ANNUAL REPORT 2006

BANQUE CENTRALE DU LUXEMBOURG

EUROSYSTEM

The BCL Annual Report 2006 is an abridged translation of the *Rapport Annuel de la BCL 2006*, which is the binding version.

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THE GOVERNOR'S MESSAGE

In 2006, the Governing Council of the ECB adjusted its monetary policy to address upside risks to price stability. It raised the key ECB interest rates on five occasions by a total of 125 basis points. As a result, the minimum bid rate in the main refinancing operations of the Eurosystem rose from 2.25% in January 2006 to 3.5% at the end of 2006.

The gradual withdrawal of monetary accommodation continued at the beginning of 2007 with an additional 25 basis points increase in the key interest rates in March. The most recent interest rate rise was decided at the Governing Council meeting of 6 June 2007, bringing the minimum bid rate in the main refinancing operations of the Eurosystem to 4.0%. This decision, which reflected the prevailing upside risks to price stability, will contribute to ensuring that inflation expectations in the euro area remain solidly anchored at levels consistent with price stability. Such anchoring is a prerequisite for the single monetary policy to make an ongoing contribution towards fostering sustainable economic growth and job creation in the euro area. After this increase, given the positive economic environment in the euro area, monetary policy remains still on the accommodative side.

The June 2007 Eurosystem staff macroeconomic projections anticipate annual real GDP growth in a range between 2.3% and 2.9% in 2007 and between 1.8% and 2.8% in 2008. Average annual HICP inflation is projected between 1.8% and 2.2% in 2007 and between 1.4% and 2.6% in 2008.

Turning to Luxembourg, the national index of consumer prices (NICP) increased by 2.7% on average in 2006, up by a 0.2 percentage point when compared with 2005. Thus, inflation has increased for the third consecutive year. The increase in inflation last year reflected both oil price developments and rising underlying inflation. Annual growth of administered prices rose from 2.1% in 2005 to 3.9% in 2006. This was a higher rate than that recorded for the euro area. The inflation differential of Luxembourg vis-à-vis the euro area and the neighbouring countries worsened further in 2006. The cumulated differential over the period from the beginning of phase III of EMU in 1999 to the end of 2006 stood at 2.1 percentage points vis-à-vis the euro area and 5.3 percentage points vis-à-vis the neighbouring countries. According to the latest BCL staff projections, inflation should decrease to 2.1% in 2007 and remain stable thereafter, reflecting a neutral contribution from energy prices. Public administration measures are projected to contribute 1.3 percentage points to the Luxembourg HICP in 2007 and 0.9 in the first half of 2008, compared to 0.9 in 2006. The contribution projected for 2007 would be the highest on record over the past decade.

The previous BCL Annual Report noted that the modification of the automatic wage indexation mechanism agreed in 2006 should slow the deterioration in Luxembourg's price and cost competitiveness, but would be unable to reverse the trend. This assessment has been confirmed by the latest available data. Indeed, the competitiveness indicators based on consumption prices and the GDP deflator continued to follow an upward trend in 2006, suggesting that the situation has worsened further. Since 1999, unit labour cost growth in Luxembourg has exceeded by 10.5% the respective indicators in our main trading partners. Furthermore, according to BCL projections, which incorporate the effects of the adjustment to the indexation scheme, the deterioration in competitiveness should continue until the end of 2009. In this context, the government should rapidly implement the structural reforms envisaged by the Lisbon strategy to durably increase productivity, thus helping Luxembourg's producers face the anticipated rise in prices and costs relative to those in our main trading partners.

Despite the worsening of the above-mentioned indicators, Luxembourg experienced strong growth in exports, production and employment in 2006. According to the first national accounts estimates for 2006, economic growth in Luxembourg increased from 4.0% in 2005 to 6.2% in 2006, which constituted the strongest performance since 2000. GDP growth has become more broadly based across sectors in 2006, as financial services, the main driver behind growth in 2005, was supported by stronger dynamics in industry, commerce and construction.

According to the BCL staff projections, average annual real GDP growth should range between 4.5% and 5.3% in 2007 and between 4.1% and 5.1% in 2008. In comparison with the previous BCL staff projections, the ranges for real GDP growth in both 2007 and 2008 were revised upwards, mainly reflecting a carry-over effect related to strong economic activity in 2006.

In contrast with the favourable developments in employment and economic growth, the unemployment rate continued its upward trend, reaching 4.5% on average in 2006 after 4.2% in 2005. This increase cannot be explained exclusively by cyclical factors and the situation calls, therefore, for active implementation of structural reforms in the labour market.

About two thirds of newly created jobs were taken up by non-residents. However, this inflow of cross-border commuters should not be seen as harming employment opportunities for residents. In any case, it would be difficult to reduce unemployment by creating more public sector jobs, as these would be mainly filled by residents previously employed in the private sector, and the jobs vacated would be occupied by new cross-border commuters rather than by unemployed residents. Finally, job creation in the private sector can be hampered by excessively rigid employment protection legislation, underlining the need to improve labour market flexibility. Fifty years after the Treaty of Rome and five years after the introduction of euro banknotes and coins one cannot overemphasise the need to facilitate free movement of persons and thereby further open the Luxembourg labour market to take advantage of EU enlargement.

According to the public sector accounts published in April 2007, general government recorded a slight surplus in 2006, contrary to what was previously projected by all observers. This better-than-expected outcome reflects to some extent the base effect from an important revision of the 2005 deficit. That deficit, which was estimated by the authorities at 1% of GDP in autumn 2006, was revised to only 0.3% in April 2007. The improvement recorded in 2006 can be explained by buoyant revenues - related to the favourable economic situation, the non-indexation of tax brackets, and the increase in taxes on oil products, rather than by expenditure restraint. Although expenditure growth decelerated in 2006, reaching 6%, it was still much higher than in the three neighbouring countries. Furthermore, the slowdown observed in expenditure growth essentially reflected lower public investments.
According to BCL staff, general government is projected to maintain surpluses over the projection horizon 2007-2009.

Maintaining a surplus position requires that any loosening of budgetary discipline be avoided, especially given the fact that significant additional revenues collected in 2006 might not last. This point is underscored by the long-term sustainability of public finances. Luxembourg is among those countries where ageing populations are likely to have a strong impact on public finances and social security systems. According to BCL projections, surpluses in the private sector pension regime will decline at the beginning of the next decade and deficits will emerge thereafter. These deficits will eventually result in sizeable net liabilities. A prefunding effort equal to about 6% of GDP is required so as to allow the private sector pension regime to accumulate a sufficient level of reserves over the longer term. Several measures could initiate such prefunding, for instance a more dynamic management of pension reserves, a temporary suspension of the biennial indexation of pensions to real wage developments, or adjustments to make the formula used to calculate pensions financially neutral. The latter measure would encourage later retirements in Luxembourg, where the average effective retirement age was 58 in 2004.

In this context, the authorities should aim for a medium-term objective of a structural surplus of at least 1% of GDP, rather than their current objective of a structural deficit of 0.8% of GDP. The currently favourable macroeconomic and financial conditions must be fully exploited to implement the consolidation measures required to attain that objective. In other words, the current economic upswing should be considered an opportunity to reach a more sustainable fiscal position.

Turning to structural reforms, Luxembourg faces several important challenges, notably related to the employment rate, research, education, internal market completion, infrastructure, energy, environment policy and both public and private governance. The current favourable cyclical position should be used to implement an ambitious reform programme. Structural measures such as those envisaged by the Lisbon strategy are necessary in order to durably enhance Luxembourg's productivity and competitiveness.

Yves Mersch

Artist: Manolo Valdès
Title: Infanta Margarita
Material: bronze
Format: height 123 cm
BCL Collection

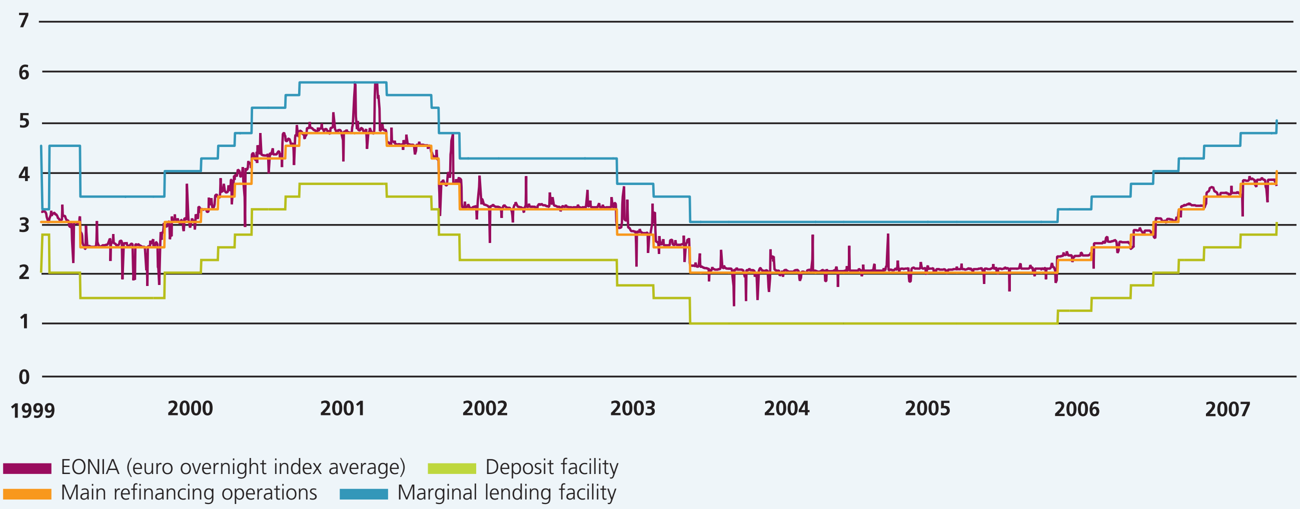
1. ECONOMIC AND FINANCIAL SITUATION

1.1 Economic situation at the international level

1.1.1 Short-term interest rates and monetary policy decisions

After raising the minimum bid rate on the Eurosystem's main refinancing operations by 25 basis points in December 2005, the Governing Council of the European Central Bank continued to address the prevailing upside risks to price stability in the period under review. Thus, the Governing Council progressively raised the Eurosystem's key policy rates by 175 basis points; the minimum bid rate on main refinancing operations now stands at 4.00%, while the interest rates on the marginal lending facility and on the deposit facility were raised to 5.00% and 3.00% respectively.

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



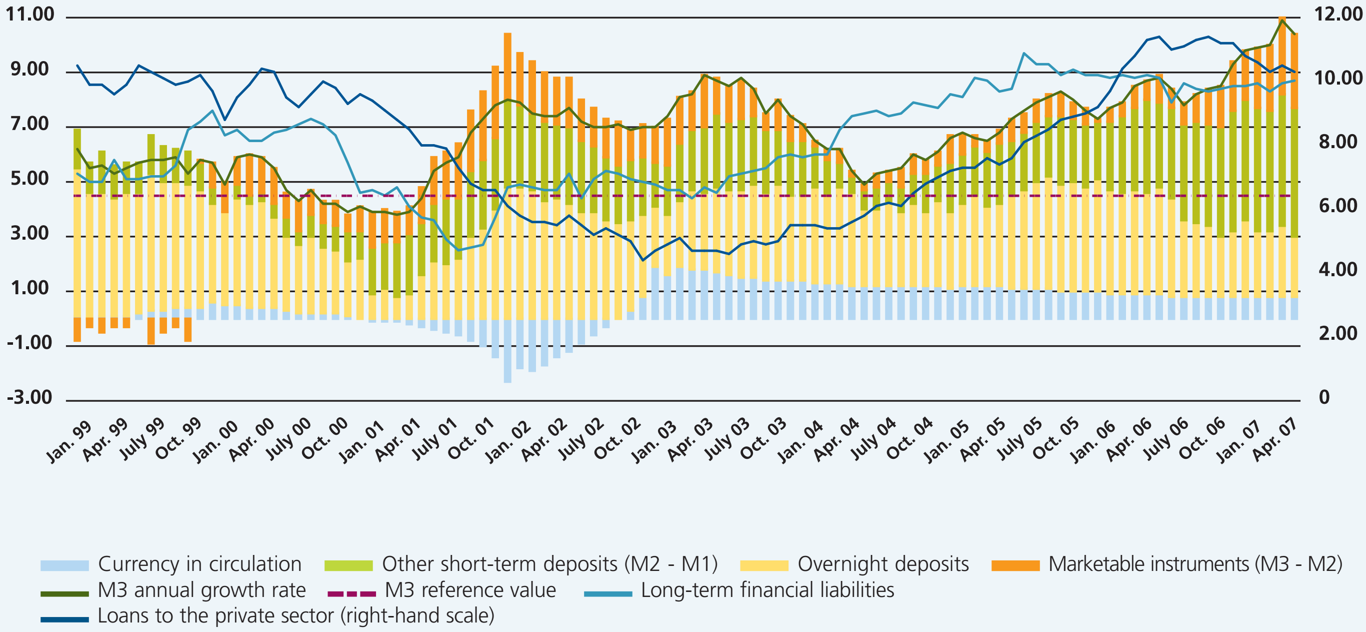
Note: The rate for main refinancing operations is the rate applicable to fixed rate tenders for operations settled before 28 June 2002. Thereafter, the rate reflects the minimum bid rate applicable to variable rate tenders.

Sources: ECB, Bloomberg

Economic developments in 2006 confirmed the Governing Council's main scenario which foresaw economic growth close to its potential rate, surrounded by risks which in the short-term remained mostly balanced in the period under review; medium and longer-term risks, on the other hand, remained on the upside. As suggested by the economic and monetary analyses, these risks pertained in particular to a stronger than anticipated pass-through of past oil price increases, unanticipated increases in administered prices and indirect taxes, and renewed oil price rises. Second-round effects arising from potential wage increases also constituted an upside risk to price stability. Average annual HICP inflation stood at 2.2% in 2006, unchanged from the previous year. More recently, HICP inflation ranged from 1.8% to 1.9% between January and April, while Eurostat's flash estimate predicts a rate of inflation of 1.9% for May.

In spite of the sharp rise in the Eurosystem's key rates, money and credit growth has remained vigorous. In the course of the third quarter of 2006, M3 growth picked up and hit a new peak in March this year, at 10.9%. While this development is largely attributable to the still low level of interest rates, strong economic activity has also contributed to the vigorous progression of the broad aggregate. If M3 growth has remained robust, the series of rate hikes has nevertheless had an impact on monetary developments in 2006 and 2007, mostly through substitution effects between the various components of M3. In particular, from the second half of 2006 stronger annual growth rates of other short-term deposits (M2-M1) made themselves felt while the narrow aggregate M1 progressed more slowly; marketable instruments (M3-M2) also picked up in the course of 2006.

CHART 2: MONEY AND CREDIT DEVELOPMENTS



Source: ECB

As for the counterparts of M3, the annual progression of loans to the private sector was particularly dynamic, although a slowdown set in around year-end; while the growth rate of private sector loans remains high, the slowdown is undoubtedly linked to the series of rate hikes since December 2005. If loans to households have evolved somewhat more slowly, in part due to a cooling off of housing markets in a number of euro area countries, loans to NFCs have picked up considerably, reaching 12.2% in April 2007.

While the Governing Council has raised the key policy rates again in June, it can be said that monetary policy has still remained accommodative.

