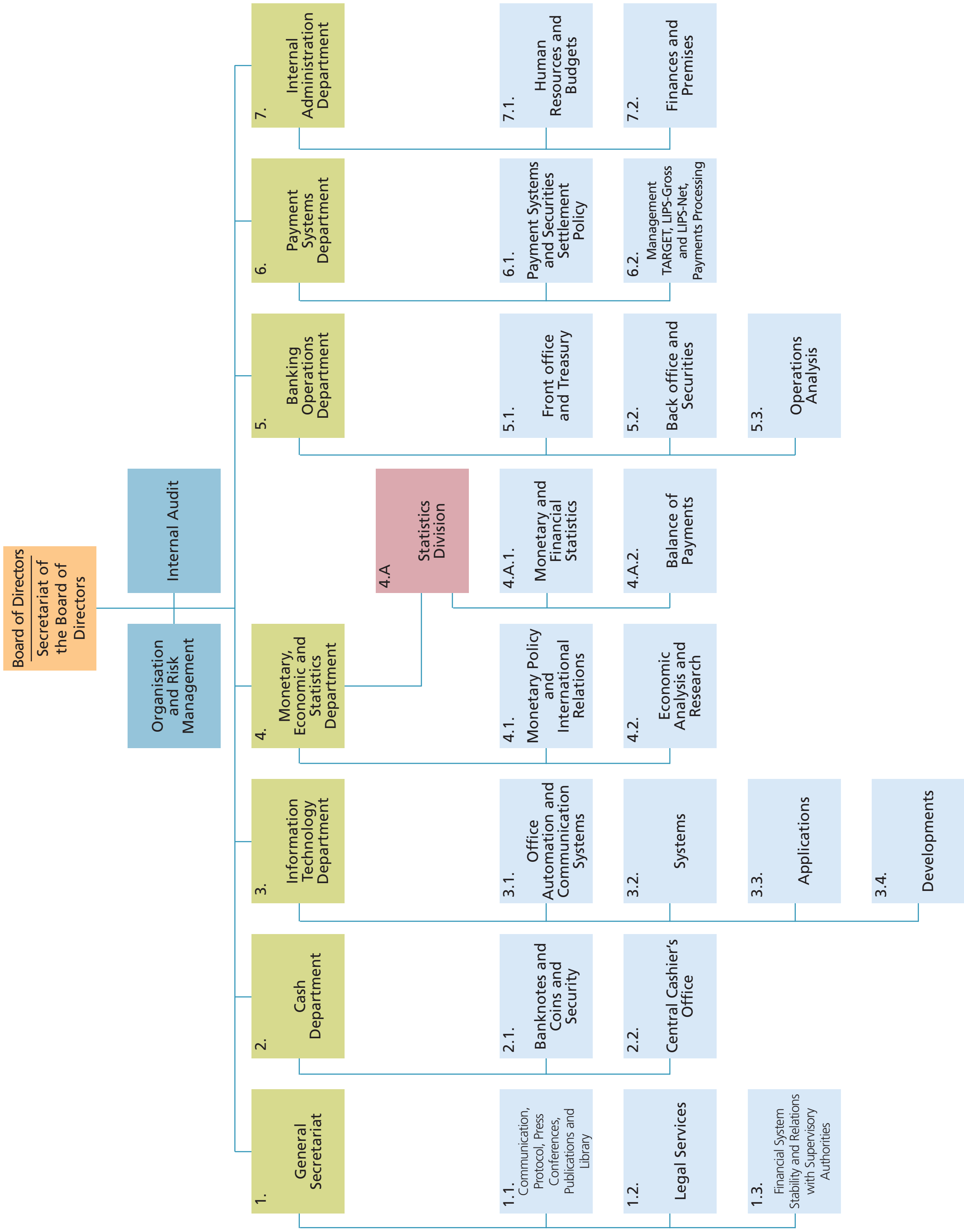
A copy of the Bank's financial reports, annual accounts and annual budget, as approved by the Council of the Bank, are presented to the government and the Chamber of Deputies. The government in Council has to decide whether to grant discharge to the BCL's decision-making bodies. This decision does not call into question the duties of the Bank within the ESCB and is taken without prejudice to the independence of the BCL vis-à-vis the government. The annual accounts and the decision granting discharge to the BCL's decision-makers are published in the *Mémorial*.

4.1.5 Corporate governance

The BCL has established a code of conduct, which defines internal and external rules of conduct applicable to all its staff. Without prejudice to public service law, social legislation or pre-existing contractual obligations, the code of conduct provides for ethical standards based on non-discrimination, solidarity, efficiency and independence which are to be strictly observed by all staff members. Moreover, certain staff members with special responsibilities are subject to particular provisions of the code of conduct.

The ECB has required, since 2002, that all members of the Governing Council observe a code of conduct which lays down the highest standards of professional ethics. The members are expected to act honestly, independently, impartially, with discretion and without regard to self-interest and to avoid any situation liable to give rise to a personal conflict of interests. They must continue to abide by these standards for one year after leaving office.

4.1.6 The BCL's organisation chart



4.2 Human resources

4.2.1 Staffing

During 2005, the total number of staff slightly fell by 1.46%, reaching 203 on 31 December 2005 (including the Board of Directors), equivalent to 192.5 full-time positions and representing a 1.79% decline compared with 2004. Eight different nationalities are represented on the staff, thus contributing to the Bank's cultural diversity.

The fact that the number of staff members decreased proportionally more slowly than the number of full-time equivalent positions is the result of a constant increase in the staff members working part-time during 2005 compared with 2004.

On 31 December 2005, 21 staff members worked part-time, as follows:

- part-time work (50%): 5 staff members
- part-time work (75%): 6 staff members
- leave for part-time work: 10 staff members

An additional three staff members were on part-time parental leave.

Finally, two staff members were granted unpaid leave and two were on special leave.

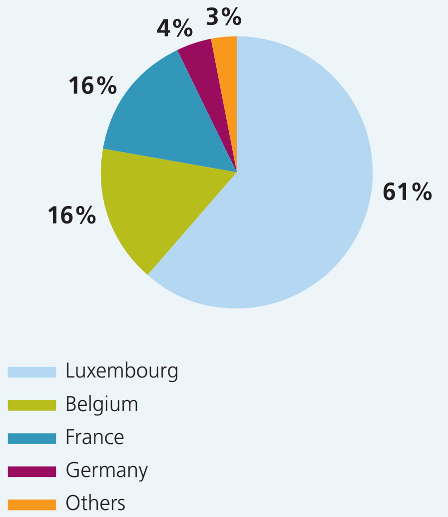
The average number of staff at the BCL in 2005 was 205.5, compared with 205 in 2004.

The overall approved headcount ceiling for 2005 amounted to 214 full-time equivalent positions. This number remains unchanged for 2006.

In 2005, four staff members left the Bank, one of whom retired. There were no recruitments. The BCL received 380 unsolicited job applications and 194 applications for internships or student jobs.

The BCL offered internships varying from six weeks to two months to eight students following university courses related to the Bank's activities and a one-year internship in the Monetary, Economics and Statistics Department to a PhD student.

CHART 1: STAFF MEMBERS BY NATIONALITY



The average age of BCL staff members slightly increased from 37.30 years in 2004 to 38.47 years as at 31 December 2005. On that date, 34% of the staff were female and 66% male.