1.1.2 Long-term government bond yields

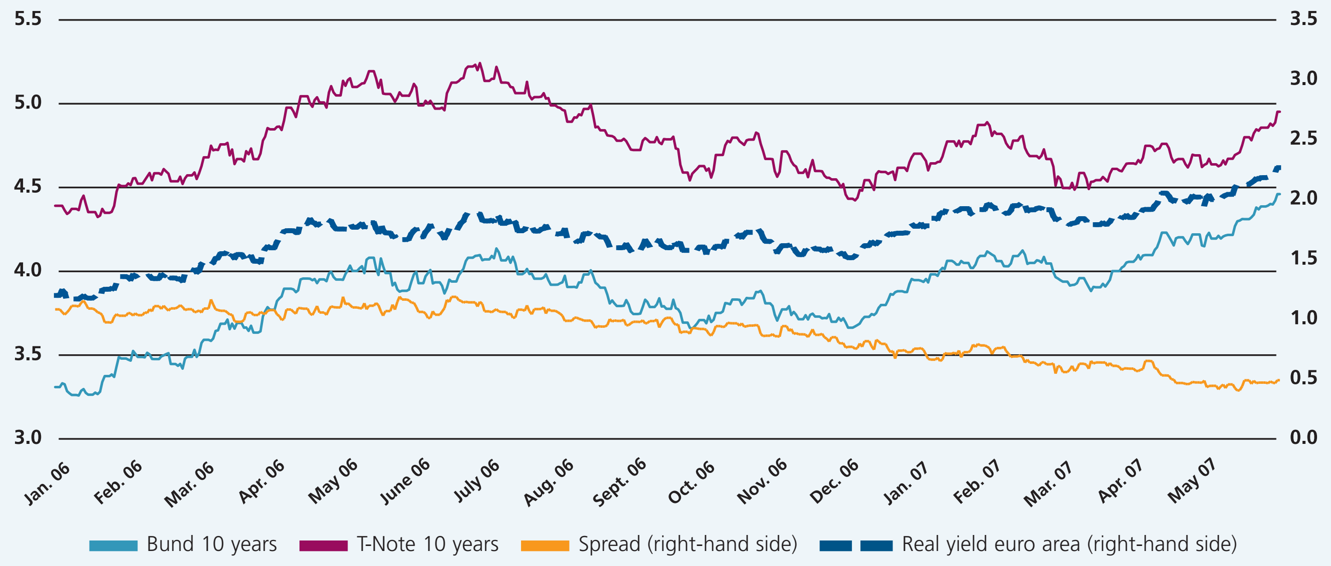
After reaching historically low levels in 2005, long-term government bond yields recovered somewhat in 2006, both in the euro area and in the United States. While several elements have contributed to this development, the strong pickup in economic activity early-2006, as well as the positive economic outlook in the medium term, were the main factors. Bund yields have risen by roughly 65 basis points in 2006; since January, they have entered a steep upward trend. In comparison, in the period under review the yield on US Treasuries has risen by merely 50 basis points, implying that the spread between euro area and US bond yields has declined.

The rise in bond yields largely reflects the positive economic outlook, in particular in the euro area, in a context of stable risk premia and inflation expectations as evidenced by the evolution of French index-linked bonds. The drop in bond yields registered in June 2006 was to a large extent due to turbulent stock market developments from May onwards as international investors were increasingly looking for safe haven investments such as government securities. Bond yields followed a downward trend until late-2006 and then picked up again, in particular in the euro area, given that various domestic factors, such as rising uncertainty regarding the housing market and the monetary policy outlook, were holding down bond yields in the United States.

Another noteworthy development is the flattening of the yield curve in the euro area. The chart illustrates how the spread between the German ten-year Bund and the two-year Schatz has decreased from over 40 basis points at the beginning of 2006 to zero by year-end; since then, the spread has remained at very low levels. Moreover, the term premium (i.e. the difference between the Bund and the three-month Euribor) has dropped considerably in the course of 2006.

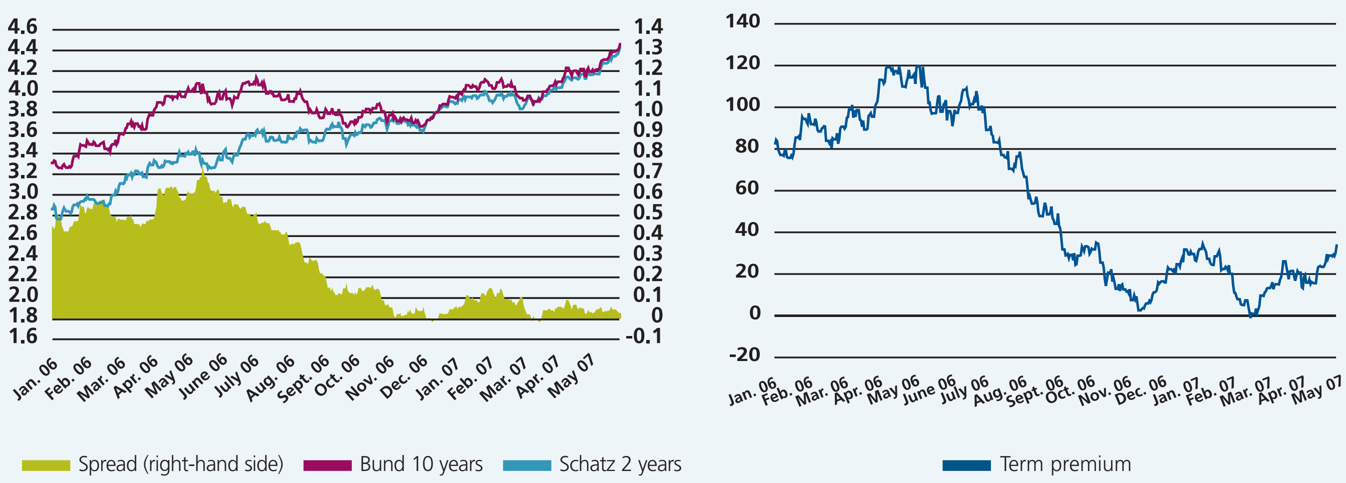
Historically, a flattening of the yield curve often precedes a slowdown in economic activity or even a recession. At this juncture, however, it appears rather to be linked to a sharp drop in risk premia embedded in the term premium.

CHART 3: LONG-TERM GOVERNMENT BOND YIELDS



Source: Bloomberg

CHART 4: FLATTENING OF THE YIELD CURVE



Source: Bloomberg

1.1.3 Equity markets

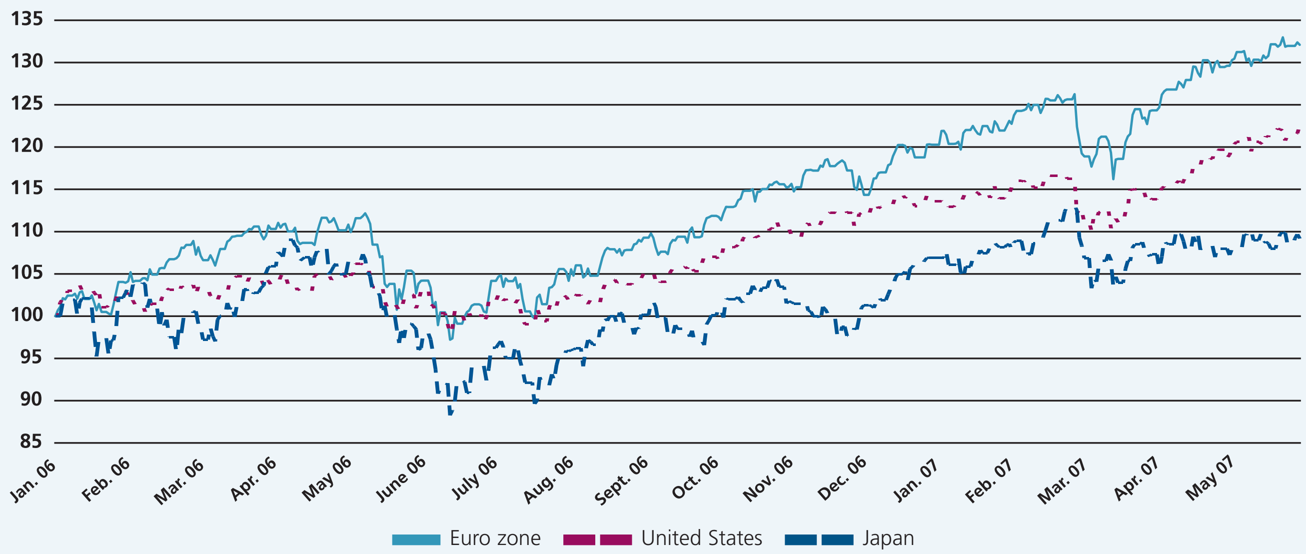
In the period under review, stock markets in the euro area largely continued on the upward trajectory they had embarked on in 2003. The Dow Jones EURO STOXX rose by over 20% last year, reaching 395.63 points at end-2006, while the Standard & Poor's 500 and the Nikkei 225 rose by 13.6% and 6.9% respectively.

The strong performance of euro area equity is largely attributable to firms' higher profitability, following a period of corporate balance sheet restructuring, but also to the importance of M&A activity; more generally, the positive stock market developments were supported by strong economic activity.

The sharp downturn in May 2006 should be seen against the backdrop of rising uncertainty regarding the sustainability of the remarkable stock market performance in the past, most notably with regard to emerging markets, where the fall in equity prices was particularly steep. While market participants were by and large aware that no major reassessment of the economic outlook had taken place, the stock market turbulences in May last year seemed to be attributable to a fall in risk appetite.

In 2007, equity markets mostly continued to progress and in February the Dow Jones EURO STOXX and the Standard & Poor's 500 reached their respective six-year peaks before global stock markets took a tumble again. The latter was triggered by a sharp contraction of the Chinese equity market and Asian markets more generally; indeed, the Shanghai Stock Exchange Composite Index fell by nearly 10% on February 27.

CHART 5: MAJOR STOCK PRICE INDICES IN THE EURO AREA, THE UNITED STATES AND JAPAN (INDEX: 1 JANUARY 2006 = 100; DAILY DATA)



Source: Bloomberg

1.1.4 Exchange rate developments

In the course of 2006, the euro appreciated against most other major international currencies. However, although the euro appreciated versus the dollar, the yen and the renminbi (which together made up over 40% of euro area trade between 1999 and 2001), it nevertheless depreciated versus the British pound.

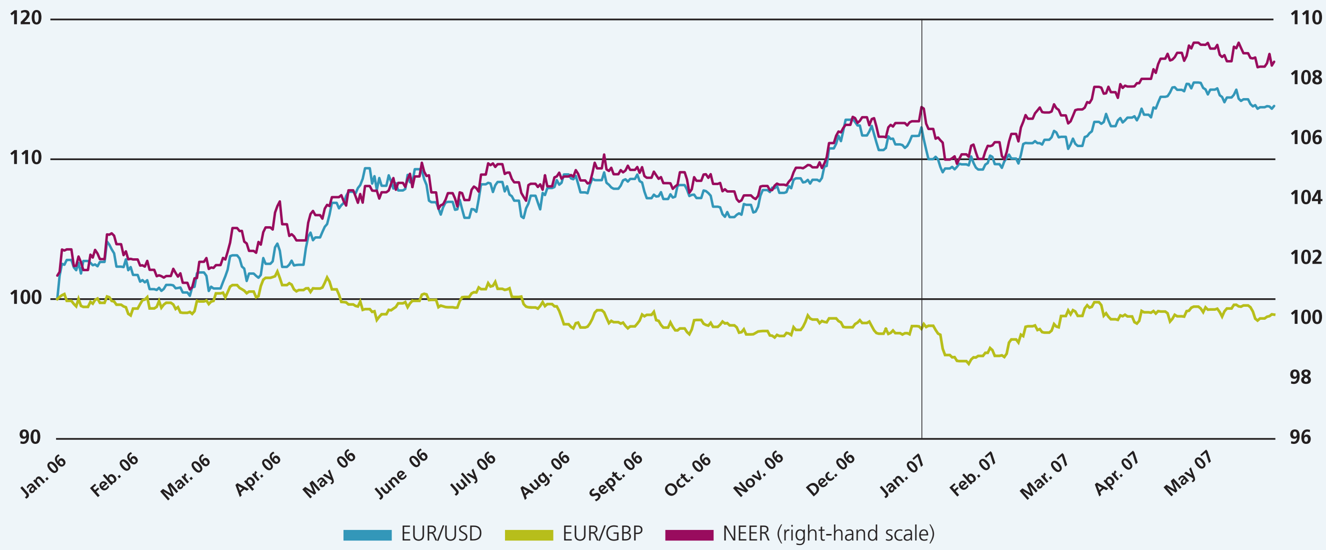
The upward trend of the euro in 2006 is mainly perceptible in the first half of the year, while the exchange rate stabilised somewhat in the second half, at least up until October when the single currency embarked on a new upward trajectory. In 2006 alone, the nominal effective exchange rate (NEER) appreciated by almost 5%, while the euro rose more than 11% against the dollar.

The euro's appreciation against the dollar is to a large extent due to diverging growth prospects on both sides of the Atlantic, which in the period under review also impinged on the monetary policy outlook and the spread between euro area and US key policy rates. Moreover, the US current account deficit and the housing market put additional downward pressure on the dollar. From October, signs of a slowdown in US economic activity and a falling interest rate differential supported the euro.

The single currency advanced much more steadily versus the yen, owing to a still considerable interest rate differential between Japan and the euro area. Indeed, interest rates are still at very low levels in Japan and the yen continues to be used as a major funding currency for carry trades.

In the first months of 2007, the euro continued to progress bilaterally against the dollar, but also in terms of its effective exchange rate. The elements responsible for this development are by and large the same as in 2006.

CHART 6: EXCHANGE RATE DEVELOPMENTS



** For EUR/USD and EUR/GBP, 2 January 2006 = 100.*
+ The nominal effective exchange rate (NEER) is calculated by the ECB (Q1 1999 = 100)

Sources: ECB, Bloomberg

1.1.5 Consumer prices

HICP inflation in the euro area averaged 2.2% in 2006, unchanged from the previous year. This exceeds the ECB Governing Council's definition of price stability of below, but close to, 2%. Inflation remained at such high levels mainly because of developments in oil and commodity prices.

Turning to consumer price developments in early 2007, euro area HICP inflation stood between 1.8% and 1.9% over the period from January to April 2007. The annual growth rate in both unprocessed food prices and services was high at the beginning of 2007. HICP inflation was 1.9% in May 2007 according to Eurostat's flash estimate.

According to the June 2007 Eurosystem staff projections, average annual HICP inflation is expected to be between 1.8% and 2.2% in 2007 and between 1.4% and 2.6% in 2008. Compared with the March 2007 ECB staff projections, the range for inflation in 2007 is somewhat higher, mainly due to higher oil prices.

TABLE 1: DEVELOPMENTS IN THE HICP AND ITS COMPONENTS IN THE EURO AREA (ANNUAL PERCENTAGE CHANGES)

	2005	2006	2005 Q4	2006 Q1	2006 Q2	2006 Q3	2006 Q4	2007 Q1	2007 Jan.	2007 Feb.	2007 Mar.	2007 Apr.	2007 May
Overall HICP of which:	2.2	2.2	2.3	2.3	2.5	2.2	1.8	1.9	1.8	1.9	1.9	1.9	1.9
- Unprocessed food	0.8	2.8	1.4	1.4	1.6	3.9	4.1	3.1	3.7	2.7	2.9	3.9	
- Processed food	2.0	2.1	2.2	2.0	2.2	2.1	2.2	2.1	2.2	2.1	1.9	1.9	
- Non-energy industrial goods	0.3	0.6	0.4	0.4	0.7	0.7	0.8	1.1	0.9	1.1	1.2	1.1	
- Energy	10.1	7.7	11.1	12.2	11.6	6.3	1.5	1.2	0.9	0.8	1.8	0.4	
- Services	2.3	2.0	2.1	1.9	2.0	2.0	2.1	2.4	2.3	2.4	2.4	2.5	
HICP excluding unprocessed food and energy	1.5	1.5	1.5	1.4	1.5	1.5	1.6	1.9	1.8	1.9	1.9	1.9	

Source: Eurostat

1.1.6 Output, demand and labour market developments

Having stood at 1.4% in 2005, real GDP growth in the euro area rebounded in 2006 to 2.9%, a level which represented the strongest growth witnessed since 2001 and exceeded available estimates of potential output growth. In 2006, euro area real GDP was essentially supported by domestic demand and marginally by net trade. On the domestic side, total investment growth contributed substantially to GDP growth (1.0pp in 2006 after 0.5pp in 2005) benefiting from increasing profit rates, a positive demand outlook and low costs of external financing. Private consumption's contribution to growth increased also in 2006 in line with disposable real income growth (1.0pp in 2006 after 0.8pp in 2005). Meanwhile, solid world growth supported exports. However, the external sector solely effected a quasi-neutral contribution to economic growth (0.3pp after -0.2pp in 2005) which was attributable, in particular, to stronger domestic economic momentum boosting imports from the rest of the world.

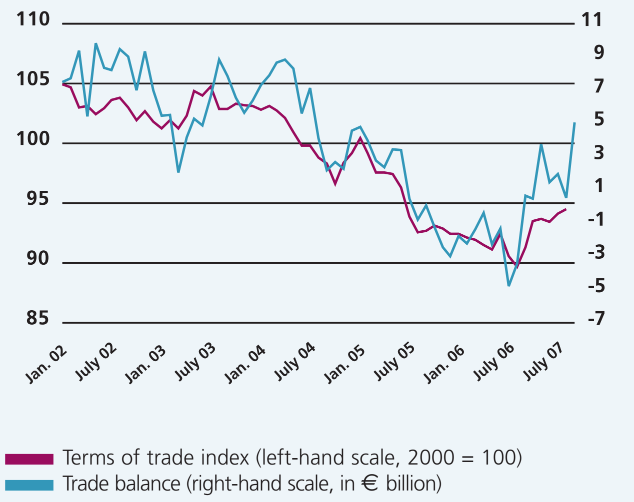
Following real GDP growth of 0.6% quarter on quarter in the first quarter 2007, quarterly growth in real GDP is expected to continue at rates of about 0.6% over the projection horizon. Against this background, average annual real GDP growth is projected to be between 2.3% and 2.9% in 2007 and between 1.8% and 2.8% in 2008.

Labour market conditions in the euro area improved significantly in 2006 in line with the pattern of economic growth. Employment growth has expanded at a robust pace in 2006 (1.6%) and its level has increased by around two million. The unemployment rate decreased further in 2006, reaching a level of 7.9% in average. The data available for the first quarter of 2007 confirms this decrease as the unemployment rate fell to 7.2% in March 2007. It should be noted that it is the first time that such levels have been achieved since the beginning of the series in 1993. Although it clearly indicates a cyclical rebound in labour market conditions in 2006, part of the decrease in the unemployment rate can be assessed as being of a structural nature, reflecting the impact of labour market reforms in some euro area countries. While several countries have made significant progress towards making their labour markets more flexible, more ambitious reforms are still needed in many countries in order to improve their resilience to various shocks that could possibly affect their labour market.

1.1.7 External trade

For the first time since 2000, the euro area trade balance recorded a deficit of €9.7 billion in 2006 compared with a surplus of €14.8 billion in 2005. The higher oil and non-oil commodity prices resulted in a 13.3% increase in import values while export values increased by 11.1%. As a result, the euro area terms of trade continued to decline in 2006, further accelerating the deterioration in the euro area trade balance (see chart 7).
The geographical allocation of trade shows that the euro area surplus with the United States reached €71 billion in 2006 up from €65 billion in 2005. However, the surplus vis-à-vis the United Kingdom declined by 2.9% to €49 billion in 2006 as a whole. Large trade deficits were recorded with oil exporting countries: OPEC members (€48.4 billion), Russia (€39.7 billion), Norway (€26 billion) and some African oil exporting countries (€32.4 billion). Moreover, the usual heavy trade deficit with China (€89.8 billion in 2006) and the deficit with Japan (€21.6 billion) continued to expand.

CHART 7: MONTHLY DEVELOPMENTS IN THE EURO AREA TRADE BALANCE AND IN THE TERMS OF TRADE (SEASONALLY ADJUSTED DATA)



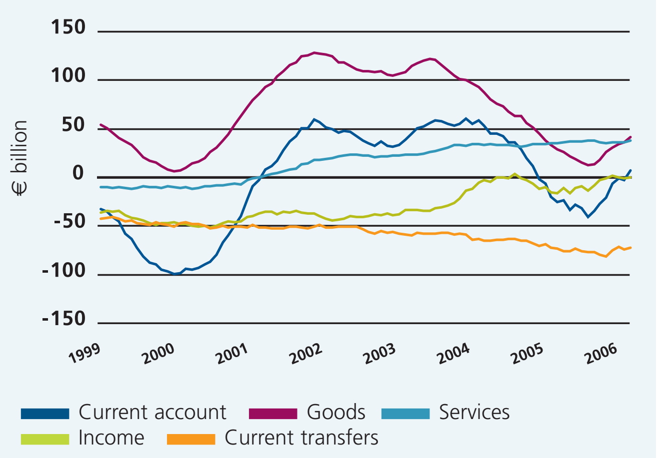
Source: Eurostat

1.1.8 Balance of payments

In 2006 the current account of the euro area recorded a slight deficit of €6.1 billion (0.1% of GDP) compared with a deficit of €1.8 billion in 2005. The higher deficit in 2006 reflected to a larger extent the drop in the goods surplus as imports grew faster than exports. The 7% increase in the deficit of the current transfers contributed also to the deterioration in the current account of the euro area, while the balances for services and for income improved strongly.

In the financial account, the euro area recorded net inflows of €134 billion in 2006, up from €25 billion in 2005. Net outflows in direct investments dropped to €156.7 billion in 2006 down from €210 billion in 2005. These net outflows were, however, largely offset by portfolio investment net inflows of €273 billion resulting from the net purchases of euro area equity and debt securities by non-resident investors.

CHART 8: CURRENT ACCOUNT BALANCE AND ITS COMPONENTS (12-MONTH CUMULATED TRANSACTIONS)



Source: ECB

1.2 ECONOMIC SITUATION IN LUXEMBOURG

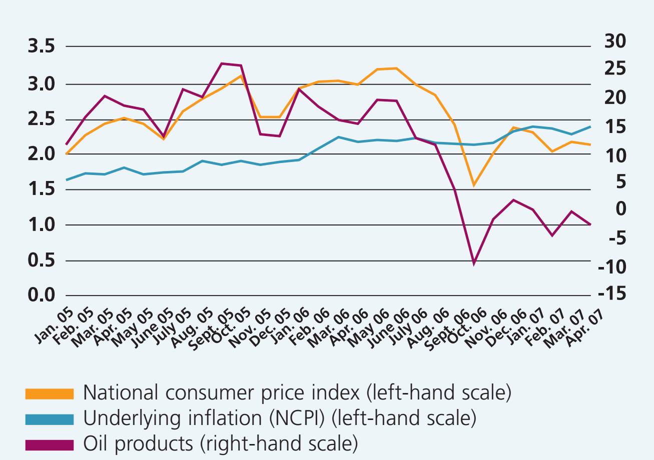
1.2.1 Prices and costs

1.2.1.1 Consumer prices and inflation projections

The national index of consumer prices (NICP) increased by an average 2.7% in 2006, up by a 0.2 percentage point when compared with 2005. Thus, inflation has increased for the third consecutive year. The increase in inflation last year was due both to oil price developments and rising underlying inflation.

The direct impact of fiscal policy on the NICP amounted to about a 0.6 percentage point in 2006, up from some 0.4 percentage point in 2005. The average annual growth rate of administered prices rose from some 2.1% in 2005 to 3.9% in 2006. This was a higher rate than the one recorded for the euro area. Hence, the increase in inflation recorded in 2006 partly reflected rises in administered prices and indirect taxes.

CHART 9: INFLATION AND OIL PRODUCTS (ANNUAL PERCENTAGE CHANGES)

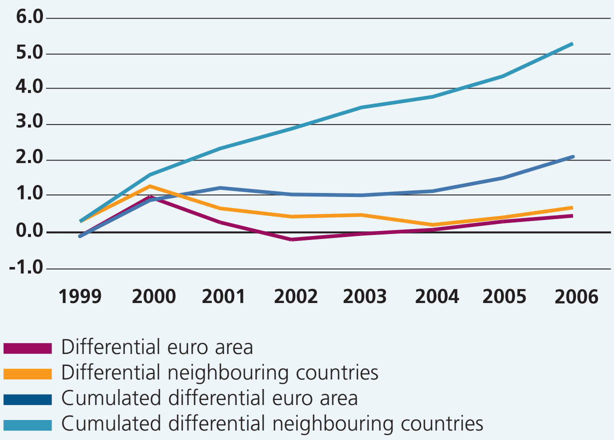


Source: STATEC

Turning to developments in early 2007, inflation hovered between 2.0% and 2.3% over the period from January to April 2007. The contribution from oil product prices to the annual rate of change was moderate during this period, reflecting mainly favourable base effects. Underlying inflation pressures continued the upward trend observed since early 2005.

The inflation differential of Luxembourg vis-à-vis the euro area and the neighbouring countries worsened further in 2006. The cumulated inflation differentials between Luxembourg and the euro area and between Luxembourg and its neighbours stood at 2.1 and 5.3 percentage points respectively (see chart 10).

CHART 10: INFLATION DIFFERENTIALS (PERCENTAGE POINTS)



Sources: STATEC, Eurostat, BCL calculations

Inflation projections

Assumptions

Mid-may, the price of oil fluctuated around 66$/bl and the markets were anticipating a marginal increase to a level close to 70$/bl in June 2008. The quote for one euro against the dollar stood at 1.36, which corresponds to an appreciation with respect to both the average of 2006 and the previous exercise. Detailed assumptions are given in the following table.

TABLE 2: ASSUMPTIONS UNDERLYING THE INFLATION PROJECTIONS

	2006	2007	07-Q1	07-Q2	07-Q3	07-Q4	08-Q1	08-Q2
Price of oil in $/bl	65.4	65.0	58.0	66.6	67.0	68.5	69.4	69.9
Exchange rate $/€	1.26	1.34	1.31	1.35	1.36	1.36	1.36	1.36
Price of oil in euros (in annual percentage changes)	18.6	-7.2	-14.1	-11.6	-10.2	9.0	15.6	4.9

Source: BCL

As regards the fiscal measures introduced by the government, they remain unchanged compared to the previous exercise. The projections take into account the increase in the level of excise duties on diesel by 12.5€/1 000l and petrol by 20€/1 000l from 1st January 2007 onwards. According to our estimates, the additional impact of these two fiscal measures on the NICP corresponds to a 0.07pp in 2007. The impact on the HICP is higher, at around a 0.2pp.

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. At the beginning of 2007, the less favourable outcome in the HICP excluding energy can be traced, first to a hike in tariffs for public services and, second to a slight acceleration in the non-energy industrial goods inflation. Economic growth in the euro area is continuing on the path that started in mid-2005. Attention is gradually shifting to the speed at which the output gap is closing, creating inflationary pressures. This is becoming important as economic growth has spilled over into the labour market, resulting in dynamic employment growth and a decline in unemployment. According to the European Commission's projections, nominal and real wage growth will accelerate in the euro area, slightly in 2007 and even more in 2008. In Luxembourg, the risk from spiralling wages seems fairly contained in the short term in light of the 2006 government measures. Imported inflation however is expected to accelerate in 2007, before declining slightly.

Results

Projections for both the energy and the ex-energy components of the NICP have been revised upwards compared to the previous exercise. On the basis of the euro oil price assumptions, the contribution of the energy component to headline inflation would be broadly neutral in 2007, whereas the HICP and the NICP excluding energy are expected to accelerate in 2007 compared to 2006, before dropping slightly at the beginning of 2008. As a result, annual average NICP inflation should be roughly stable around or slightly above 2.0%. However, the quarterly is somewhat more volatile (see chart 11), with the rate dropping below 2.0% in the third quarter of 2007 followed by an acceleration close to 2.5% at the end of the year and an easing of inflation thereafter.

The impact of government measures on headline inflation is set to accelerate in 2007 compared to 2006, mainly on the basis of the surprisingly strong hikes in public tariffs that have been observed at the beginning of 2007. In return, though, the payout of the upcoming automatic wage indexation, projected for November 2007, would be postponed until March 2008, in line with the government measures agreed in 2006.

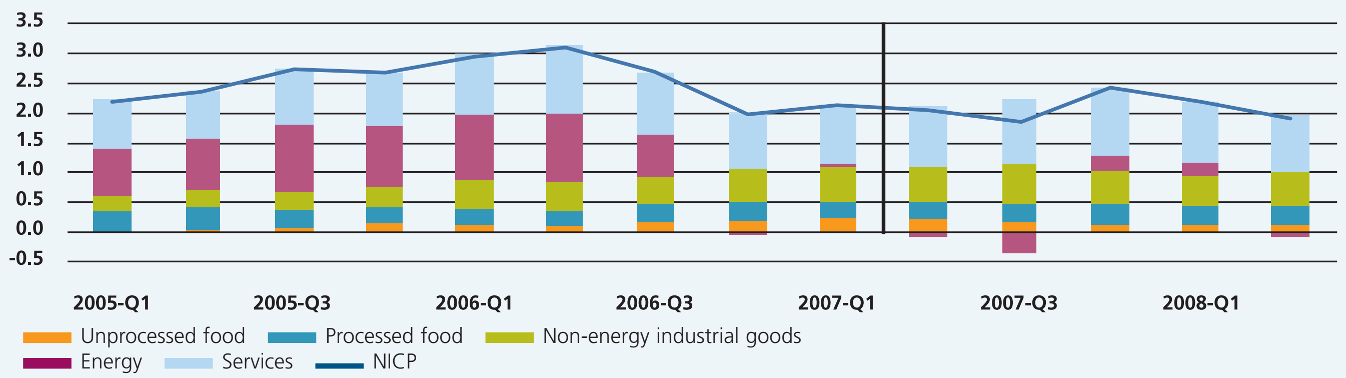
TABLE 3: INFLATION PROJECTIONS AND REVISIONS COMPARED TO THE PREVIOUS EXERCISE (IN ANNUAL PERCENTAGE CHANGES, RESP. IN PERCENTAGE POINTS)

	2006	2007	2007-1st half	2007-2nd half	2008-1st half
NICP	2.7	2.1 (0.2)	2.1 (0.2)	2.1 (0.2)	2.0
NICP ex energy	2.1	2.3 (0.1)	2.3 (0.1)	2.4 (0.1)	2.1
HICP	3.0	2.4 (0.4)	2.3 (0.5)	2.5 (0.3)	2.5
HICP energy	7.9	-0.3 (2.3)	-0.5 (3.2)	-0.2 (1.4)	1.3
HICP ex energy	2.3	2.8 (0.2)	2.7 (0.2)	2.9 (0.2)	2.7
Impact of government measures[1] on the NICP, in pp	0.6	0.8			
Impact of government measures on the HICP, in pp	0.9	1.3			

[1] *The total impact encompasses the impact of administered prices, indirect taxation and of tobacco.*

Source: BCL

CHART 11: CONTRIBUTIONS TO NICP INFLATION



Sources: STATEC, BCL calculations

1.2.1.2 Producer prices in industry

Industrial producer prices increased on average by 7.7% in 2006, broadly at the same pace as observed in 2005. The price adjustments reflect mostly price increases of intermediate goods, and steel goods in particular, whereas the price hikes for capital and consumer goods were much more muted. Three factors probably explain to a large extent these price developments. The oil price increased in 2006, on average by 11$/bl compared to 2005. Despite the weakening of the U.S. economy, world growth has also remained steady, particularly on the back of the dynamism observed in the South-east Asian economies. Finally, the euro has appreciated in effective terms, both in 2006 and at the beginning of 2007 (see 1.1.4).