CHART 2: STAFF MEMBERS BY AGE GROUP

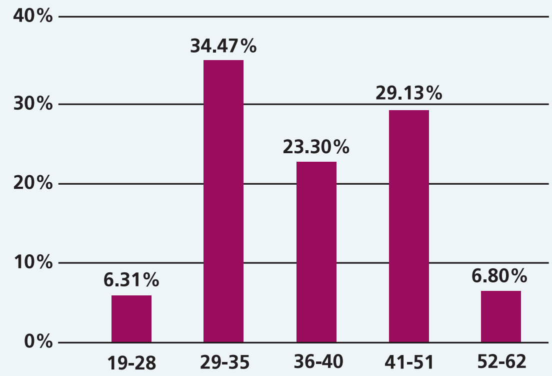
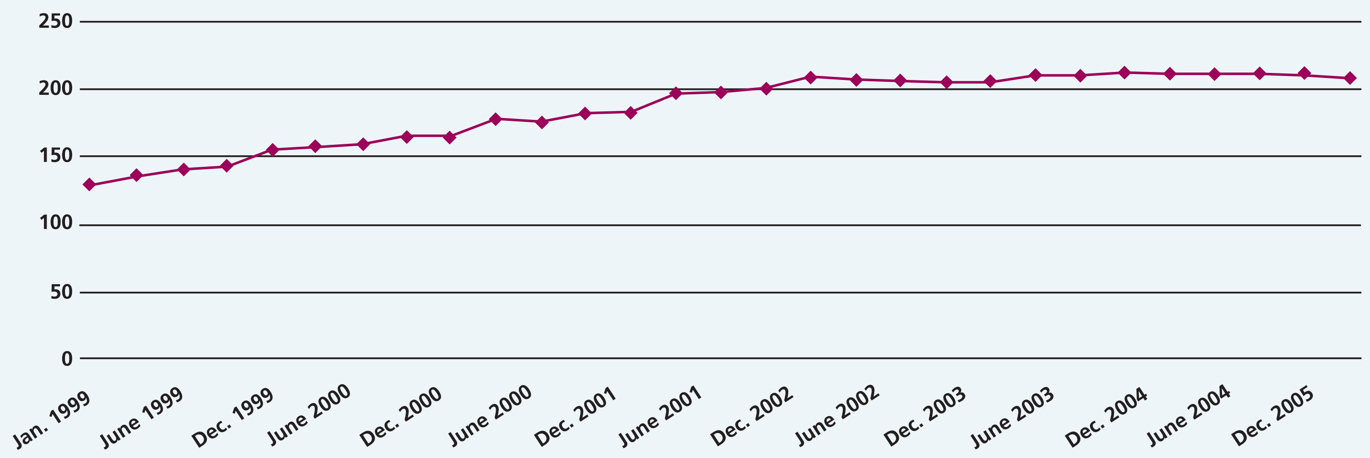


CHART 3: STAFF NUMBERS SINCE 1 JANUARY 1999



4.2.2 Human resources management

From September to November 2005, the Board of Directors commissioned an external consultant to analyse existing processes within the Bank. The study produced a diagnosis of the current situation and enabled human resources management to draw up a specific action plan to mobilise the skills of the BCL's staff members, giving them a greater say in their career development. In this context, much greater emphasis will be placed on recognising performance and on following up development possibilities (internal job rotation, working experience within the ESCB, training).

The annual appraisal of each staff member should consider how well he/she has attained specific objectives as well as identify training needs.

4.2.3 Staff training

The Bank sees itself as a centre of competence, if not excellence, and aims to keep the public's confidence. It is one of the necessary conditions for an efficient development of the Bank.

In order to make sure that training fully performs this role, a supplementary part was elaborated during 2005 in the framework of the Bank's training policy. A concept aiming at reconciling the objectives with the requirements following from the Bank's strategy with the identification of the training needs should permit the development of an efficient training plan for every staff member. Essentially, this means that defining training needs in terms of objectives should be favoured in order to make the right training choices. These needs will be identified by specialists who know the Bank's activities well and give priority to organisational effectiveness. After drawing up this very ambitious concept, it will need to be set up at the Bank in 2006 and 2007.

The training policy to be developed within the BCL should aim:

- to develop a higher degree of professional mobility within the BCL by ensuring an appropriate balance between the staff members' skills and the Bank's requirements;
- to promote a closer identification with the Eurosystem. This goal was given clear expression in three documents adopted by the Governing Council of the ECB in January 2005: the Mission Statement, the Strategic Intents and the Organisational Principles of the Eurosystem. The training offered in this context aims to foster a team spirit and to help all staff members understand that they are an integral part of the Eurosystem.

Therefore, besides the basic internal training given to new recruits, all staff members are encouraged to do external training, mainly with other central banks in the ESCB so as to consolidate their professional skills.

4.2.4 The Pension Fund

Article 14 of the Founding Law of 23 December 1998 relating to the monetary status and the Banque centrale du Luxembourg 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 also governed by this statute, which reads as follows (paragraph 4(b)):

"The pensions of the Bank's agents shall be paid by the Bank. These costs shall be financed by a pension fund of the Bank. The pension fund shall be financed on the one hand by statutory deductions from agents' salaries in accordance with the rules governing the pension scheme corresponding to their status, on the other hand by contributions made by the Bank itself."

The Law also provides for transitional arrangements for BCL agents who contributed previously to another pension fund, as follows: "Luxembourg pension funds which have received contributions for persons who are, or become, agents of the Bank on the day this Law enters into force, shall pay those contributions into the Bank's pension fund" and "the contribution periods of those agents to these pension funds are fully valid as contribution periods to the Bank."

The BCL's pension fund, which started operating in 2001, is governed by a set of internal rules. It has a decision-making Executive Committee (*Comité directeur*) and a consultative Tactical Benchmark Committee. The Executive Committee consists of the BCL's Board of Directors, two elected representatives from the staff, two co-opted members acting as delegated managers and one member designated by the Staff Committee.

The Luxembourg Supreme Court of Justice, in a judgement dated 20 April 2005, ordered two Luxembourg pension funds to pay to the BCL's pension fund, in accordance with Article 35 of the Founding Law of 23 December 1998, the contributions they had received.

The financial aspect having been clarified by this judgement and its subsequent enforcement, the legal aspect still requires further clarification in respect of the coordination of national, and even international, pension schemes, involving transfers to and from the BCL's pension fund.

In concrete terms, the pension fund needs to be recognised as a fully-fledged actor in the decision-making process affecting individual rights with regard to the transfer of pension rights within the country and abroad, but also in respect of the scope of decisions relating to occupational disability and the administrative coordination underlying these different fields.

The need for legal safety and the protection of individual rights has led the Bank to meet - immediately after the judgment entered into force of *res judicata* - representatives of other social security bodies as well as the civil servants' administration, in order to propose the required legislative reforms during 2006. These reforms have become necessary in order to reconcile the need for workers' mobility with the principles of financial independence of the Bank and its functional autonomy.

Against this backdrop, it has been agreed that a draft law amending the law of 28 July 2000 coordinating the different pension schemes and any other texts dealing with individual pension rights and beneficiaries of the BCL's pension fund be prepared by the government department responsible for monitoring social security and submitted to the national legislator.

4.3 Buildings/facilities

Construction of the shell of the BCL's new building in the boulevard Prince Henri continued in 2005. In addition to work on the stone and glass façade, the installation of technical equipment also began.

The building will be completed on time, at the end of 2006, and on budget.

Concerning the Bank's main building, efforts in 2005 were mainly focused on the maintenance of the building and its facilities. Work was also carried out to ensure that its equipment and fittings comply with the legal requirements.

An analysis concerning health and security at the workplace has been undertaken together with the public service medical department.

4.4 Accounting and the budget

4.4.1 Accounting and finance

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 Eurosystem requires the daily reporting of balance sheet data from each of its members according to harmonised rules.

The controlling systems in place proved to be effective during the year.

The Bank regularly checks the development of balance sheet, off-balance-sheet and profit and loss items. Investments, revenues and expenses are in particular closely monitored, with special attention paid to signing powers.

The cost accounting system gives an indication concerning costs and invoicing of services. The methodology follows the rules recommended by the Eurosystem. It consists of allocating BCL's operational expenses according to their destination, e.g. according to the respective sections and units, and it permits the costs of each of the Bank's activities to be determined.

The monthly balance sheet of the Bank is published on its internet site.

The management information system meets the need to follow the Bank's activities. It is based on a set of indicators, which are calculated daily, weekly, monthly, quarterly and annually. These tables include all activities of the Bank. The analysis of the profit and loss items is complemented by an analysis concerning the net profit 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 monitors within this framework 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. It carries out prospective analyses of external factors like interest rates, exchange rates and other variables of the Eurosystem and of the economic situation.