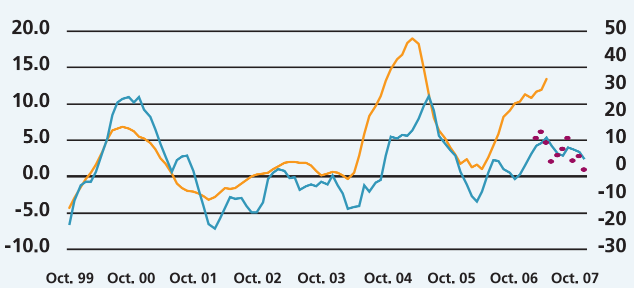
The outlook for industrial producer prices has turned less favourable in recent months. While inflation has steadily increased since the beginning of 2006, a trend reversion in the near future is likely according to the results of the harmonised business surveys (see chart). These developments imply a stabilisation of inflation in the near term, followed by a mild decline in mid-2007.

TABLE 4: INDUSTRIAL PRODUCER PRICES (CHANGES WITH RESPECT TO THE PREVIOUS PERIOD)

	2005	2006	06-Q2	06-Q3	06-Q4	07-Q1
Total	8.1	7.7	3.2	3.8	2.1	2.5
Intermediate goods	10.4	8.8	4.3	4.8	3.0	3.9
Capital goods	0.1	0.9	0.8	0.9	1.5	1.4
Consumer goods	0.9	1.2	0.5	0.4	0.4	-0.7
Energy	11.2	19.9	2.0	2.2	2.1	2.1

Sources: STATEC, BCL

CHART 12: INDUSTRIAL PRODUCER PRICES, PAST AND EXPECTED DEVELOPMENTS



Industrial producer prices ex-energy (3-month MA, in annual percentage changes, left-hand scale)

Selling price expectations (3-month MA, lead of 5 months, right-hand scale)

Selling price expectations (gross, right-hand scale)

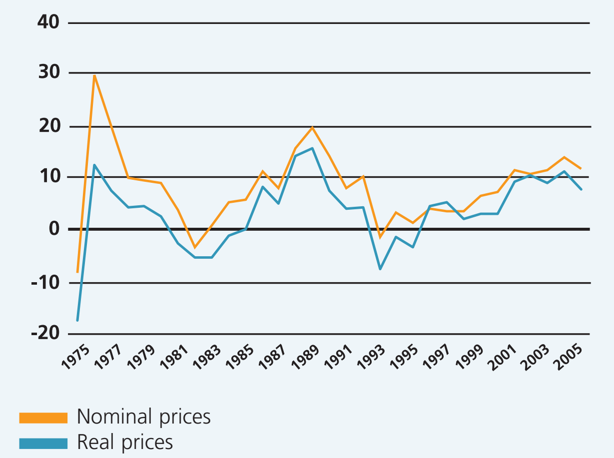
Sources: Eurostat, BCL

1.2.1.3 Construction prices

Prices of construction services increased by 2.6% in 2006, less than the 3.1% observed in 2005. This increase is also below the 2.9% hike in nominal wages that is solely attributable to the automatic wage indexation scheme and which compensates for past consumer price inflation.

The next chart illustrates that residential property price inflation remained strong in 2005, albeit at a diminishing rate. Indeed, the annual nominal (real[1]) growth rate declined to 11.7% (7.8%) in 2005, from 14.0% (11.1) in 2004. The chart also shows that nominal and real house price growth recorded over the past years, albeit high, does not seem exceptional given past experience.

CHART 13: RESIDENTIAL PROPERTY PRICES (ANNUAL PERCENTAGE CHANGES)



Sources: STATEC, BCL calculations

[1] The private consumption deflator was used here.

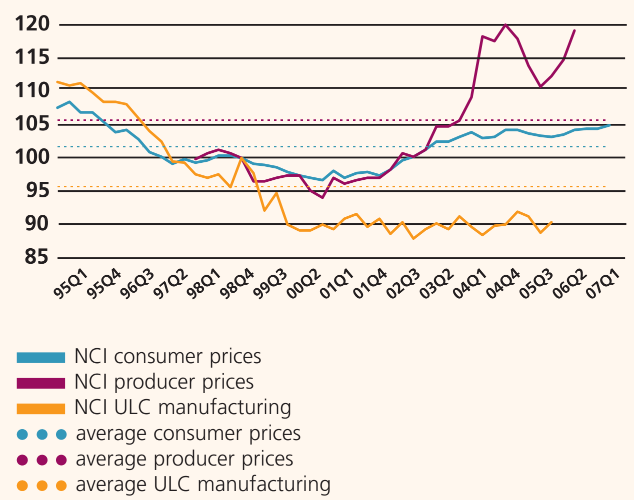
Competitiveness Indicators

The BCL regularly publishes competitiveness indicators based on effective exchange rates deflated by using different price or cost indices. These indicators compare prices or costs in Luxembourg with a weighted average of those in partner countries, where the prices or costs are expressed in a common currency and the weights reflect the importance of the country in question in Luxembourg's international trade. These indicators are calculated for 37 countries (27 in the EU and 10 others, see BCL bulletin 2005/2) depending on data availability.

The latest observations confirm that Luxembourg's competitiveness has continued to deteriorate. However, in 2006 Luxembourg also witnessed strong growth of exports, output and employment, complicating the interpretation of these indicators. It bears repeating that real effective exchange rates only measure price- or cost-competitiveness and neglect other dimensions of this multifaceted concept. Luxembourg's exporters may benefit from other advantages that provide them with some market power, allowing them to raise prices when facing higher demand, and thus to absorb higher costs. In fact, the real effective exchange rate is only one of several indicators considered by the Observatoire de la compétitivité or in the recent publication by the Swiss IMD institute, which found an improvement in Luxembourg's relative position.

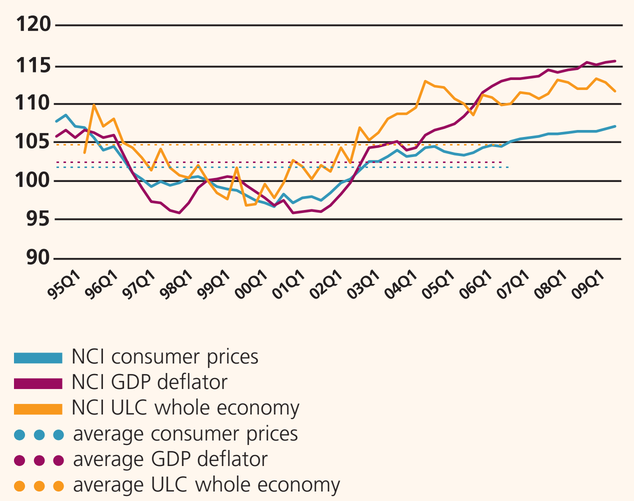
The first chart plots Luxembourg's real effective exchange rate deflated by the index of consumer prices, by the index of producer prices, and by unit labour costs in manufacturing. An increase in the curve represents a deterioration of Luxembourg's competitiveness (prices or costs rising faster in Luxembourg than in its trading partners). The latest observations confirm the upward trend in the consumer price indicator. In 2007Q1 this indicator lies above its historical average (calculated since 1995Q1) by 3.2%. However, many of Luxembourg's exports are not in the consumer price index, which instead includes many goods and services that are only imported. The producer competitiveness price indicator is limited to goods that are more likely to be tradables. In 2006, this indicator exceeded its old peak in 2004Q4 and reached a new record 20.6% above its historical average (since 1998Q1). These strong fluctuations reflect robust price growth in the steel sector, which is over-represented in Luxembourg's industry. Therefore, the producer price indicator probably gives a distorted view of competitiveness developments in the economy as a whole. For the indicator based on unit labour costs in manufacturing, the latest available observations are still below the historical average (-5.5% in 2005Q4). However, this indicator is not yet available for 2006 as the underlying data is only available with a substantial lag in some partner countries.

CHART 14: NATIONAL COMPETITIVENESS INDICATORS BASED ON CONSUMER PRICES, PRODUCER PRICES, AND UNIT LABOUR COSTS IN MANUFACTURING



Sources: ECB, IMF, and BCL calculations

CHART 15: NATIONAL COMPETITIVENESS INDICATORS BASED ON CONSUMER PRICES, GDP DEFLATORS, AND UNIT LABOUR COSTS IN THE WHOLE ECONOMY



Sources: Eurosystem, IMF, and BCL calculations

Three of Luxembourg's competitiveness indicators can be extended using the results of the recent Eurosystem projections. These are the consumer price indicator, the one based on the GDP deflator, and the indicator based on unit labour costs in the whole economy. Note that GDP deflator projections are only available for the 13 euro area member states and some of the most important other commercial partners. Indicators based on consumer prices and on the GDP deflator reflect not only the projections for euro area member countries but also technical assumptions regarding nominal exchange rates and GDP deflators in the UK, the US, Switzerland and Japan. For the indicator based on whole economy unit labour costs, the projections only consider euro area member countries and the US.

According to the indicator based on the GDP deflator and that based on whole economy unit labour costs, the most recent observation (2006Q4) confirms the continuing deterioration of competitiveness. According to the projections, this deterioration should continue on all three indicators until the end of the forecast horizon in 2009Q4. The consumer price indicator should pass from 3.3% above its historical average in 2007Q1 to +5.2% in 2009Q4. The indicator based on the GDP deflator should pass from +10.3% in 2006Q4 to +12.7% in 2009Q4. Finally, the indicator based on whole economy unit labour costs should pass from +5.0% in 2006Q4 to +6.6% in 2009Q4.

The box in the last annual report argued that the "modulation" of automatic wage indexation agreed in 2006 could mitigate the competitiveness deterioration but could not reverse its trend. In fact, in 2006 the deterioration was 0.5% on the consumer price indicator and 4.0% according to the indicator based on the GDP deflator. On the other hand, competitiveness improved 1% in 2006 according to the indicator based on whole economy unit labour costs, mostly thanks to higher than anticipated growth (and therefore productivity). However, according to the projections (based on "modulated" wage indexation) all three indicators should deteriorate in 2007, 2008 and 2009. The indicator based on the GDP deflator should increase faster than the one based on whole economy unit labour costs, suggesting that firms have enough market power to increase their margin. This puts into perspective the loss in price competitiveness. In any case, the recent increase in productivity has slowed the increase in unit labour costs, but is not sufficient to avoid a deterioration of cost competitiveness vis-à-vis our main commercial partners.

In conclusion, yet again price and cost competitiveness indicators confirm that the deterioration has continued. This message needs to be seen in perspective given the good performance of Luxembourg's economy in 2006. However, the government should rapidly implement the structural reforms envisaged by the Lisbon process to durably increase productivity, thus helping Luxembourg's exporters face the anticipated rise in prices and costs relative to those in our main trading partners.

Towards a New Business Cycle Indicator for Luxembourg
Methodological presentation and preliminary results[2]

One major aim of economic analysis is to track economic growth and provide an assessment of the present economic situation. On the one hand, GDP is frequently considered basic series of reference. On the other hand, it is released on a quarterly basis with a certain delay and may be subject to significant revisions. For these reasons, it is interesting to consider other economic and financial data series with shorter publication lags and other advantages such as fluctuations in line with those of GDP, released at monthly intervals. This is the case for most monthly statistics related to employment, industrial production, interest rates or business surveys which are published by national statistics institutes or central banks.

At this level, two main approaches exist. First, one selects a limited number of series and tracks their evolution. The selection criteria may reflect the ex-post ability of the series to reproduce GDP movements or a priori beliefs based on economic theory. Given the huge quantity of data series available, the choice may be criticised as subjective. The second approach provides a partial escape from this issue. The selection criterion does not matter because a large number of economic and financial time series may be considered. Generalised dynamic factor models are a typical illustration of this second approach[3]. The aim is to synthesise information contained in a large sample of economic and financial time series, which sometimes exhibit erratic monthly movements.

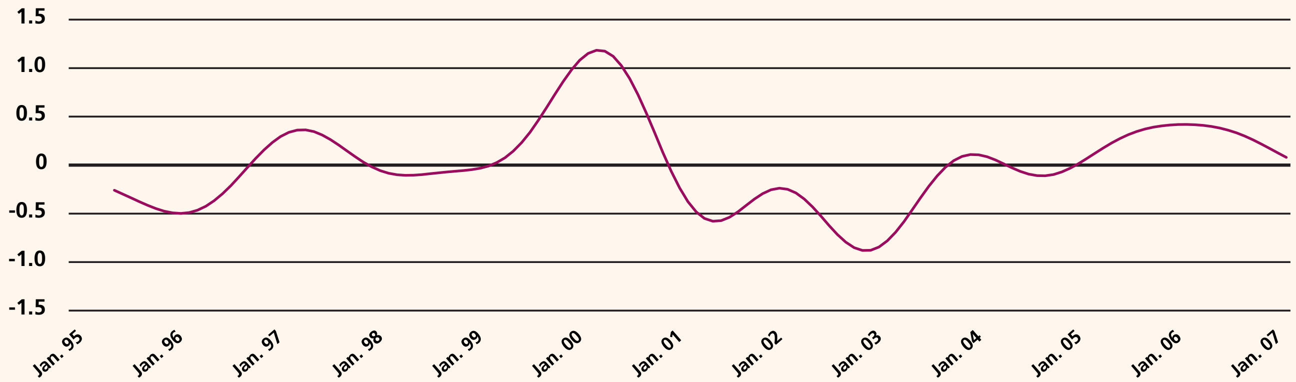
Using a dynamic factor model to construct an indicator of economic activity remains a purely statistical approach. The model assumes the existence of a limited number of factors that explain most of the individual fluctuations in time series. These factors - which may be viewed as fundamental shocks that affect the economy - are also used to construct the business cycle indicator. Using such a model has several benefits. Firstly, the resulting indicator will be based on a well-defined econometric representation. Secondly, the indicator will be less volatile than GDP and thus more informative. Thirdly, it will reflect medium- to long-run developments of the economy, i.e. those that are adjusted from short-term fluctuations - due to noise, seasonality, etc. It is important to note that €urocoin is the only regularly-published indicator of economic activity that is backed by a generalised dynamic factor model[4]. This methodology has also been used by the Banque centrale du Luxembourg for its forthcoming indicator of economic activity. The results presented here are still preliminary.

In order to construct a business cycle indicator for Luxembourg, 76 monthly and one quarterly time series from January 1995 to December 2006 have been used. Apart from GDP, the dataset contains data series related to financial markets, business surveys, prices, industrial production, turnover, employment and external trade. The raw business cycle indicator is based on two factors that summarise the information contained in the 77 series. As a result, it is more stable than the individual series in the sample (e.g. stock exchange indices are less volatile than the individual shares they include).

The smoothed business cycle indicator is obtained by removing the most volatile movements that are likely to be inverted in the short-run. This smoothed version of the business cycle indicator (see chart 16) captures the more persistent component of economic growth. The interpretation is as follows. The business cycle indicator is centred on 0. Positive values (negative values) of the indicator indicate economic activity growing above (below) its historical mean. This historical mean is equal to a quarterly GDP growth of about 1.1%.

The business cycle indicator gives a clear message. It identifies the strong growth of 1999-2000, and detects the slowdown observed in 2001. After having reached a local peak at end 2005, the indicator decreased. Latest data suggests that economic activity is currently growing at a pace which is closer to its historical mean. At this stage, interpreting these latest observations requires caution because the indicator is likely to be revised with the release of new data.