The Bank's decision-making bodies are regularly informed of the results in order to be in a position to decide on future directions and actions to take.

The asset/liability committee closely follows the risk exposure and the financial situation during the year, and in particular the risk resulting from the appropriateness of assets and liabilities. It checks the investment limits imposed by the balance sheet positions of the NCB and the ECB.

4.4.2 Budget

Every year in December, the BCL's Council approves the budget for the coming year. The 2005 budget was drawn up in accordance with a budgetary procedure which aims to manage the Bank's resources in a rational manner.

The procedure ensures that the limit set when drawing up the budget will not be exceeded. Within this limit, expenses can be engaged only as far as they are in line with the Bank's rules regarding profitability and economic efficiency. The operational costs for 2005 have stayed within the budgetary limit approved by the Council.

All in all, it is important to underline that the BCL's budget reflects the Bank's corporate values, which are:

- professionalism
- quality in all its services
- stability provided by taking a long-term perspective
- objectivity resulting from the undiscriminating application of precise rules
- integrity resulting from the transparency of its internal operations and respect for professional ethics.

As regards the budget projections for 2006, a certain number of priorities have been identified during a reassessment of the BCL's objectives, notably: the formulation of an attractive vision for the Bank; the creation of a common orientation; the strengthening of the efficiency and a greater sense of individual responsibility; a streamlining of the organisational structure; and the mobilisation of the staff members' skills. All these priorities need to be further developed.

Finally, several options for centralising certain administrative tasks and for reorganising some internal resources have to be explored.

4.5 Internal audit activities

The BCL's internal control system is based on generally accepted standards prevailing in the financial sector and adapted to its activity as a central bank. The principles of internal control as well as the various responsibilities resulting thereof are described in the internal Manual of Procedures.

The main activity of the internal audit function is to assess the internal control system. The Internal Audit unit reports directly to the President of the Bank. The internal audit mission statement 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 (IIA) and the ESCB Audit Policy.

The Internal Audit unit is in charge of the follow-up of the recommendations issued during its audit activities. Based on the annual internal audit plan which comprises audit engagements that are coordinated by the Internal Auditor's Committee at the level of the ESCB, as well as audit engagements at a national level, the Internal Audit unit carried out various reviews in 2005 in the fields of the Exchange Rate Mechanism (ERM) II, of the transport and storage of banknotes and coins, of statistical systems, and of telecommunication and information systems.

4.6 Financial statements as at 31 December 2005

Preamble

Only the French version of the present financial statements has been reviewed by the Independent Auditor. Consequently, the financial statements only refer to the French version of the financial statements; other versions result from a conscientious translation made under the responsibility of the Board of Directors. In case of differences between the French version and the translation, the French version is binding.

4.6.1 Key figures as at year-end (in euro unless otherwise indicated)

	2004	2005	Variation en % 2005/2004
Total assets	34,795,519,545	43,907,910,680	26%
Banks' current accounts	5,063,321,077	6,810,321,790	35%
Claims on credit institutions	28,353,710,277	31,797,051,656	12%
Own funds (1), revaluation accounts, administrative provisions and specific banking risks	456,816,923	531,760,240	16%
Net result of banking activities (2)	81,998,162	84,434,406	3%
Total net revenues	36,851,687	42,335,991	15%
Administrative expenses	29,225,981	29,236,695	0%
Net profit	2,605,967	2,601,176	0%
Cash Flow (3)	56,200,003	74,824,801	33%
Personnel	206	203	-1%
BCL's part in the capital of the ECB	0.1568%	0.1568%	
BCL's part in the Eurosystem's monetary policy operations	**8.213%**	**7.832%**	

(1) Capital, reserves, provisions for general banking risks and net profit to be affected to the reserves.

(2) Net interest income, net result from fees and commissions, net result on financial operations.

(3) 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.

4.6.2 Report of the Independent Auditor

To the Council of the Banque centrale du Luxembourg

To the Government

To the Chamber of Deputies

We have audited the attached financial statements of the Banque centrale du Luxembourg for the year ended 31 December 2005. The financial statements are the responsibility of the Board of 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 the Board of 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 2005 and of the results of its operations for the year then ended.

DELOITTE S.A.
Réviseur d'entreprises

8 March 2006

Pascal Pincemin
Partner

Vafa Moayed
Partner

4.6.3 Balance sheet as at 31 December 2005

	Note	2005 EUR	2004 EUR
ASSETS			
Gold and gold receivables	3	32,207,057	23,860,617
Claims on non-euro area residents denominated in foreign currency	4	203,694,972	218,661,158
- Receivables from the IMF		63,001,000	113,377,895
- Balances with banks, security investments, external loans and other external assets		140,693,972	105,283,263
Claims on euro area residents denominated in foreign currency	5	31,704,438	51,831,953
Claims on non-euro area residents denominated in euro	6	1,037,748,672	466,612,637
- Balances with banks, security investments and loans		1,037,748,672	466,612,637
Lending to euro area credit institutions related to monetary policy operations denominated in euro	7	31,796,282,172	28,353,620,150
- Main refinancing operations	7.1	24,611,000,000	21,478,000,000
- Long-term refinancing operations	7.2	7,185,139,250	6,875,620,150
- Marginal lending facility	7.5	142,922	0
Other claims on euro area credit institutions denominated in euro	8	769,484	90,127
Securities of euro area residents denominated in euro	9	1,678,903,325	1,463,985,126
Intra-Eurosystem claims	10	7,876,701,417	3,488,282,255
- Participating interest in ECB	10.1	9,660,235	9,660,235
- Claims related to the transfer of foreign reserves	10.2	87,254,014	87,254,014
- Other claims within the Eurosystem	10.3	7,779,787,168	3,391,368,006
Items in course of settlement		180	192
Other assets	11	1,249,898,963	728,575,330
- Tangible and intangible fixed assets	11.1	62,072,621	58,365,712
- Other financial assets	11.2	1,034,432,666	582,682,793
- Off-balance sheet instruments revaluation differences		0	607,500
- Accruals and prepaid expenses	11.3	108,605,281	60,940,395
- Sundry	11.4	44,788,395	25,978,930
Total assets		**43,907,910,680**	**34,795,519,545**

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

Balance sheet as at 31 December 2005 (continued)

	Note	2005 EUR	2004 EUR
LIABILITIES			
Banknotes in circulation	12	1,141,736,320	1,012,539,140
Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	13	6,810,321,790	5,063,321,077
- Current accounts (covering the minimum reserve system)	13.1	6,810,321,790	5,063,321,077
Liabilities to other euro area residents denominated in euro	14	514,683,375	554,852,262
- General government	14.1	514,683,375	554,852,262
Liabilities to non-euro area residents denominated in euro	15	314,195,393	58,327,526
Liabilities to non-euro area residents denominated in foreign currency	16	47,455,312	51,854,230
Counterpart of special drawing rights allocated by the IMF	17	20,513,855	19,321,918
Intra-Eurosystem liabilities	18	34,202,831,350	27,341,616,355
- Net liabilities related to the allocation of euro banknotes within the Eurosystem	18.1	34,202,831,350	27,341,616,355
Items in course of settlement	19	9,735,110	3,947,631
Other liabilities	20	237,388,936	160,572,809
- Off-balance sheet instruments revaluation differences		1,205,990	664,000
- Accruals and income collected in advance		190,360,110	141,871,653
- Sundry		45,822,836	18,037,156
Provisions	21	412,064,679	355,941,192
Revaluation accounts	22	48,960,115	27,802,136
Capital and reserves	23	145,423,269	142,817,302
- Capital	23.1	25,000,000	25,000,000
- Reserves	23.2	120,423,269	117,817,302
Profit for the year		**2,601,176**	**2,605,967**
Total liabilities		**43,907,910,680**	**34,795,519,545**

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

4.6.4 Off-balance sheet as at 31 December 2005

	Note	2005 EUR	2004 EUR
Custody deposits	24	145,773,541,714	132,113,030,126
Commitments and similar instruments	25	1,900,000,000	1,900,000,000
Foreign currency reserve assets managed on behalf of the ECB	26	92,352,754	76,187,489
Forward transactions	27	101,625,000	694,214,750
Numismatic collection		125,249	122,709
		147,867,644,717	**134,783,555,074**