CHART 16: THE BUSINESS CYCLE INDICATOR FOR LUXEMBOURG



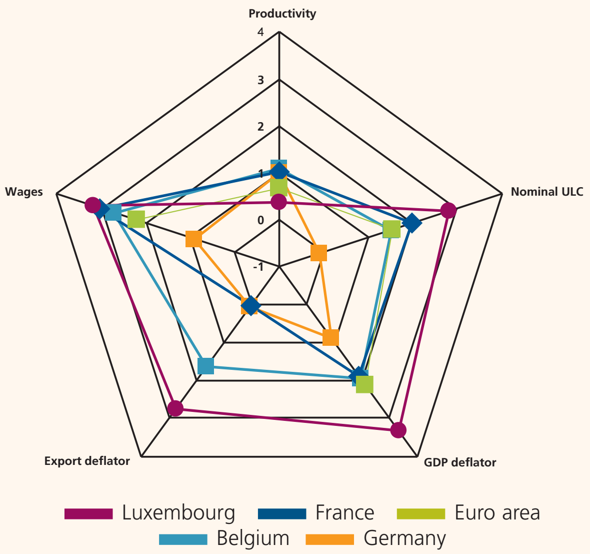
Source: BCL

[2] The definitive version of the indicator is expected for the end of 2007. It will be presented in detail in a forthcoming working paper.
[3] See Forni, M., M. Hallin, M. Lippi and L. Reichlin (2000): The Generalized Dynamic-Factor Model: Identification and Estimation. The Review of Economics and Statistics, 82(4), 540-554.
[4] See Altissimo F., Bassanetti A., Cristadoro R., Forni M., Lippi M., Reichlin L. and Veronese G. (2001): EuroCOIN: A Real Time Coincident Indicator of the Euro Area Business Cycle. CEPR Discussion Paper 3108, Centre for Economic and Policy Research.

Evolution of employment, GDP and productivity in Luxembourg

Compared to its neighbours as well as to the euro area, Luxembourg recently appears to have performed poorly with respect to productivity (growing slowly) as well as compensation per employee, unit labor cost, export prices and GDP deflator (all rising quickly).

CHART 17: PRODUCTIVITY, PRICES AND COSTS (2001-2006)



Sources: Eurostat, BCL calculation

However, Luxembourg outperformed most euro area countries in terms of employment, real GDP and export growth.

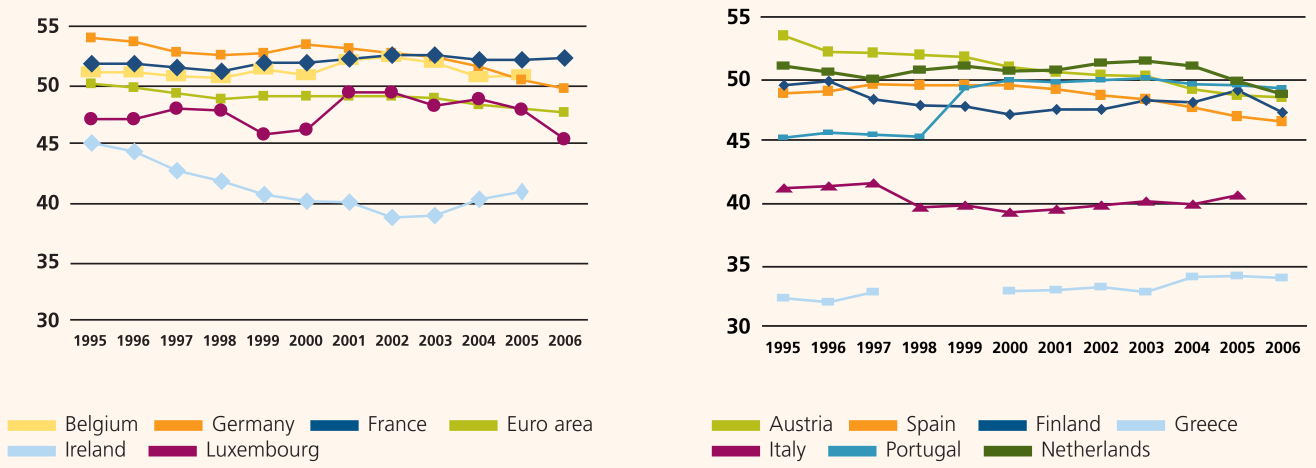
TABLE 5: ECONOMIC PERFORMANCE OF EURO AREA COUNTRIES (2001-2006)

	Annual real GDP growth	Annual real export growth	Annual total employment growth	GDP deflator	Export deflator
Greece	4.4	2.1	1.3	3.3	2.6
Ireland	4.3	4.1	2.4	3.5	0.5
Luxembourg	**3.6**	**7.1**	**3.2**	**3.3**	**2.8**
Spain	3.3	3.6	3.2	4.1	2.0
Finland	3.0	4.8	1.0	1.0	-0.4
Euro area	**1.6**	**-**	**0.9**	**2.1**	**-**
France	1.6	2.5	0.5	1.9	0.0
Belgium	1.5	2.7	0.6	1.9	1.6
Netherlands	1.4	4.2	0.4	2.5	0.7
Austria	1.3	5.8	0.1	1.6	1.1
Germany	1.0	7.0	0.0	0.9	0.1
Italy	0.9	0.3	1.0	2.7	3.8
Portugal	0.9	3.5	0.7	3.2	1.3

Source: Eurostat

As prices and volumes increased simultaneously, it turns out that a favourable evolution of (international) demand was the main determinant of prices and quantities rather than supply side developments. Strong growth of the GDP deflator, rather than being a competitive disadvantage, allowed for relatively high wage increases without any significant increase in the wage share.

CHART 18: EVOLUTION OF THE WAGE SHARE



Sources: Eurostat, BCL calculation

However, developments differ across sectors. For instance, the manufacturing sector experienced increasing productivity, low value added deflator growth and a simultaneous drop in employment, virtually stagnating output as well as a marked increase in the wage share with a resulting drop in profitability. The financial services sector suffered a drop in productivity, an important rise in the price of value added, a strong increase in both employment and output, with the wage share remaining virtually constant. For the economy as a whole, even though productivity stagnated, the increase in compensation per employee did not cause a significant increase in the wage share.

TABLE 6: EVOLUTION BY SECTOR (2000-2005)*

	Nominal VA	Real VA	Total Employment	Wage share	Productivity	Compensation of employees	Compensation per employee
Industry including energy	10.3	5.6	-0.9	4.0	6.6	17.7	19.1
Manufacturing	**4.8**	**1.5**	**-1.5**	**7.1**	**3.0**	**16.8**	**18.6**
Construction	35.2	18.5	17.0	2.1	1.3	39.6	18.6
Trade	34.1	20.8	13.2	1.3	6.8	37.9	20.6
Sales; Repair of cars and of domestic articles	35.9	8.0	12.6	0.7	-4.1	37.8	20.9
Hotels and restaurants	34.2	5.8	11.8	0.1	-5.4	34.5	18.0
Transport and communication	32.5	37.5	15.1	2.0	19.5	38.8	20.0
Financial activities; real estate, renting and services to enterprises	35.5	15.9	22.0	1.5	-5.0	40.5	14.3
Financial services	**29.5**	**10.7**	**15.6**	**0.7**	**-4.2**	**31.6**	**13.9**
Services for real estate, renting and services to enterprises	43.5	22.1	26.8	3.0	-3.7	56.3	21.2
Other services	51.7	19.5	25.6	-1.3	-4.9	49.3	17.8
Total	**34.1**	**16.2**	**16.5**	**1.7**	**-0.3**	**38.6**	**17.9**

* *Cumulated change (in percent, except for the wage share, the change of which is indicated in cumulated percentage points)*

Sources: STATEC, BCL calculations

Apparently, the sectoral and/or geographical specialization of Luxembourg's exports has been such that the demand for these exports was so dynamic it allowed for an economic performance that was better than what productivity developments would justify. While this may explain the favorable evolution of the Luxembourg economy during recent years, nothing guarantees a further continuation of this evolution. In the medium and long run, wage moderation and productivity growth remain key determinants of competitiveness and of Luxembourg's ability to generate income.

1.2.2 Sectoral developments

1.2.2.1 Industry

In the context of a favourable international environment, the industrial sector has witnessed a very positive performance in 2006. Benefiting from price increases, turnover rose by more than 14% in 2006. Production per working day also accelerated when compared to 2005. The overall positive result, however, was almost exclusively due to the intermediate goods segment and the steel industry in particular. The rest of the sector fared less well and merely saw a stabilisation of its production level.

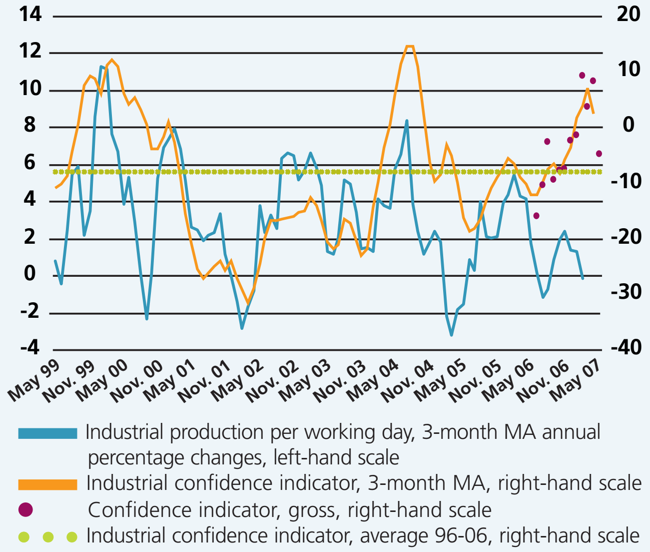
TABLE 7: INDICATORS FOR THE INDUSTRIAL SECTOR (IN ANNUAL PERCENTAGE CHANGES)

	2005	2006	06-Q1	06-Q2	06-Q3	06-Q4
Turnover	2.2	14.7	15.3	16.4	12.8	14.4
Total production	0.5	2.1	5.8	1.9	-1.0	1.5
Production per working day	0.5	2.3	5.5	1.7	-0.7	2.4
Intermediate goods (ppwd)	-0.1	6.2	6.5	7.6	4.2	6.4
Capital goods (ppwd)	11.8	1.2	3.6	0.4	-7.9	8.9
Energy (ppwd)	-0.8	-1.4	5.3	0.5	-5.6	-7.9

Sources: STATEC, BCL

On the back of euro area dynamism, the business surveys in the industrial sector point to relatively favourable developments at the beginning of 2007. The industrial confidence indicator has run up to record levels signalling an acceleration in production in the following months. The capacity utilisation rate, at 89%, has reached its all-time high pointing to the likely emergence of bottlenecks. Companies have also announced an extension of the production facilities via an increase in their investment expenditures.

CHART 19: CONFIDENCE INDICATORS AND INDUSTRIAL PRODUCTION



Sources: STATEC, BCL

1.2.2.2 Construction

The construction sector also fared well in 2006 as both production per working day and turnover accelerated in 2006. But, unlike in manufacturing, growth was more broad-based with similar growth rates being observed in both the civil engineering and the building sectors. As regards the building sector, most demand-related short-term indicators point to a continuation of the relatively favourable trends. Building permits in 2006 have remained at broadly the same level as in 2005 and loans for house purchases were up by 11%, in spite of the upward trend in mortgage rates. Although the ECB has raised rates to 4.0% in June 2007, financing conditions remain favourable.

TABLE 8: INDICATORS FOR THE CONSTRUCTION SECTOR (IN ANNUAL PERCENTAGE CHANGES)

	2005	2006	06-Q2	06-Q3	06-Q4	07-Q1
Turnover - Total	3.1	5.1	3.3	12.9	6.7	Na
Production per working day - Total	-0.6	2.3	1.3	2.1	4.1	Na
Production per working day - Building	1.3	2.2	1.6	1.8	3.4	Na
Production per working day - Civil engineering	-7.5	2.8	-0.2	2.9	7.4	Na
Building permits[1]	21.3	-5.9	-10.9	-0.4	-13.5	Na
Loans for house purchases[2]	16.6	11.2	3.9	2.3	17.1	Na
Mortgage rates	3.5	4.1	3.8	4.0	4.5	4.6

[1] *Number of dwellings*

[2] *Total of mortgage loans to residents*

Sources: STATEC, BCL

1.2.2.3 Commerce and other sectors

The various trade sectors have fared fairly well in 2006, probably as a result of the overall good performance of the Luxembourg economy. Turnover figures in retail and wholesale trade have accelerated, and so have car registrations. These trends can probably be linked to the increase in consumers' purchasing power which has arisen in the context of the strong employment growth and the robust growth in real wages.

Although hotels and restaurants saw slower growth in turnover, this seems nonetheless a very positive result in light of the exceptional circumstances in the first half of 2005, i.e. activities related to the Luxembourg Presidency of the EU.

TABLE 9: TURNOVER AND CAR REGISTRATIONS (IN ANNUAL PERCENTAGE CHANGES)

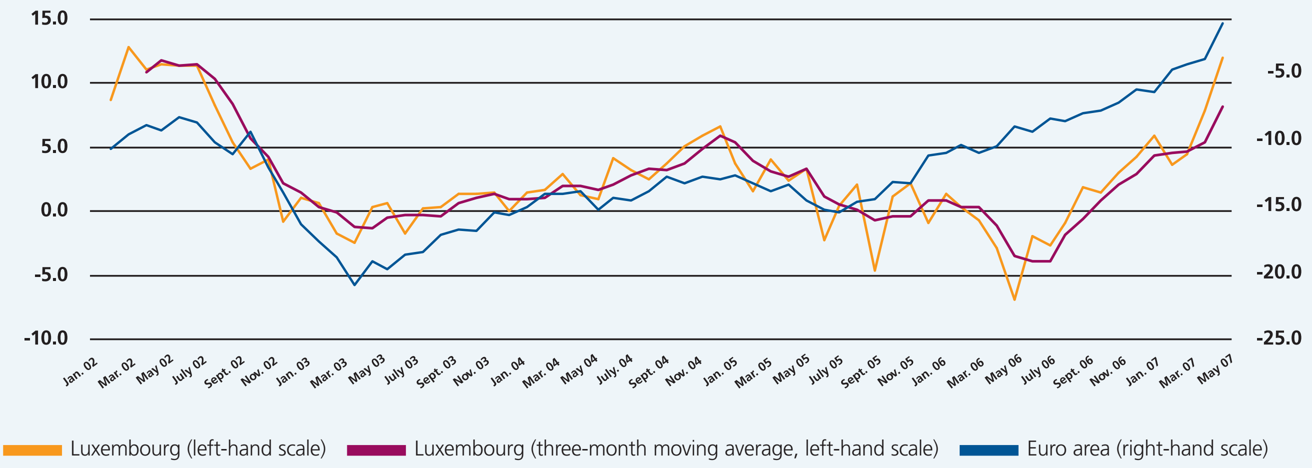
	2005	2006	06-Q2	06-Q3	06-Q4	07-Q1
Car registrations	0.8	4.7	15.5	-0.8	5.9	1.4
Wholesale trade	6.8	7.2	5.3	4.4	7.3	Na
Retail trade	2.3	4.7	6.1	3.4	0.9	Na
Hotels and restaurants	4.7	1.9	1.5	1.3	0.1	Na

Sources: STATEC, BCL

1.2.3 Consumer survey

In early 2006, consumer confidence continued to follow the downward trend observed over 2005, reaching its lowest level since the series began in 2002. This negative trend was then fully reversed, with consumer confidence in May 2007 recording its highest level since April 2002 (see chart). This recovery in confidence was mainly driven by growing optimism concerning future economic developments (i.e. general economic situation and unemployment). Consumers' expectations concerning their financial situation and their ability to save also contributed, albeit to a lesser extent.
The chart also shows that the parallel-movement between Luxembourg and euro area consumer confidence was restored as a result of the improvements recorded in Luxembourg. Domestic factors like the uncertainty surrounding the discussions on the structural reforms and the announcements of lay-offs in several big Luxembourg-based companies seem to have played a lesser role since mid-2006.

CHART 20: CONSUMER CONFIDENCE INDICATOR (SEASONALLY ADJUSTED DATA)



Sources: BCL, European Commission

1.2.4 Financial sector

1.2.4.1 Financial sector activity

Strong growth in major world economies accompanied by a declining petrol price and an environment of well-performing stock prices supported Luxembourg's financial centre. Stock market corrections in the principal indexes surveyed in May and June 2006 were only temporary. Nevertheless, they had repercussion effects on the annual balance sheet of the financial sector.