4.6.5 Profit and loss account for the year 2005

	Note	2005 EUR	2004 EUR
Interest income	28	868,636,311	669,225,751
Interest expense	28	(779,311,460)	(585,693,474)
Net interest income	**28**	**89,324,851**	**83,532,277**
Realised gains / (losses) arising from financial operations	29	10,643,464	5,951,518
Write-downs on financial assets and positions	30	(15,693,001)	(7,422,706)
Transfer to/from provisions for foreign exchange rate and price risks	31	(46,032,505)	(41,498,079)
Net result of financial operations, write-downs and risk provisions		**(51,082,042)**	**(42,969,267)**
Fees and commissions income	32	9,723,673	7,648,934
Fees and commissions expense	32	(9,564,581)	(7,711,862)
Net result from fees and commissions	**32**	**159,092**	**(62,928)**
Income from participating interest	33	-	-
Net result of pooling of monetary income	34	(10,394,032)	(14,320,344)
Other income	35	14,328,122	10,671,948
Total net income		**42,335,991**	**36,851,686**
Staff costs	36	(18,753,866)	(17,858,894)
Other administrative expenses	37	(8,233,361)	(7,622,472)
Depreciation of tangible and intangible fixed assets	11.1, 38	(5,296,464)	(5,019,739)
Banknote production services	39	(714,270)	(497,560)
Other expenses	40	(6,736,854)	(3,247,054)
Profit for the year		**2,601,176**	**2,605,967**

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

4.6.6 Notes to the financial statements as at 31 December 2005

Note 1 - General

The Banque centrale du Luxembourg (BCL) was founded in accordance with the law of 22 April 1998. The Founding Law of 23 December 1998 stipulates that the main task of the BCL shall be to contribute to 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 the BCL on their settlement date.

2.4 Gold, assets and liabilities in foreign currencies

Assets and liabilities denominated in foreign currencies (including gold) are converted into euro at the exchange rate in force on the balance sheet closing date. Income and expenses 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 euro are valued at the market price prevailing on the balance sheet date. The revaluation took place item-by-item on the basis of their 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 are not considered in the profit and loss account, but transferred to a revaluation account on the liabilities side of the balance sheet.

Unrealised losses are recognised in the profit and loss account when they exceed 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 in gold holdings are 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 are calculated and presented on a prorata basis as part of the interest positions 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 European Central Bank (ECB) and the 12 national central banks (NCBs), which together comprise the Eurosystem, have issued euro banknotes as from 1 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 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".

From 2002 until 2007 the intra-system balances arising from the allocation of euro banknotes are adjusted in order to avoid significant changes in NCBs' relative income positions 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 from July 1999 to 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; income on banknotes thereafter 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, which arises from the 8% share of euro banknotes allocated to the ECB, shall not be distributed for 2005. This income has been allocated, in the ECB's accounts, to a provision for foreign exchange rate, interest rate and gold price risks.

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 1 January 1999, after the entry into force of the Founding Law of 23 December 1998, the pension claims of the BCL's staff members are fully supported by the BCL. The pension fund aims to cover the risks related to ageing, infirmity and survival, was set up in 2000. The actuarial method for determining the BCL's liabilities towards its agents was approved by the pension fund's Management Committee as at 12 February 2001.

The actuarial method determines the pension fund's liability related to ageing, 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 60 years as well as on 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 provision increases as a result of regular transfers by the agent and by the BCL as employer. 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 cases where transfers are insufficient cover the BCL's pension liabilities, the difference between the existing provision and the effective claim is covered by a special transfer to be supported by the BCL.

2.12 Provision for banking risks

The BCL's provision policy is intended to cover specific and general risks resulting from the Bank's activities.

Note 3 - Gold and gold receivables

As at 31 December 2005, the BCL held 2,063.73 ounces of fine gold amounting to €0.9 million (2,202.23 ounces of fine gold amounting to €0.7 million as at 31 December 2004) and a top-rated gold bond issued by the International Bank for Reconstruction and Development purchased in 2002 and valued at €31.3 million (€23.2 million as at 31 December 2004).

On the balance sheet date, gold is valued on the basis of the euro price per fine ounce derived from the quotation in US dollars established at the London fixing on 30 December 2005.

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

	2005 EUR	**2004 EUR**
Receivables from the IMF	63,001,000	113,377,895
Balances with banks, security investments, external loans and other external assets	140,693,972	105,283,263
	203,694,972	**218,661,158**

Under this item are recorded the BCL's foreign exchange reserve holdings with counterparties situated 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) are made up of reserve tranche position and SDR holdings. SDR are reserve assets created *ex nihilo* by the IMF and allocated by it to its members. A country's SDR holdings initially amount to the SDR allocated. Afterwards, SDR holdings are subject to fluctuations as a result of encashments and transactions with other SDR holders. The reserve tranche position corresponds to the net amount of the quota and the IMF's currency holding and takes into account the re-evaluation of the general account.

- balances held on accounts with banks outside the euro area as well as securities, loans and other foreign currency assets issued by non-residents of the euro area. This sub-item includes in particular the US dollar securities portfolio which could be used, if needed, for monetary policy operations.

This portfolio, which amounted to €71.7 million as at 31 December 2005 (€52.8 million as at 31 December 2004), only contains government bonds and top-rated bonds issued by international and supranational institutions denominated in US dollars. Securities are valued at market prices. As at 31 December 2005, their value at market prices included an unrealised loss amounting to €0.4 million (unrealised loss amounting to €0.2 million as at 31 December 2004).

Balances with banks amounted to €68.9 million as at 31 December 2005 (€52.5 million as at 31 December 2004).

Note 5 - Claims on euro area residents denominated in foreign currency

This item comprises BCL's balances denominated in foreign currency with counterparties inside the euro area.

Note 6 - Claims on non-euro area residents denominated in euro

	2005 EUR	2004 EUR
Balances with banks	6,711,897	589,696
Security investments	1,031,036,775	466,022,941
	1,037,748,672	**466,612,637**

This item contains balances held on accounts with banks outside the euro area as well as securities, loans and other euro-denominated assets issued by non-residents of the euro area.

This portfolio only contains government bonds and first rated bonds issued by companies outside the euro area denominated in euro. Securities are valued at market prices. As at 31 December 2005, their value at market prices included an unrealised loss amounting to €14.2 million (unrealised loss amounting to €4.9 million as at 31December 2004).

Note 7 - 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:

	2005 EUR	2004 EUR
Main refinancing operations	24,611,000,000	21,478,000,000
Longer-term refinancing operations	7,185,139,250	6,875,620,150
Fine-tuning reverse operations	-	-
Structural reverse operations	-	-
Marginal lending facility	142,922	-
Credits related to margin calls	-	-
	31,796,282,172	**28,353,620,150**

7.1 *Main refinancing operations*

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

7.2 *Long-term refinancing operations*

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

7.3 *Fine-tuning reverse operations*

This sub-item records open market operations carried out on a non-regular basis, intended primarily to meet unexpected fluctuations in market liquidity.

7.4 *Structural reverse operations*

These are open market operations carried out with the primary intention of bringing about a lasting change in the structural liquidity position of the financial sector vis-à-vis the Eurosystem.

No such transactions were made during the year under review.

7.5 *Marginal lending facility*

This sub-item records a standing facility enabling counterparties to obtain 24-hour credit from the Bank at a pre-specified interest rate, against eligible collateral.

7.6 *Credits related to margin calls*

This sub-item records additional credit extended to credit institutions and resulting from the increase in the value of the securities pledged as collateral for other credits extended to these same institutions.

No such operation took place during the year just ended.

Note 8 - Other claims on euro area credit institutions denominated in euro

This item includes the BCL's current accounts and fixed-term deposits not related to monetary policy operations with credit institutions inside the euro area.

Note 9 - Securities of euro area residents denominated in euro

This item covers the BCL's portfolio in euro issued by residents of the euro area which could be used, if needed, for monetary policy operations. This amounted to €1,679 million as at 31 December 2005 (€1,464 million as at 31 December 2004).