The good performance of main stock exchanges as well as the influx of new capital have particularly favoured growth of the investment fund industry, which shows a significantly higher growth rate than credit institutions. Moreover, growth of the Luxembourg financial industry is also fostered by the success of investment companies in risk capital (SICAR), with 114 registered units on the official list at 31 December 2006 against 47 units at the end of 2005. The number of securitisation vehicles approved in accordance with the law of 22 March 2004 relating to securitisation passed from 6 to 11 units. However, the number of pension funds, separated into pension saving companies with variable capital (sepcav) and pension savings associations (assep), has decreased by one unit reaching a level of 14 entities.

By the end of 2006, 2 238 UCIs (undertakings for collective investment) were recorded on the official list, showing an increase of 178 units compared with figures end December 2005. This upward trend is confirmed by NAV (net assets value) growth of 319 642 million euros (21%) between these year end periods. The NAV reached 1 844 850 million euros by 31 December 2006. Moreover, net capital investment amounted to 241 344 million euros during 2006 against 236 277 million euros during the year 2005.

TABLE 10: GLOBAL SITUATION OF UNDERTAKINGS FOR COLLECTIVE INVESTMENTS (IN MILLIONS OF EUROS, OUTSTANDING AMOUNTS AT END OF PERIOD, EXCEPT WHERE OTHERWISE STATED)

	Number of UCIs	Number of sub funds	Net asset value	Net capital investment [1)2)]	Variation of financial market [2)3)]	Annual change in EUR million	Annual percentage change
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	113,731	39,189	152,920	16.0
2005	2,060	8,497	1,525,208	236,277	182,709	418,986	37.9
2006							
March	2,091	8,724	1,675,260	106,569	43,483	481,250	40.3
June	2,130	8,909	1,652,126	46,996	-70,130	362,339	28.1
Sep.	2,170	9,122	1,733,030	32,872	48,032	309,479	21.7
Dec.	2,238	9,473	1,844,850	54,907	56,913	319,642	21.0
2007							
Jan.	2,260	9,563	1,895,810	30,749	20,211	312,566	19.7
Feb.	2,278	9,637	1,908,707	29,083	-16,186	270,601	16.5
March	2,248	9,680	1,927,360	6,378	12,275	252,100	15.0
April	2, 276	9,793	1,966,966	22,233	17,403	264,757	15.6

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) Figures cumulated on a yearly / quarterly / monthly basis.

3) The column variation of financial markets reflects the yearly / quarterly / monthly change in net assets which is due to the fluctuation of financial markets.

Source: CSSF

Regarding money market funds, the balance sheet went up by only 8 889 million euros in 2006 (4.9%) to reach 189 601 million euros at 31 December 2006. This relatively weak development of money market funds reflects strong performance of stock markets. Against this background, investors have been looking for products with higher yields than usually achievable with money market funds.

Regarding the banking sector, aggregate balance sheets have increased virtually uninterrupted since 2003, and continued to do so in 2006 and during the three first months of 2007. The aggregate balance sheet increased by 47 145 million euros (5.9%) between 31 December 2005 and 31 December 2006. On a quarterly basis, this increase reached 2.5% calculated for the time span end-December 2006 to end March 2007. Growth was mainly due to portfolio investment activity, to loans to non-banking customers on the asset side, and to deposits from non-banking customers on the liability side.

Luxembourg banks hold a growing part of their assets and liabilities in connection with non-banking customers, clients where margins are usually more important compared to less profitable interbank business. Accordingly, on the asset side, the volume of interbank credits increased by 3.0% between end December 2005 and end-December 2006. This is low compared to annual growth rates marked by loans to non-banking customers (10.0%) and investment portfolios (8.4%).

TABLE 11: MAIN FIGURES RELATING TO THE ASSET SIDE OF THE AGGREGATE BALANCE SHEET (OUTSTANDING AMOUNTS AT END OF PERIOD)

Assets	Amounts in million euros			Variation in million euros and in %				Relative weight[1]
	2005/12	2006/12	2007/03	2005/12 - 2006/12		2006/12 - 2007/03		2007/03
				million euros	in %	million euros	in %	
Interbank loans	405,891	417,942	433,740	12,052	3.0	15,798	3.8	50.4
Loans to non-banking customers	146,640	161,250	167,001	14,610	10.0	5,751	3.6	19.4
Portfolio investment	215,439	233,602	233,915	18,163	8.4	313	0.1	27.2
Other assets	24,451	26,771	26,085	2,321	9.5	-686	-2.6	3.0
Total assets	792,420	839,565	860,741	47,145	5.9	21,176	2.5	100.0

[1] *Relative weight in relation to total assets*

Source: BCL

TABLE 12: MAIN FIGURES RELATING TO THE LIABILITY SIDE OF THE AGGREGATE BALANCE SHEET (OUTSTANDING AMOUNTS AT END OF PERIOD)

Liabilities	Amount in million euros			Variation in million euros and in %				Relative weight[1]
	2005/12	2006/12	2007/03	2005/12 - 2006/12		2006/12 - 2007/03		2007/03
				million euros	in %	million euros	in%	
Interbanks debts	386,031	386,087	407,625	56	0.0	21,538	5.6	47.4
Deposits to non-banking customers	255,580	296,803	293,970	41,223	16.1	-2,833	-1.0	34.2
Debt securities issued	89,535	90,043	90,352	507	0.6	309	0.3	10.5
Other liabilities	61,273	66,632	68,794	5,359	8.7	2,162	3.2	8.0
Total liabilities	792,420	839,565	860,741	47,145	5.9	21,176	2.5	100.0

[1] *Relative weight in relation to total liabilities*

Source: BCL

The liability side of the aggregate balance sheet of Luxembourg credit institutions appears rather different. Indeed, most growth stems from the strong performance of refinancing activities through issues of debt securities bought by non-banking customers. This activity demonstrates a remarkable dynamism, with growth of 16.1% (41,223 million euros) on an annual basis between December 2005 and December 2006. However, the first quarter of 2007 showed a sign of consolidation, with growth diminishing slightly by 1.0% with debt vis-à-vis private clients reaching a level of 293 947 million euros by end of first quarter 2007.

With a growth rate of 0.7% or 6,052 million euros with reference to 31 March 2007, the data for April 2007 confirm the further strengthening of the aggregate balance sheet observed during the first quarter 2007.

1.2.4.2 Retail interest rates in Luxembourg

During 2006, the development of retail interest rates followed roughly those of the Eurosystem's main refinancing rate. The latter increased from 2.25% by the end of December 2005 to 3.50% at the end of 2006.

The cost of floating rate housing loans granted by Luxembourg's banks to euro area residents (including Luxembourg) increased by 89 basis points between end December 2005 (3.62%) and end-December 2006 (4.51%).
As of 30 April 2007, the cost of housing loans reached 4.66%.

Meanwhile, new business volumes have increased from a monthly average of €164 millions during 2005 to €186 millions during the year 2006. For April 2007, €191 million housing loans were granted by Luxembourg's banks to euro area's consumers.

Besides, the share of floating rates in total new business remains quite steady at 84% by the end of the first quarter 2007.

The cost of consumption loans, with interest rate fixed between one and five years, has increased by 40 basis points between end-December 2005 (5.42%) and end-December 2006 (5.82%). At the end of the first four months of 2007, the cost of consumption loans reached 5.76%. This decline is due to commercial fairs that take place during February but that have a lagging effect on new business rates.

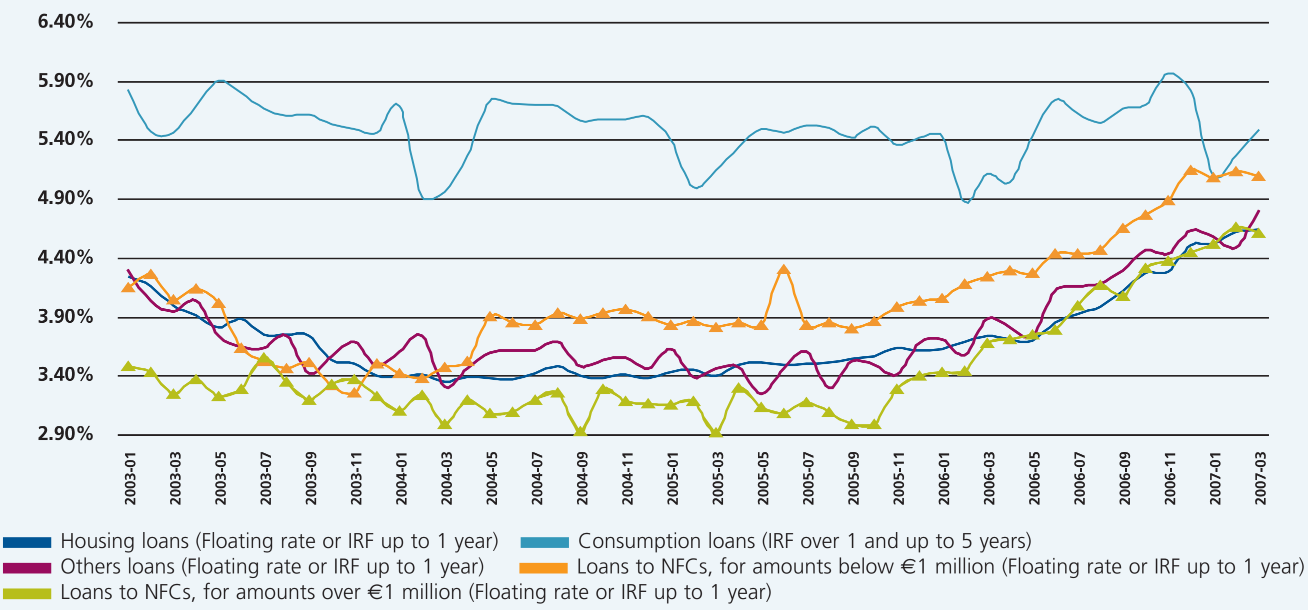
The cost of other floating rates loans increased by 96 basis points during 2006 to reach 4.63% as of end-December 2006. The situation in April 2007 confirmed the trend formerly observed in 2006, since interest rates on other loans reached 4.94%. It is worth mentioning that 90% of other loan contracts are granted to non-resident households.

The cost of floating rate loans to non-financial corporations (NFCs) and concerning amounts below one million euros, increased by 111 basis points between end December 2005 (4.04%) and end-December 2006 (5.15%). During the first quarter of 2007, costs increased by 17 basis points, amounting to 5.32 % as of 30 April 2007.

Regarding loans to NFCs with amounts over one million euros, the underlying floating rate increased 104 basis points between end-2005 (3.41%) and end-2006 (4.45%). The latter loans were granted with an interest rate of 5.24% by end-April 2007.

During the period December 2005 to December 2006, rates on deposits from households and NFCs have increased by 110 and 115 basis points, respectively. This trend continues through the first quarter of 2007 and deposit rates went up to 3.45% and 3.85%, respectively, as of end-April 2007.

CHART 21: INTEREST RATES ON LOANS: JANUARY 2003 - MARCH 2007



Source: BCL

1.2.4.3 Employment in the financial sector

By the end of 2007 Q1, Luxembourg's banks employed 25 178 staff members (of which 29% are residents). Employment in Luxembourg credit institutions increased by 1,424 units (5.99%) between 31 March 2006 and 31 March 2007. This figure comprises a real increase of 1,209 units and a technical increase of 215 units due to an enlargement of coverage (i.e. the number of institutions that were taken into account). Since the first quarter of 2007, local offices (caisses rurales) of the Raiffeisen Bank are included.

However, with 229 jobs created during the first quarter of 2007 (at constant perimeter) employment growth remains significant. The upward trend observed is confirmed by developments registered in 2004 (+0.16%), 2005 (+2.99%) and 2006 (+6.50%), respectively.

1.2.4.4 Profit and loss accounts

2006 has been an excellent year for Luxembourg's credit institutions, which achieved an aggregate net result after taxes of €5,716 million. This represents a rise of €2,170 million, or 61.2% compared with 2005. Strong world economic growth, a generally favourable performance of the major stock indices as well as a boost of other net income due to realized nominal holding gains in the course of 2006 allowed Luxembourg credit institutions to obtain these good results. Having declined for four consecutive years, the interest margin rose by 23.8% in 2006. Net income has been influenced, in particular, by a drop in net income from securities of 75.6%, or €292 million, whereas other net income progressed by 265.5%, or €1,216 million. General administrative expenditure (staff costs and other administrative expenditure) rose by 9.8% during 2006. Staff costs increased due to wage adjustments and to new job creation in the banking sector (+ 1510 jobs).

TABLE 13: AGGREGATE PROFIT AND LOSS ACCOUNT OF THE LUXEMBOURG BANKS AT YEAR-END, INCLUDING THEIR FOREIGN BRANCHES[1) 2)]

(EUR millions except otherwise indicated)

Debit and credit items	2001	2002	2003	2004	2005	2006
1 Interest receivable and income from securities	52,790	43,170	35,135	30,964	36,249	49,972
2 Interest payable	48,332	38,895	31,000	26,874	32,288	45,069
3 Interest margin (1-2)	4,458	4,275	4,135	4,090	3,961	4,903
Other income:						
4 from securities	174	173	288	417	386	94
5 from commission	2,830	2,654	2,552	2,853	3,253	3,761
6 from foreign exchange	290	317	282	300	356	446
7 other net income	399	949	429	68	458	1,674
8 Net income (4+5+6+7)	3,693	4,093	3,552	3,638	4,453	5,975
9 Gross income (3+8)	8,151	8,368	7,687	7,728	8,414	10,878
10 Staff costs	1,804	1,871	1,790	1,884	1,994	2,208
11 Other administrative expenditures	1,506	1,416	1,370	1,425	1,499	1,628
12 General administrative expenditures (10+11)	3,310	3,287	3,160	3,309	3,493	3,836
13 Taxes other than tax on income	95	51	41	35	40	46
14 Write downs of non-financial fixed assets	402	316	293	302	273	235
15 Results before provisions (9-12-13-14)	4,344	4,714	4,193	4,082	4,608	6,761
16 Provisions and write downs of fixed financial assets	1,405	1,928	1,241	1,025	906	712
17 Write back of provisions	686	526	590	625	615	519
18 Net provisions	719	1,402	651	400	291	193
19 Result after provisions (15-18)	3,625	3,312	3,542	3,682	4,317	6,568
20 Tax on income	833	636	665	762	771	852
21 Net result (19-20)	2,792	2,676	2,877	2,920	3,546	5,716
22 Average balance sheet total	696,778	700,110	668,146	687,486	754,825	838,227

(in per cent of average balance sheet total)

Debit and credit items	2001	2002	2003	2004	2005	2006
23 Operating costs (row 10 to 14)	0.55	0.52	0.52	0.53	0.50	0.49
24 Results before provisions (row 15)	0.62	0.67	0.63	0.59	0.61	0.81
25 Net provisions (row 18)	0.10	0.20	0.10	0.06	0.04	0.02
26 Result after provisions (row 19)	0.52	0.47	0.53	0.54	0.57	0.78

[1] *Data has been revised in the light of new information. Discrepancies may arise from rounding.*
[2] *2006: provisional data*

Source: BCL

TABLE 14: INTERIM AGGREGATED PROFIT AND LOSS ACCOUNT OF LUXEMBOURG BANKS, EXCLUDING THEIR FOREIGN BRANCHES[1]

Euro millions	2006 / 03	2007 / 03	Annual percentage change	Annual absolute change
1 Interest receivable and income from securities	11,728	15,097	28.7	3.369
2 Interest payable	10,652	13,729	28.9	3.077
3 Interest margin (1-2)	1,076	1,368	27.1	292
Other income:				
4 from securities	79	59	-25.3	-20
5 from commission	1,005	1,076	7.1	71
6 from foreign exchange	126	136	7.9	10
7 other net income	582	188	-67.7	-394
8 Net income (4+5+6+7)	1,792	1,459	-18.6	-333
9 Gross income (3+8)	2,868	2,827	-1.4	-41
10 Staff costs	538	605	12.5	67
11 Other administrative expenditures	396	433	9.3	37
12 General administrative expenditures (10+11)	934	1,038	11.1	104
13 Taxes other than tax on income	12	10	-16.7	-2
14 Write downs of non-financial fixed assets	60	61	1.7	1
15 Results before provisions (9-12-13-14)	1,862	1,718	-7.7	-144

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

Source: BCL

1.2.4.5 Credit institutions' 2007 Q1 results

The interest margin reached €1,368 million in 2007 Q1, which represents a rise of €292 million, or 27.1% compared to the same period a year before. Income from securities represents 1.97% only of the total amount of Interest receivable and Income from securities. However, from an analytical point of view, these dividend payments represented 21.7% of the interest margin, or in absolute terms €297 million, against 13.5% at the end of March 2006.