This portfolio only contains government bonds in euro issued by Member States of the European Union and first rated bonds issued by companies of the euro area. Securities are valued at market prices. As at 31 December 2005, their value at market prices included an unrealised loss amounting to €16.2 million (unrealised loss amounting to €1.5 million as at 31 December 2004).

Note 10 - Intra-Eurosystem claims

10.1 *Participating interest in ECB*

Pursuant to Article 28 of the ESCB Statute, the ESCB national central banks are the sole subscribers to the capital of the ECB. Subscriptions depend on shares which are fixed in accordance with Article 29.3 of the ESCB Statute and which are subject to adjustment every five years. The first such adjustment following the establishment of the ECB took effect on 1 January 2004. On 1 May 2004 a second change of the ECB's capital key followed as a result of the accession of ten Member States.

On 31 December 2005, the share that the BCL held in the capital of the ECB was 0.1568%, which amounted to €9,660,235, on a total of subscribed capital of the ECB of €5.565 billion (no change compared with 31 December 2004).

The share that the BCL held in the accumulated net profits of the ECB reflects the repayment of €0.9 million by the ECB.

10.2 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. The claims are denominated in euro at a value fixed at the time of their transfer.

They are remunerated at the latest available marginal rate for the Eurosystem's main refinancing operations, adjusted to reflect a zero return on the gold component.

As at 31 December 2005, the claim of the BCL amounted to €87,254,014 (no change compared with 31 December 2004).

10.3 Other claims within the Eurosystem

This sub-item represents the BCL's net claims towards the Eurosystem, mostly from transactions resulting from cross-border payments initiated for monetary or financial operations, made via the TARGET system, between the BCL and the other national central banks as well as the ECB. This claim amounts to €7.8 billion as at 31 December 2005 (€3.4 billion as at 31 December 2004).

The net position vis-à-vis the ECB bears interest at the marginal interest rate applying to the main refinancing operations.

Note 11 - Other assets

11.1 Tangible and intangible assets

Tangible and intangible fixed assets developed as follows:

The sub-item "Buildings" comprises the acquisition cost of the premises located at 2, boulevard Royal, the costs incurred in relation to the reconstruction and fitting-out of the Pierre Werner building and the renovations made to the Siège Royal (main building). The building located on boulevard Prince Henri was completely written off in 2003, having been demolished in order to construct a new one. Construction started in 2004 and is progressing as expected.

The Pierre Werner building and the one on the boulevard Prince Henri are considered as new buildings and are being amortised over a period of 25 years while the costs incurred in relation to the transformation of the Siège Royal are considered as renovations and are being amortised over 10 years.

11.2 Other financial assets

The components of this item are as follows:

	2005 EUR	2004 EUR
Other participating interests	216,994	162,033
Pension fund	78,219,526	64,005,693
Securities portfolio	955,996,146	518,515,067
	1,034,432,666	**582,682,793**

The other participating interests comprise the entry fees in LIPS-Net and the BCL's investments in RTGS-L GIE, SWIFT and ATTF.

	Buildings EUR	Furniture and equipment EUR	Software EUR	Total EUR
Cost as at 1 January 2005	73,791,708	9,689,846	3,934,114	87,415,668
Disposals	-	(72,719)	-	(72,719)
Acquisitions	7,535,465	1,247,421	220,487	9,003,373
Cost as at 31 December 2005	**81,327,173**	**10,864,548**	**4,154,601**	**96,346,322**
Accumulated depreciation as at 1 January 2005	19,060,369	7,008,130	2,981,457	29,049,956
Disposals	-	(72,719)	-	(72,719)
Depreciation	3,396,806	1,349,845	549,813	5,296,464
Accumulated depreciation as at 31 December 2005	22,457,175	8,285,256	3,531,270	34,273,701
Net book value as at 31 December 2005	**58,869,998**	**2,579,292**	**623,331**	**62,072,621**

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 2005.

The securities portfolio recorded under this heading corresponds to the securities held by the BCL for the purpose of the investment of own funds and amounts owed to third parties amounting to a total of €956.0 million (€518.5 million as at 31 December 2004). Securities are valued at market prices. As at 31 December 2005, their value at market prices included an unrealised gain amounting to €5.4 million (unrealised gain amounting to €14.0 million as at 31 December 2004).

11.3 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 are the commissions receivables, prepaid expenses (including salaries paid for January 2006) and other income receivable.

11.4 Sundry

	2005 EUR	2004 EUR
Withdrawals in advance	9,735,000	3,947,500
Others	35,053,395	22,031,430
	44,788,395	**25,978,930**

The sub-item "Withdrawals in advance" corresponds to the amount of euro banknotes ordered by the credit institutions as at 31 December 2005 and which were not put into circulation by that date.

The sub-item "Others" consists mainly of the counterpart of the unrealised loss on SDR 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 as well as a claim in relation to the pension fund.

Note 12 - Banknotes in circulation

This item includes 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 €1,141,7 million (€1,012,5 million as at 31 December 2004).

Note 13 - Liabilities to euro area credit institutions related to monetary policy operations denominated in euro

	2005 EUR	2004 EUR
Current accounts (covering the minimum reserves)	6,810,321,790	5,063,321,077
Deposit facility	-	-
Fixed-term deposits	-	-
Fine-tuning reverse operations	-	-
Deposits related to margin calls	-	-
	6,810,321,790	**5,063,321,077**

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

13.1 Current accounts (covering the minimum reserves)

This sub-item records accounts denominated in euro of credit institutions which mainly serve to meet minimum reserve requirements. These requirements have to be respected over an average unsettled period starting the Wednesday following the Governing Council's meeting to set the interest rate.

13.2 Deposit facility

This sub-item records the standing facility allowing credit institutions to make 24-hour deposits with the Bank at a pre-specified interest rate.

13.3 Fixed-term deposits

This sub-item records deposits made at the Bank for the purpose of absorbing market liquidity in connection with fine-tuning operations in the Eurosystem.

13.4 Fine-tuning reverse operations

This sub-item records other monetary policy operations aimed at tightening liquidity.

No such operation took place in 2005.

13.5 Deposits related to margin calls

This sub-item records deposits made by credit institutions to compensate for the decrease in the value of securities pledged as collateral for other credits granted to these same institutions.

No such operation took place in 2005.

Note 14 - Liabilities to other euro area residents denominated in euro

14.1 Liabilities to general government

This item records the amounts owed to the Luxembourg Treasury as follows:

	2005 EUR	**2004 EUR**
Current account	567,560	597,552
Account related to euro coins issued by the Treasury	124,115,815	104,254,710
Fixed-term deposit	390,000,000	450,000,000
	514,683,375	**554,852,262**

In accordance with the amendment of 10 April 2003 to the agreement between the State of Luxembourg and the BCL establishing their financial relationship, the "Account related to euro coins issued by the Treasury" corresponds to the amount of coins issued by the BCL in the name and for the account of the Treasury.

The fixed-term deposit relates to the agreement 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 National Bank of Belgium in relation to Belgian banknotes circulating in Luxembourg. The fixed-term deposit matured on 1 March 2002 and was replaced, following agreement between parties, by a term deposit renewed on a monthly basis.

In order to strengthen the BCL's own funds and in accordance with the articles of the agreement which foresee this possibility, the State waived the remuneration of its term deposit. The related income, amounting to €4.3 million (€4.9 million as at 31 December 2004), is recorded under "Other income".

Note 15 - Liabilities to non-euro area residents denominated in euro

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

Note 16 - Liabilities to non-euro area residents denominated in foreign currency

This item includes current accounts in foreign currency held by central banks outside the euro area.

Note 17 - Counterpart of special drawing rights allocated by the IMF

The amount shown under this item represents the countervalue of the SDR, converted to euro at the same rate as applied to the SDR assets, which should be returned to the IMF if the 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 17.0 million, or €20.5 million as at 31 December 2005 (SDR 17.0 million, or €19.3 million as at 31 December 2004).