The high level of income from commission (+28%) in 2006 Q1 was increased by 7.1% to reach €1 076 million on 31 March 2007. Net income in the first quarter of compared with the first quarter of 2006, mainly due to a drop in other net income by 67.7%, or €394 million. Nevertheless, other net income still represented €188 million; a considerable level due to another extraordinary result of €72 million. This drop in net income was almost compensated by the increased interest margin so that gross income just slightly diminished from €2 868 million to €2 827 million, or 1.4%, during the first quarter of 2007 in comparison with the first quarter of 2006.

Within the same time frame, general administrative expenditures (staff costs and other administrative expenditures) rose by 11.1% (€104 million) to a level of €1,038 million. This is mainly due to the creation of 1,424 new jobs and a rise in wages (+2.5%) resulting from the triggering of the automatic wage indexation mechanism in August that became effective in December 2006.

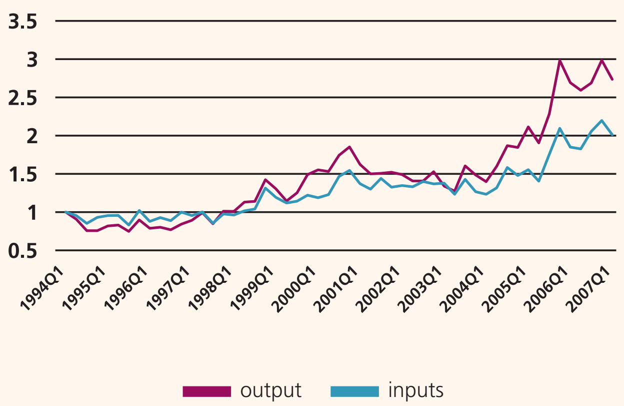
Compared to one year earlier, gross income of 2007 Q1 was only marginally lower. In particular, growth of general administrative expenditures led to a reduction of aggregate gross income before taxes and provisions of 7.7%, or €144 million, from €1,862 million to €1,718 million. However, excluding extraordinary results, during the first three months of 2007, credit institutions reached gross income before taxes and provisions of €1,646 million, 17.2% or €242 million more than during the first quarter of the previous year.

Banking Output and Productivity Measures

The measurement of bank output (and therefore productivity) has long been controversial. This box adopts the user cost approach to measuring output and prices in Luxembourg's banking sector using quarterly reports transmitted by banks to the BCL. The method consists of associating the different flows in the profit-and-loss account to the different assets and liabilities in the balance sheet. Thus, for each asset or liability a rate is calculated on the basis of the associated cost or revenue flows. The user cost of the asset/liability in question is then calculated as the difference between this rate and a reference rate representing the opportunity cost of financial capital. A negative user cost identifies an asset or liability as a product, while a positive user cost identifies it as an input in production. The traditional approaches to measuring bank output, the "intermediation" approach and the "production" approach, are based on an a priori classification. Instead, the user-cost approach allows for a data-driven classification which can, theoretically, combine elements from the two traditional approaches.

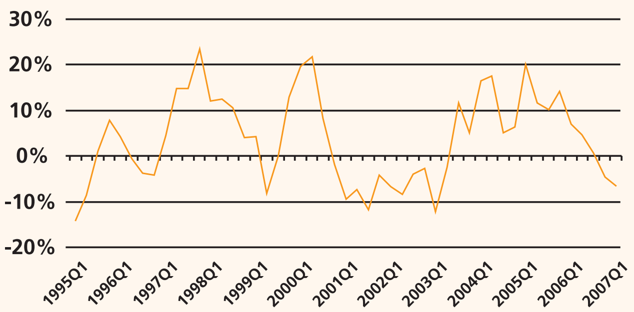
In practice, results suggest that neither of the traditional approaches is consistent with Luxembourg data. Among the four asset classes considered, loans to customers and to depository institutions are identified as outputs, which is consistent with the "intermediation" approach. The other two asset classes are also classified as outputs (fixed and variable income securities). However, among the liabilities, deposits by customers are identified as an output (consistent with the "production" approach) while deposits by banks are classified as an input. An additional output class was defined a priori to include those revenue flows which could not be associated with a particular asset or liability, this includes commissions received and other interest income. On the other hand, four inputs were also defined on an a priori basis, including commissions paid and administrative costs, labour and capital.

CHART 22: VOLUME OF OUTPUT AND INPUTS (TÖRNQVIST INDICES, REPRESENTATIVE FIRM)



Source: BCL

CHART 23: ANNUAL GROWTH IN TOTAL FACTOR PRODUCTIVITY (REPRESENTATIVE FIRM)



Source: BCL

Having identified inputs and outputs, these are aggregated using multilateral Törnqvist indices. These indices are based on a representative firm that serves as a benchmark to track the performance of the banking sector through time. Results suggest that gross output grew at an average annual rate of 11% over the period 1994Q1-2006Q4. This high rate of growth is largely attributable to the process of European financial integration, but also to financial innovation, with balance sheets benefiting from the introduction of new financial instruments and from changes in the regulatory framework. Results are robust to several alternative measures of the reference rate.

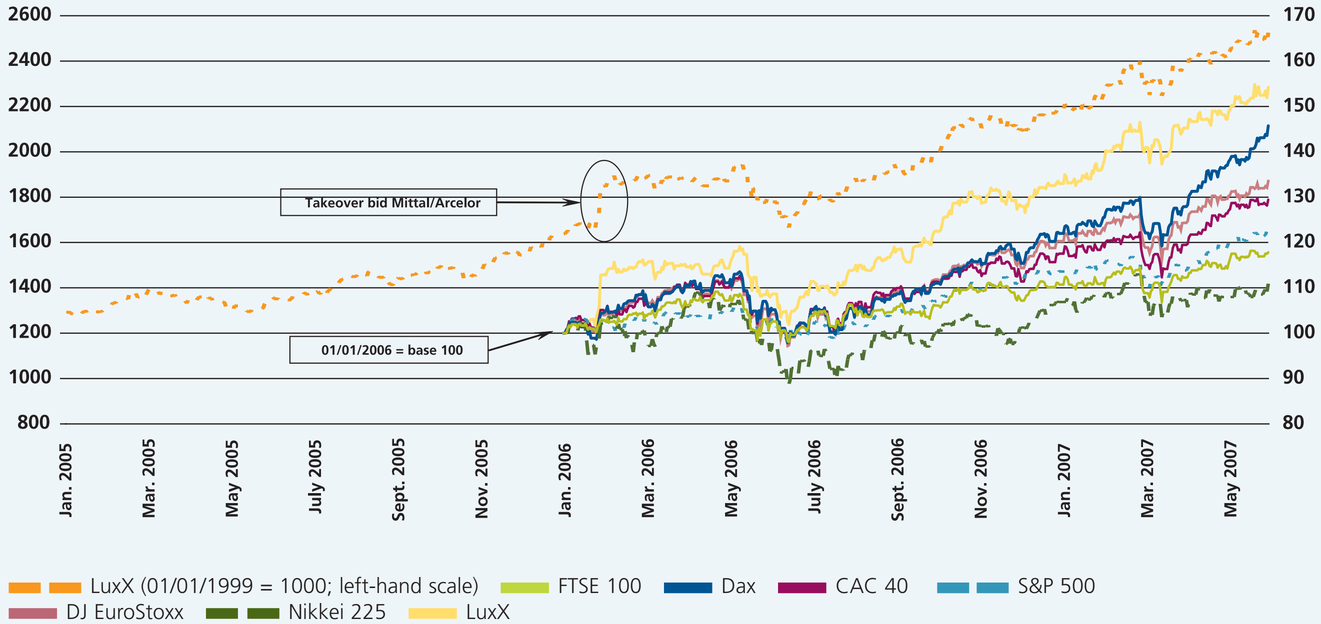
Total Factor Productivity (TFP), measured as the difference between input and output indices, increased by 4% per year. Productivity growth has been volatile but persistent, moving pro-cyclically. Although the most recent data is still preliminary and subject to revisions, the fall in TFP over the last two quarters suggests a possible turning point. In any case, this fall is consistent with the combination of strong employment growth in the sector along with the levelling of the aggregate balance sheet. Productivity was also calculated for individual banks. Although it varies widely, it seems to be higher in banks with larger balance sheets.

An implicit price index was also derived and suggests that the price of financial intermediation services fell over the sample period. This may be attributed to new information and communication technologies, whose impact on costs should be larger in the banking sector. Alternatively, it could be associated with the downwards trend in nominal interest rates over the last decade. By compressing the interest rate margin, lower interest rates have reduced the user cost of both assets and liabilities and, therefore, the implicit price of output. In this context, the user cost approach is particularly attractive because it provides a price measure for financial intermediation services that are indirectly charged, meaning that their price cannot be directly observed.

1.2.5 Luxembourg Stock Exchange

In 2006, the Luxembourg stock price index again progressed strongly, moving from almost 1,637 to over 2,524 at end-May 2007. Nevertheless, behind this outstanding performance lie more heterogeneous developments of some of the index components. In particular, the Mittal Steel takeover bid for Arcelor had a strong upward impact on the index at large; in August, Mittal Steel shares were introduced into the LuxX index and Arcelor shares were withdrawn.

CHART 24: THE LUXX AND MAJOR INTERNATIONAL EQUITY INDICES (INDEX: 1 JANUARY 2006 = 100 UNLESS OTHERWISE INDICATED; DAILY DATA)



Source: Bloomberg

Between August and December, Mittal Steel shares progressed by 18%; overall in 2006, Fortis, KBC Group, BGL Investment Partners, Cegedel, Foyer and RTL progressed between 17% and 23%, while SES Global fell by 9%. Since January 2007, the share prices of all index members have risen although the progression of Audiolux and Mittal Steel shares has been particularly impressive.

There were 10,544 new listings in 2006; warrants have increased particularly sharply since 2005 in terms of the number of listings. In spite of the large increase in the number of listings, total turnover has fallen sharply in 2006: bond turnover fell by 34%, equity turnover by 10%, UCI turnover by 64% and warrant turnover by 95%. Bonds and equity now make up 98.6% of the total in terms of turnover by volume, while the share of warrants is close to zero.

1.2.6 Labour market

In 2006, employment accelerated, but unemployment still remained on an ascending trend. Employment grew by 12,000 units in 2006 (10,000 in 2005) which constitutes the best performance since 2001. To a large extent, employment growth drew on an increased inflow of non-residents. Average growth in cross-border employment reached 6.7% in 2006 after 6.4% in 2005. Among cross-border commuters, 51% live in France, 26% in Belgium, and 23% in Germany. The sectoral breakdown of employment in 2006 showed that employment growth spread to all sectors, although the financial sector has been the main source of jobs.

Despite the rise in employment, the unemployment rate increased throughout 2006 to 4.5% on average. Apparently, GDP growth was insufficient to stabilise the unemployment rate which is not caused only by cyclical factors. A certain amount of skill mismatch is certainly present as more than half of the resident unemployed have only a primary education level whereas most jobs offered require higher qualifications or a specialization especially in the financial sector. In addition, one-third of the unemployed are unemployed for more than 12 months so they may be subject to depreciation of their skills. Finally, the unemployed are competing with a large cross-border labour force, which makes it more difficult for them to find a job, at least in the short run.

Preliminary figures issued in the framework of the Quarterly National Accounts suggest that growth in compensation per employee slowed drastically in 2006 (2.3% after 3.7% in 2005). This deceleration could be attributed to a negative wage drift, as the contribution of wage indexation alone was 2.1pp and the negotiated wage was certainly positive. This negative wage drift does not seem consistent with robust real GDP growth in 2006. Therefore, this moderation in compensation per employee should be interpreted with caution, and could be revised.

Unemployment and labour market policies

Unemployment is currently rising in Luxembourg despite strong employment growth. One possible explanation for this 'unemployment paradox' is that employers in Luxembourg prefer to recruit cross-border commuters rather than residents. The share of cross-border commuters in domestic employment is indeed rising. About 66% of net employment creation is currently due to non-residents. In other words, the employment dynamics in Luxembourg seem to mainly benefit non-residents. Is job competition by commuters the correct explanation for unemployment problems? And which labour market policies could we implement to reduce unemployment while keeping employment growth strong?

To address these questions, we refer to a theoretical model developed at the Central Bank of Luxembourg (see Pierrard, 2007, for an in-depth exposition of the model and the results). We also enlarge our discussion by looking at labour market policies (and their results) implemented in several neighbouring countries.

Crowding-out of the residents by the commuters?

An increase in the number of potential cross-border commuters has two opposite effects on domestic unemployment: (i) a congestion effect and (ii) a vacancy effect. At a given level of employment, the congestion effect means that more commuters mechanically reduce resident employment. However, the level of employment is not given and the vacancy effect means that more potential commuters increase the probability of filling a vacancy, which reduces the average vacancy opening cost, lowers wage pressures, and therefore stimulates new job creation. The sign of the total effect is ambiguous a priori. More competition will generate a positive externality (i.e. the vacancy effect will dominate) as long as firms raise profits by employing commuters rather than residents.

By calibrating our model with Luxembourg data, we confirm that the latter is the case. Indeed, because of higher unemployment rates and less generous unemployment benefits in the neighbouring countries, salary claims by commuters are lower than salary claims by residents; and profits realized by a firm hiring a commuter are higher than profits realized by a firm hiring a resident. As a result, an increase in the number of commuters alone cannot explain the unemployment rise in Luxembourg. Quite the reverse, it should even be seen as a great opportunity since it strongly stimulates employment.

Public employment

Over the last decade, public sector employment has increased from 47,000 to 72,000, although its share in total domestic employment has remained stable around 24%. Unlike private sector employment which is open to all, public sector employment is mainly open to residents with Luxembourg nationality. So could we reduce unemployment by creating more public sector jobs? Our simulations show that new public sector jobs would be mainly filled by residents previously employed in the private sector, and these would not be replaced by resident unemployed but rather by new cross-border commuters. Thus, we would need to create 10 new public sector jobs to reduce unemployment by one person, which would be very costly.

Another option would be to create new public sector jobs reserved for resident unemployed. However, even in this case, the increase in labour demand would generate wage pressures within the whole economy, which would in the end result in the destruction of some private jobs. Creating public sector jobs to reduce unemployment, therefore, seems a costly and inefficient policy, especially in a small open economy such as Luxembourg.

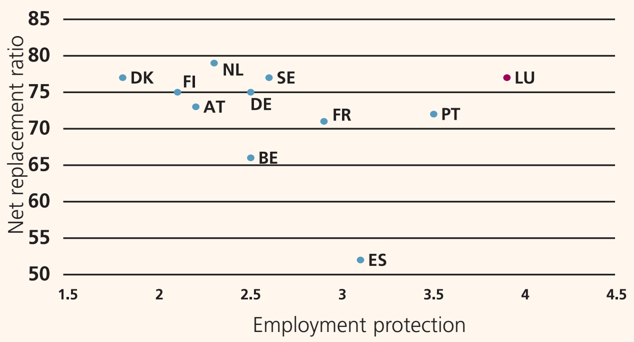
Unemployment income

Unemployment benefits (unemployment insurance) in Luxembourg are available for up to one year after job loss and the gross replacement rate is 80% of the last salary. Once this period has elapsed, the unemployed have access to the 'Revenu Minimum Garanti' (unemployment assistance), which is open-ended, provided the unemployed are willing to consider all employment possibilities to improve their situation. In theory, reducing the generosity of unemployment income would help cut unemployment, by lowering the reservation wage and increasing the willingness to find a job. However, the effect on total welfare is ambiguous: employment is stimulated but at the cost of lower income.