Note 18 - Intra-Eurosystem liabilities

18.1 Net liabilities related to the allocation of euro banknotes within the Eurosystem

This item consists of the liabilities of the BCL vis-à-vis the Eurosystem relating to the allocation of euro banknotes within the Eurosystem. The net position bears interest at the marginal interest rate applying to the main refinancing operation.

Note 19 - Items in course of settlement

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

Note 20 - Other liabilities

This item comprises mainly the negative revaluation differences on financial instruments linked to interest rates and market prices, accrued interest, including accrued interest on intra-Eurosystem liabilities, as well as miscellaneous expenses payable, including suppliers, and the Luxembourg banknotes not yet returned.

The Luxembourg banknotes still circulating as at 31 December 2005 amount to €5.6 million (€5.8 million as at 31 December 2004).

Note 21 - Provisions

The provisions are as follows:

	2005 EUR	2004 EUR
Provisions for banking risks	327,182,153	281,149,648
Provisions for pensions	79,680,870	71,758,670
Other provisions	5,201,656	3,032,874
	412,064,679	**355,941,192**

21.1 Provisions for banking risks

Provisions for banking risks include the following items:

	2005 EUR	2004 EUR
Provision covering credit risk	141,982,925	112,937,113
Provision covering operational risk	11,150,000	13,000,000
Provision covering liquidity risk	13,523,377	11,658,367
Provision covering interest rate risk	200,000	200,000
	166,856,302	**137,795,480**
Provisions for general banking risks		
Provision for liabilities resulting from monetary agreements	32,341,954	32,341,954
Other provision for general banking risks	127,983,897	111,012,214
	160,325,851	**143,354,168**
	327,182,153	**281,149,648**

21.1.1 Provision covering credit risk

The provision for €142.0 million (€112.9 million as at 31 December 2004) corresponds to:

- 4% of the BCL's own securities portfolio existing as at 31 December 2003 and still kept as at 31 December 2005 (portfolio allocated to monetary policy operations if necessary and structural portfolio) and participations other than the participating interest in the ECB;
- 2% of the increase between 31 December 2003 and 31 December 2005 of the BCL's own securities 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 the BCL (0.21933 %).

  The BCL's aim is to attain a rate of 4% on all items in the medium term.

21.1.2 Provision covering operational risk

This provision is intended to cover the risk of losses resulting from an inadequacy or fault attributable to procedures, to the human factor or to the BCL's systems or to external causes. Because of a lack of relevant statistics on the dimension of risk, the transfer to the provision is based on the Basic Indicator Approach described in the consultative working paper of the Basel Committee as being 15% of the average for the last three years of the net banking product (including payments allocated on monetary income).

21.1.3 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 in order to face any future monetary liabilities.

In 2004, the Bank reversed €3 million of this provision to cover the BCL's participation in the ECB's loss for the accounting year 2004.

21.1.4 Other provision for general banking risks

In 2005, for prudence's sake and to safeguard its assets, the BCL transferred €17.0 million (€17.9 million for the financial year 2004) to the provision for general banking risks to cover any inherent risks related to central bank activities.

21.2 Provisions for pensions

Provisions for pensions include the following items:

	2005 EUR	2004 EUR
Provision for pensions	77,289,000	69,366,800
Provision for equalisation and financial risks	850,252	850,252
Provision for increase of PBO	1,541,618	1,541,618
	79,680,870	**71,758,670**

21.2.1 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 amounted to €77.3 million as at 31 December 2005 (€69.4 million as at 31 December 2004).

The increase of the provision during the year results from:

- monthly deductions from the gross salaries of BCL agents (employee's part) as well as the employer's share;
- periodic transfers from the account "Booking reserve of the pension fund" to adjust the account "Provision for pensions" to its actuarial value;
- a transfer, if needed, to adjust the account "Provision for pensions" to its actuarial value.

In 2001 and according to Article 35 paragraph 4(c) of its Founding Law, the BCL made an exceptional 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 states that "the Luxembourg pension funds that received contributions from persons that are or become BCL agents shall pay these amounts into the BCL's pension fund".

At the date of this Annual Report, Luxembourg pension funds had not paid the contributions as stipulated in Article 35 paragraph 4(a). Consequently, the exceptional transfer from the reserves in 2001, amounting to €33.8 million, was determined without considering the claim on the pension funds, which will be used for the reconstitution of the reserves.

21.2.2 Provision for equalisation and financial risks

A provision of €3 million for equalisation and financial risks was set up in 2001 to cover fluctuations in the pension fund's liabilities in its early years and/or to compensate for a lower return on assets. In 2002, the provision was used to the amount of €2.1 million. The provision has not changed since then.

21.2.3 Provision for increase of Projected Benefit Obligation

The provision of €1.5 million (same figure as at 31 December 2004) is based on the average expense in relation to pensions, disability and death for new agents who belong to the BCL's staff or are included in the budgeted figures for 2005 but are not included in the pension fund's liabilities calculation as at 31 December 2005. The liability (Projected Benefit Obligation or PBO) equals the potential payments at their present value taking into account individual parameters and the actuarial method used.

21.3 Other provisions

A provision of €5.2 million (€3.0 million as at 31 December 2004) has been created in relation to the difference between the amount of a claim of the BCL's pension fund against the Luxembourg pension funds as decided by the *Cour d'Appel* (following the BCL's judicial proceedings). The *Cour d'Appel's* decision has not been subject to appeal at the *Cour de Cassation*. The amount booked has been determined according to the rules which govern the future financial relationship between the BCL and the Luxembourg pension funds (see Note 35).

The provision of €3.0 million set up by the BCL in 2004 to offset the ECB's loss was used following the decision taken by Governing Council at its meeting on 17 March 2005.

Note 22 - 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 the 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 23 - Capital and reserves

23.1 Capital

The State of Luxembourg is the sole shareholder of the BCL's capital, which is fixed at €25 million euro.

23.2 Reserves

The reserves amount to €120.4 million (€117.8 million as at 31 December 2004). This amount was increased by €2.6 million in 2005 following the allocation of profit for 2004 according to the decision of the BCL's Council and its Founding Law (Article 31).

Note 24 - Custody deposits

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

This item 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 Correspondent Central Banking Model (CCBM). This agreement allows commercial banks to obtain funding from their country of residence's central bank by using the securities held in another Member State as a guarantee.

As at 31 December 2005, the market value of these securities amounted to €145.8 billion (€132.1 billion as at 31 December 2004).

Note 25 - Commitments and similar instruments

	2005 EUR	**2004 EUR**
Commitments and similar instruments	1,900,000,000	1,900,000,000

This item corresponds to the guarantee issued by the BCL for the night-time link project. This commitment is guaranteed by assets received in custody for the same amount.

Note 26 - Foreign currency reserve assets administrated on behalf of the ECB

This item includes the foreign currency reserves at market value managed by the BCL on behalf of the ECB.

Note 27 - Forward contracts

The 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 and for the purpose of adjusting the duration of the existing portfolio depending on market conditions.

As at 31 December 2005, the total liabilities related to these forward contracts amounted to €101.6 million (€694.2 million as at 31 December 2004). One security has been given as a guarantee in order to cover the initial margin deposit. This security remains on the BCL's balance sheet for an amount of €5.0 million as at 31 December 2005 (€5.2 million as at 31 December 2004).

Note 28 - Net interest income

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

Composition of interest income

	Amounts in foreign currency EUR		Amounts in euro EUR	
	2005	**2004**	**2005**	**2004**
IMF	2,394,911	2,201,200	-	-
Monetary policy	-	-	622,542,527	537,611,506
Intra-Eurosystem claims	-	-	148,403,622	67,627,565
Securities	2,762,511	846,835	89,498,935	59,758,435
Gold	406,745	371,258	-	-
Other	2,537,122	667,778	89,938	141,174
Total	**8,101,289**	**4,087,071**	**860,535,022**	**665,138,680**

Composition of interest expense

	Amounts in foreign currency EUR		Amounts in euro EUR	
	2005	**2004**	**2005**	**2004**
IMF	(529,901)	(368,866)	-	-
Current accounts (including minimum reserves) and deposits related to monetary policy operations	-	-	(146,465,831)	(136,206,536)
Liabilities related to the reallocation of euro banknotes in the Eurosystem	-	-	(625,344,817)	(441,887,406)
Other intra-Eurosystem liabilities	-	-	(26,768)	(919,153)
Interests on term deposits	-	-	(4,284,514)	(869,228)
Other liabilities	(1,707,550)	(538,813)	(952,079)	(713,961)
Total	**(2,237,451)**	**(907,679)**	**(777,074,009)**	**(584,785,795)**

The increase in interest results from an increase in amounts outstanding rather than from a change in the interest rates.

Note 29 - Realised gains / (losses) arising from financial operations

This item includes the result from transactions in foreign currencies, from securities and from financial instruments linked to interest rates and market prices, i.e. gains realised minus loss realised on these transactions. In 2005, they amounted to €17.4 million (€15.4 million as at 31 December 2004) and to €6.8 million (€9.4 million as at 31 December 2004) respectively, making a net income of €10.6 million (€6.0 million as at 31 December 2004).

Note 30 - Write-downs on financial assets and positions

This item includes revaluation losses on securities for €15.5 million and on financial instruments linked to interest rates and market prices for €0.2 million in 2005 (€0.7 million and €0.7 million respectively plus €6.0 million on foreign currencies in 2004).

Note 31 - Transfer to/from provisions for foreign exchange rate and price risks

This item includes the transfers to and from provisions for banking risks.

Note 32 - Net result from fees and commissions

Fees and commissions income and expense are as follows:

	Fees and commissions income EUR		Fees and commissionsexpense EUR	
	2005	**2004**	**2005**	**2004**
Securities	9,119,748	7,309,392	(9,488,128)	(7,610,313)
Others	603,925	339,542	(76,453)	(101,549)
Total	**9,723,673**	**7,648,934**	**(9,564,581)**	**(7,711,862)**

Note 33 - Income from participating interest

This item may include the dividend distributed by the European Central Bank.

No dividend was distributed in 2005.

In 2005, the ECB's income on euro banknotes in circulation amounting to €868 million was used in full by the ECB in accordance with a decision of the Governing Council with respect to the establishment of a provision for foreign exchange rate, interest rate and gold price risks.

Note 34 - Net result of pooling of monetary income

Since 2003, the monetary income of each Eurosystem NCB is determined by measuring the actual annual income that derives from the earmarkable assets held against its liability base. The liability base consists of the following items:

- banknotes in circulation;
- liabilities to credit institutions related to monetary policy operations denominated in euro;
- net intra-Eurosystem liabilities resulting from TARGET transactions;
- 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 earmarkable assets consist of the following items:

- lending to euro area credit institutions related to monetary policy operations denominated in euro;
- intra-Eurosystem claims equivalent to the transfer of foreign reserve assets to the ECB;
- net intra-Eurosystem claims resulting from TARGET transactions;
- net intra-Eurosystem claims related to the allocation of euro banknotes within the Eurosystem;
- a limited amount of each NCB's gold holdings in proportion to its capital key.

Gold is considered as generating no income.

Where the value of an NCB's earmarkable assets exceeds or falls short of the value of its liability base, the difference shall be offset by applying to that difference the average rate of return on the earmarkable assets of all NCBs taken together.

The monetary income pooled by the Eurosystem is allocated among NCBs according to the subscribed capital key (0.21933% for the BCL).

Calculation of net monetary income allocated to the BCL:

		(EUR millions)
	2005	**2004**
Monetary income pooled by BCL	(31.9)	(29.2)
Monetary income reallocated to BCL	21.5	17.9
Retained monetary income by the ECB	0.0	(3.0)
Net result arising from the calculation of monetary income	**(10.4)**	**(14.3)**

Note 35 - Other income

Other income includes revenues for €4.3 million (€4.9 million for 2004) that reflect the waiving by the State of Luxembourg of the interest due for 2005 on its term deposit with the BCL (see also Note 14.1) and the remuneration of the claim on the Luxembourg pension funds and reimbursement of amounts taken into account by the BCL for the Luxembourg pension funds for the years 2001 to 2005 for €5.2 million (€0 million in 2004).

This item also includes revenues for services rendered to third parties, transfers from administrative provisions and income from numismatic activities.

Note 36 - Staff costs

This item includes the salaries and compensations as well as the employer's share of contributions to the pension and social security schemes. The compensations paid to the Board of Directors amounted to €472,927 for the year 2005 (€456,830 for the year 2004).

As at 31 December 2005, the BCL employed 203 persons (206 as at 31 December 2004). The average number of persons working for the BCL from 1 January to 31 December 2005 was 206 (205 for the year 2004).

Note 37 - Administrative expenses

This item includes all general and recurring expenses, meaning rents, cleaning and repair of buildings and equipment, small goods and materials, fees paid and other services and supplies as well as training expenses. The compensations paid to the members of the Council amounted to €71,082 in 2005 (€68,237 in 2004).

Note 38 - 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.

Note 39 - Banknote production services

This item shows mainly the costs related to the production and issue of banknotes denominated in euro.

Note 40 - Other expenses

The bulk of other expenses are related to the transfer to the administrative provisions (see Note 21.3) and costs related to numismatic activities.

Artist: Roger Bertemes
Title: The Blue Abstraction
Material: Oil on canvas
Format: 150 x 120 cm
BCL collection

5. ANNEXES

5.1 List of BCL circulars published in 2005

- BCL Circular No 2005/188 of 13 May 2005 – amendments to the BCL's general terms and conditions – sent to all credit institutions as well as to the financial services of the Postal and Telecommunications Services Company (giro accounts service).

- BCL Circular No 2005/189 of 13 May 2005 – surveys on foreign direct investment – sent to all credit institutions and to the financial services of the Postal and Telecommunications Services Company (giro accounts service).

- BCL Circular No 2005/190 of 11 July 2005 – collection of balance of payments data: taxation of savings income resulting from interest payments. Special treatment of the balance of payments – sent to all credit institutions and to the financial services of the Postal and Telecommunications Services Company (giro accounts service).

- BCL Circular No 2005/191 of 19 October 2005 – dates of submission of statistical reports to the BCL – sent to all Luxembourg-based Undertakings for Collective Investment in Transferable Securities (UCITS).

- BCL Circular No 2005/192 of 19 October 2005 – dates of submission of statistical reports to the BCL and starting and end dates of the periods of holding minimum reserves in 2006 – sent to all credit institutions.

5.2 BCL publications

The BCL's publications may be downloaded from the BCL's website, www.bcl.lu. The website contains all the Bank's publications since its founding in June 1998. The website exists in English and in French. Paper copies of publications may be obtained at the BCL's counters as long as stocks last and according to the BCL's conditions.

BCL Bulletins in 2005

- BCL Bulletin No 2005/1, April 2005, special edition on financial stability:

- *L'environnement financier;*
- *Le secteur financier luxembourgeois en 2004;*
- *Le secteur des assurances;*
- *La Banque centrale du Luxembourg face aux mesures d'assainissement et de liquidation des établissements de crédit.*

- BCL Bulletin No 2005/2, September 2005

- *Sektorale Spezialisierung und Produktivität der Luxemburger Wirtschaft im internationalen Vergleich;*
- *Estimation du taux d'intérêt réel naturel pour la zone euro et pour le Luxembourg;*
- *La rigidité des prix. Une étude sur données macro-économiques de prix à la consommation au Luxembourg;*
- *La politique de change actuelle du Cap-Vert et ses alternatives.*

- BCL Bulletin No 2005/3, December 2005

- *Le calcul d'indices des conditions monétaires pour la zone euro et le Luxembourg;*
- *La position extérieure globale du Luxembourg;*
- *Das Preissetzungsverhalten im Euroraum;*
- *Comportement de fixation des prix: résultats d'une enquête auprès des entreprises luxembourgeoises;*
- *L'identité de Fisher et l'interaction entre inflation et la rentabilité des actions: l'importance des régimes sous-jacents aux marchés boursiers.*

BCL Annual Reports

- Rapport Annuel 2003 (in French), April 2004
- Annual Report 2003 (in English), May 2004
- Rapport Annuel 2004 (in French), June 2005
- Annual Report 2004 (in English), July 2005
- Rapport Annuel 2005 (in French), June 2006
- Annual Report 2005 (in English), July 2006

BCL Working Papers in 2005

- Working Paper No 13, February 2005
  Les déterminants du solde de la balance des transactions courantes au Luxembourg, by Abdelaziz Rouabah;

- Working Paper No 14, April 2005
  Nominal rigidities and inflation persistence in Luxembourg: a comparison with EU15 member countries with particular focus on services and regulated prices, by Patrick Lünnemann and Thomas Y. Mathä;

- Working Paper No 15, June 2005
  Estimating the natural interest rate for the euro area and Luxembourg, by Ladislav Wintr, Paolo Guarda and Abdelaziz Rouabah;

- Working Paper No 16, October 2005
  Cape Verde's exchange rate policy and its alternatives, by Romain Weber;

- Working Paper No 17, November 2005
  Consumer price behaviour in Luxembourg: evidence from micro CPI data, by Patrick Lünnemann and Thomas Y. Mathä.

BCL brochures

- *The Banque centrale du Luxembourg in the European System of Central Banks,* by Michael Palmer, May 2001

- *La Banque centrale du Luxembourg*, a brochure on the BCL and its tasks in English, French and German, June 2003

General conditions for the BCL's operations (CD ROM)

A complete list of the ECB's publications in various languages is available at www.ecb.int, the ECB's website.

5.3 Statistics series of the BCL

Statistical tables listed hereunder are available on the BCL's website at www.bcl.lu ("Statistics") and are regularly updated. These tables are also published in the BCL's bulletin in French.

1. Monetary policy statistics

1.1 Financial statement of the Banque centrale du Luxembourg
1.2 Luxembourg minimum reserve statistics

2. Monetary and financial developments

2.1 Aggregated balance sheets of Luxembourg MFIs (excluding the BCL)
2.2 Liabilities of the Luxembourg MFIs included in the euro area monetary aggregates

3. Capital markets and interest rates

3.1 Luxembourg bank interest rates on euro-denominated deposits and loans by euro area residents – new business
3.2 Luxembourg bank interest rates on euro – denominated deposits and loans by euro area residents – outstanding amounts
3.3 Money market interest rates
3.4 Government bond yields
3.5 Stock market indices
3.6 Exchange rates

4. General data on the Luxembourg financial system

4.1 Employment in the Luxembourg credit institutions and financial sector professionals
4.2 Employment in the Luxembourg credit institutions
4.3 Geographic origin of credit institutions established in Luxembourg
4.4 Interim aggregated profit and loss account of Luxembourg banks
4.5 Aggregated profit and loss account of the Luxembourg banks as at year-end
4.6 Long term aggregated profit and loss account of the Luxembourg banks as at year-end
4.7 Aggregated balance sheet of the Luxembourg banks
4.8 Luxembourg banks loans by counterpart and original maturity

5.4 List of abbreviations

ABBL	*Association des Banques et Banquiers, Luxembourg*
AGDL	*Association pour la garantie des dépôts, Luxembourg*
ALCO	Asset and Liability Management Committee
BCL	*Banque centrale du Luxembourg*
BIS	Bank for International Settlements
BLEU	Belgian Luxembourg Economic Union
BNB	*Banque Nationale de Belgique*
CBL	Clearstream Banking Luxembourg
CCBM	Correspondent central banking model
CESR	Committee of European Securities Regulators
CETREL	*Centre de transferts électroniques Luxembourg*
CPI	Consumer Price Index
CMFB	Committee on monetary, financial and balance of payments statistics
CSSF	*Commission de surveillance du secteur financier*
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
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
ESP	European Service Providers
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
IGC	Intergovernmental conference
IMF	International Monetary Fund
IML	*Institut Monétaire Luxembourgeois* (1983-1998)
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
MRA	maximum risk allowance
MRO	main refinancing operation
NAV	net asset value
NCB	national central bank
OECD	Organisation for Economic Cooperation and Development
OFI	Other Financial Intermediaries
OPEC	Organisation of Petroleum Exporting Countries
LTRO	Longer term refinancing operation
PBO	Projected Benefit Obligation
ROA	Return on Assets
ROE	Return on Equity
RTGS system	Real-Time Gross Settlement system
RTGS-L 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
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 economic 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
VaR	Value at Risk

5.5 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 that 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". A base effect occurs 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; or (ii) an undertaking or any other legal person, other than those under (i), which issues means of payment in the form of electronic money.

Currency in circulation: comprises banknotes and coins which are legal tender. **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 Monetary Union (EMU): the **Treaty** describes the process of achieving EMU in the European Union (EU) in three stages. 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): weighted averages of bilateral euro exchange rates against the currencies of the **euro area's** important trading partners. The **European Central Bank** publishes nominal EER indices for the euro against two groups of trading partners: the EER-23 (comprising the 13 non-euro area EU Member States and 10 main trading partners outside the EU) and the EER-42 (composed of the EER-23 and 19 additional countries). The weights used reflect the share of each partner country in euro area trade and account for competition in third markets. Real EERs are nominal EERs deflated by a weighted average of foreign, relative to domestic, prices or costs. They are thus measures of price and cost competitiveness.

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.

ESA 95: see **European System of Accounts 1995**

ERM II (exchange rate mechanism II): the exchange rate arrangement which provides the framework for exchange rate policy cooperation between the **euro area** and EU Member States not participating in the euro area from the start of Stage Three of **Economic and Monetary Union**. Membership of the mechanism is voluntary. Nevertheless, Member States with derogation are expected to join the mechanism. Foreign exchange intervention and financing at the margins of the standard or narrower fluctuation bands are, in principle, automatic and unlimited, with very short-term financing available. The **European Central Bank** and the participating non-euro area national central banks could, however, suspend automatic intervention if this were to conflict with their primary objective of maintaining **price stability**.

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 the EU Member States which have adopted the **euro** as their single currency in accordance with the **Treaty** and in which a single monetary policy is conducted under the responsibility of the **Governing Council** of the **European Central Bank**. The euro area currently comprises of 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 Accounts 1995 (ESA 95): a system of uniform statistical definitions and classifications aimed at achieving a harmonised quantitative description of the economies of the Member States. The ESA 95 is the Community's version of the world System of National Accounts 1993 (SNA 93).

European System of Central Banks (ESCB): composed of the **European Central Bank (ECB)** and the national central banks of all 25 Member States. The ESCB includes, in addition to the members of the **Eurosystem**, the national central banks of the Member States which have not yet adopted the **euro** and are thus not involved in the conduct of the monetary policy of the Eurosystem.

Eurosystem: comprises of 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 of 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 of 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 25 EU national central banks.

Governing Council: the supreme decision-making body of the **European Central Bank (ECB)**. It comprises of 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 as of 10 March 2004 they normally have a maturity of one week.

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 of 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.

Open market operation: an operation executed on the initiative of the central bank in the financial markets. With regard to their aims, regularity and procedures, **Eurosystem** open market operations can be divided into four categories: **main refinancing operations; longer-term refinancing operations; fine-tuning operations**; and **structural operations**. As for the instruments used, **reverse transactions** are the main open market instrument of the Eurosystem and can be employed in all four categories of operations. In addition, the issuance of debt certificates and outright transactions are available for structural operations, while outright transactions, **foreign exchange swaps** and the collection of fixed-term deposits are available for the conduct of fine-tuning operations.

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%. In May 2003, the Governing Council announced clarified that, in its pursuit of price stability, it aims to maintain inflation rates below, but close to, 2% over the medium term.

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 annual growth rate of **M3** over the medium term that is consistent with the maintenance of **price stability**. At present, the reference value for annual M3 growth is 4½%.

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 minimum amount of reserves a **credit institution** is required to hold 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**.

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: the Treaty establishing the European Community. The initial Treaty of Rome was amended on several occasions, notably by the Treaty on European Union (Maastricht Treaty) which constitutes the basis for **Economic and Monetary Union** and defines the statutes of the **ESCB**.