Moreover, lower unemployment income may give rise to problems of social justice: why should we reduce unemployment income if no jobs are available or if the unemployed cannot find a job because of individual characteristics? On the other hand, providing unemployment income to non-cooperative unemployed (unemployed who do not search for a job or who systematically refuse all propositions) creates moral hazard, causes negative externalities and is inefficient for the economy. It is, therefore, important to effectively monitor the unemployed and to apply sanctions when fraud is detected.

In conclusion, it should be possible to keep Luxembourg's current generous regime (see chart 26) as well as the open-ended design of the social security system (unemployment insurance followed by unemployment assistance), but we believe it is very important to credibly and effectively apply sanctions to avoid fraud and limit resource losses. In the latest survey on Luxembourg, the OECD notes that sanctions are only applied in exceptional cases in Luxembourg, which renders the whole system globally inefficient.

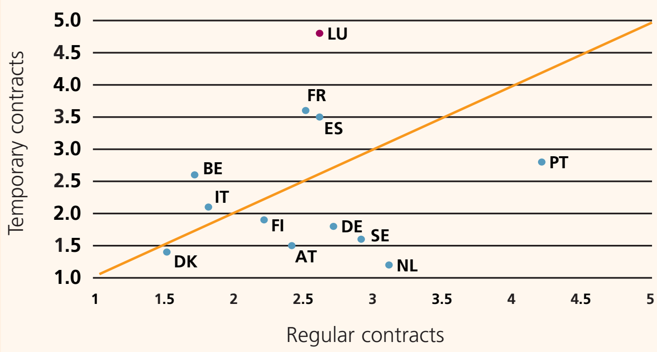
CHART 25: NET REPLACEMENT RATIO AND EMPLOYMENT PROTECTION INDEX



Note: Net replacement ratio: unweighted average of net replacement rate (including all benefits and social assistance) over 60 months of unemployment, for two earnings levels and four family types. Employment protection overall index: weighted average of the employment protection for different types of contracts and different types of dismissals.

Source: OECD

CHART 26: EMPLOYMENT PROTECTION INDEX, DEPENDING ON THE TYPE OF CONTRACT



Source: OECD

<u>Employment protection</u>

Employment protection legislation in Luxembourg is the strictest among OECD countries (see chart 26 for definitions and comparisons). Employment protection decreases the job destruction rate and protects workers (usually called 'insiders' in this context). But employment protection also reduces the job creation rate (because of a lack of flexibility, firms will be reluctant to create new jobs), which negatively affects the unemployed (usually called 'outsiders'). In the end, employment protection favours the insiders to the detriment of the outsiders and the resulting effect on employment is ambiguous. Job turnover, however, decreases unambiguously and unemployment duration increases, which reduces the participation rate (because higher unemployment duration leads to qualification losses and generates discouragement effects). The resulting effect of employment protection is, therefore, rather negative[5].

Is the solution to drastically reduce employment protection in Luxembourg? Firstly, decomposing employment protection by type of contract, we see that protection of workers with regular contracts (permanent contracts) is around the EU average, whereas protection of workers with temporary contracts (fixed-term contracts) is very high (see chart 27). Reducing protection for temporary contracts would increase the flexibility of firms and would stimulate job creation. However, this would further emphasize the duality between unstable fixed-term contracts and stable long-term contracts. Some economists, such as Blanchard (2006a), propose to merge these two contract types into a single but gradual one. This contract (called CUP, 'Contrat Unique Progressif' in French) would progressively increase employment protection with seniority in the firm, and avoid the sharp contrast between temporary and permanent contracts that exists today.

[5] The government of Luxembourg recently implemented new legislation called 'Plan de maintien dans l'emploi' which attempts to avoid layoffs (see Ministère du Travail, 2007). We do not fully agree with this plan because it increases further employment protection and ultimately protects insiders to the detriment of outsiders. We rather suggest helping all unemployed in order to reduce unemployment duration, for instance through training or individual coaching.

Secondly, decreasing employment protection (protecting firms' freedom) does not mean that firms no longer have social responsibilities. Firms that lay off workers impose economic costs on society and these costs should be internalized. Blanchard (2006b) suggests that firms pay contributions equal to the benefits paid to the workers they lay off (financial constraint for firms). This would force firms to provide on-the-job training for their workers (to avoid skill losses) and help laid-off workers to find a new job, in order to reduce unemployment duration and therefore limit contributions.

Of course, these proposals (single contract with financial constraints) remain quite theoretical but deserve discussion in a country where sectoral diversification (and therefore new job creation) is crucial to enlarge the employment basis.

Flexicurity: the wonder drug?

In the last few years, Denmark managed to reduce unemployment and increase participation. The solution? Flexicurity, from flexibility (for firms) and security (for workers), which combines loose employment protection legislation, generous unemployment benefits (subject to very strict eligibility conditions), and training and individual coaching of the unemployed (see chart 26). The philosophy of flexicurity is not to avoid unemployment inflows but to avoid long-term unemployment (the unemployment trap). Last year, the European Commission even published a green book to promote the Danish model across Europe (European Commission, 2006)[6].

Could we implement such a model in Luxembourg? Our answer is affirmative, since most of its features are in accordance with our analysis above. Firms must be flexible because flexibility stimulates employment creation. And laid-off workers must receive significant unemployment benefits as well as training and individual coaching. But these generous and open-ended benefits must be subject to strict eligibility conditions: in particular, abuses must be effectively sanctioned[7].

Which policies for employment?

With respect to the above analysis, we do not think that Luxembourg's labour market legislation needs a revolutionary reform. However, some adjustment would be welcome, such as a decrease in employment protection (for instance by merging the two types of contracts into a single but progressive one) or more effort on training and individual coaching of the unemployed. The open-ended unemployment income regime (insurance followed by assistance) could be maintained, but under very strict conditions (commitment to really search for a job). Abuses must be effectively sanctioned. We also want to stress that the government has the duty to improve the functioning of the labour market. However, reform must be agreed with the social partners. In fact, several studies have shown that a good relationship between social partners is important for employment.

Finally, we would conclude with three observations. First, we cannot attribute the unemployment increase in Luxembourg to higher job competition from cross-border commuters. Quite the reverse, this inflow of commuters contributes to high domestic growth and stimulates labour market dynamics. Second, addressing the unemployment problem by the creation of public sector jobs is costly and inefficient. Third, even the best labour market legislation will be useless if the economy is unable to create employment, that is if the economy is not competitive enough.

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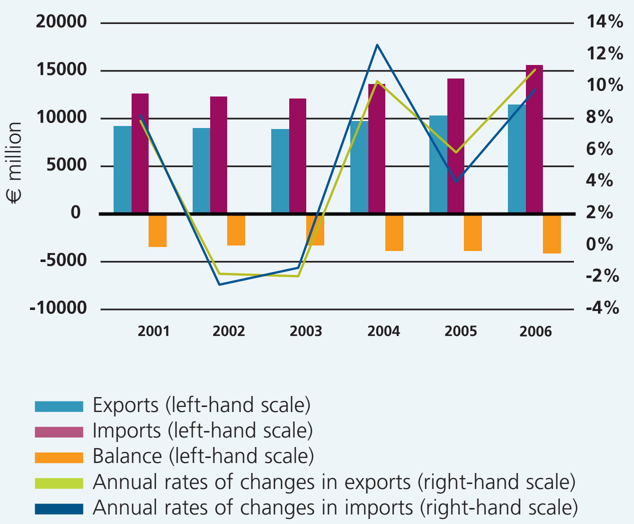
[6] The goal of a green book is to disseminate ideas in order to launch public discussions in the European Union. After consultations with the member states, the Commission may then decide to publish a white book, which contains concrete proposals in order to give birth to political decisions.

[7] However flexicurity system is costly: Denmark is the European country with the highest financial cost for active labour market policies (1.8% of GDP in 2004, compared to only 0.9% in the euro area (excluding Finland) and 0.6% in Luxembourg; sources: OECD Economic Outlook Database and 2006 budget proposal for Luxembourg).

1.2.7 External trade

Luxembourg trade in goods expanded robustly in 2006, reflecting the pick-up in international economic activity. Exports of goods rose by 11.1% reaching €11.5 billion. Import of goods also increased strongly (9.6%) to €15.6 billion in 2006. As a result, the trade deficit increased by 5.6% reaching €4.1 billion in 2006 as a whole. The rise in imports of goods was driven by higher oil and non-oil commodity prices while steel sector sales largely explain the increase in the export values.

CHART 27: LUXEMBOURG TRADE IN GOODS



Source: STATEC

1.2.8 Balance of payments

In 2006, the Luxembourg current account surplus rose by 7% reaching €3.5 billion (or 10.6% of GDP). This improvement was driven by the strong increase (26.6%) in the services surplus that was partly offset by a 49% rise in the combined deficit of the current transfers and labour and investment income. The improvement in net services receipts was for the most part driven by favourable developments in the financial sector. The goods balance was positively affected by fuel sales to non-residents and by sales of non-monetary gold. In the income balance, dividend payments abroad and compensation of non-resident employees turned the overall balance into a huge deficit in 2006, while the rising deficit in current transfers was mainly driven by monetary income redistribution within the Eurosystem.

In the financial account, Luxembourg registered net inflows in equity securities (in portfolio as well as in direct investments), which were largely offset by net outflows in debt securities and in other investments.

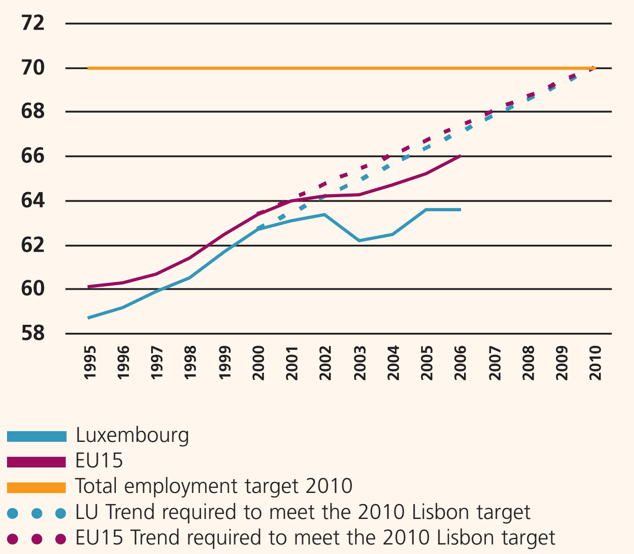
The implementation of the Lisbon strategy in Luxembourg

The Lisbon European Council in 2000 decided a set of structural reforms in product and labour markets that was relaunched under Luxembourg Presidency in 2005 by refocusing its priorities. These reforms aim to improve the flexibility of EU Member States' economies, increase their resistance to shocks, support sustainable non-inflationary growth and create new employment opportunities.

Eurosystem interest in structural reform reflects the fact that it facilitates the conduct of the single monetary policy and enhances its effectiveness. Structural reforms improve price and wage flexibility and foster the mobility of factors of production, which are necessary conditions for the efficient operation of the single monetary policy.

Therefore, structural reforms reduce the risk that price shocks may have enduring effects on inflation.

CHART 28: TOTAL EMPLOYMENT RATE (EMPLOYED PERSONS AGED 15-64 AS A PERCENTAGE OF THE TOTAL POPULATION OF THE SAME AGE GROUP)



Note: The trendlines are straight lines connecting the starting points in 2000 with the targets for 2010.

Source: Eurostat

This box evaluates the implementation of structural reforms in Luxembourg compared to progress achieved in the EU. The box concentrates only on selected areas of economic reform which are particularly important. Its focus is on areas in which Luxembourg must step up its efforts. Progress achieved is mainly measured on the basis of structural indicators compiled by Eurostat[8], which are compared to the targets set for the EU as a whole. It should be noted that the targets are non-binding for the Member States and that Luxembourg, like most EU Member States, has not set any national targets, except in the domain of research and development.

Employment

An important objective of the Lisbon strategy is to increase the employment rate. Luxembourg's total employment rate increased 0.90 percentage point over the period 2000-2006, reaching 63.6%, while the EU total employment increased to 66% over the same period. It should be noted that the European Council's total employment target is 70% in 2010.

The employment rate for women has increased significantly from 50.1% in 2000 to 54.6% in 2006, while remaining well below the target of 60% set for the EU as a whole. The employment rate for workers aged between 55 and 64 also picked up by about 6.5 percentage points to 33.2%, compared to the EU 2010 target of 50%. Luxembourg's performance is disappointing, as it ranks 14th among the EU15.

In its latest assessment[9] of the Luxembourg reform programme, the European Commission notes that: "Despite encouraging reforms on the employment front, no new initiative has been announced to raise the level of employment among older workers." The Commission encourages Luxembourg to "focus on a strategy for further increasing the employment rate among older workers; a detailed strategy aimed, in particular, at further reforming the current early-retirement systems…".

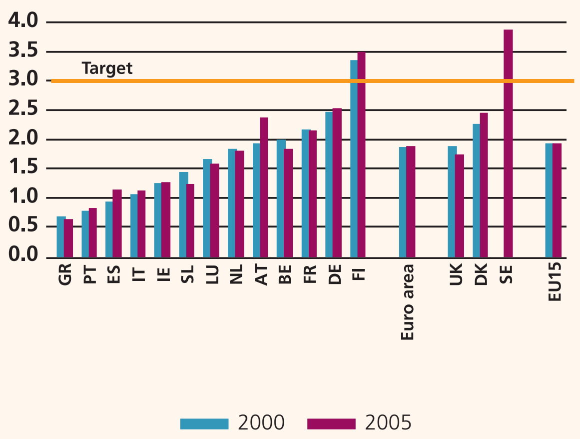
Innovation and research

The European Council set the target of raising research and development (R&D) spending to 3% of GDP. The Luxembourg government also adopted 3% of GDP as its national target. However, over the period from 2000 to 2005 the ratio of R&D expenditure to GDP remained broadly stable for the EU15, while it decreased slightly in the case of Luxembourg to 1.56% (in 2005), which is substantially below the 3% target (see chart). However, it should be noted in this context that the Luxembourg government substantially increased R&D expenditure budgeted for 2007 and that the figures shown in the graph also include private sector R&D expenditure.

8 *http://ec.europa.eu/eurostat/structuralindicators*

9 *European Commission, "Implementing the renewed Lisbon Strategy for Growth and Jobs - a year of delivery - assessment of the national reform programmes", part II/2, page 109, 23 February 2007*

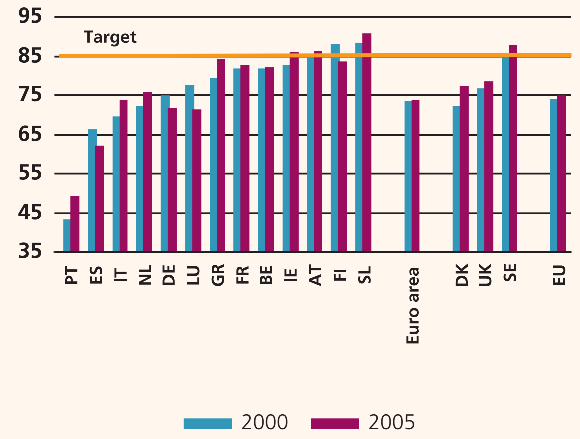
CHART 29: RESEARCH AND DEVELOPMENT EXPENDITURE (PERCENTAGE OF GDP)



Note: Figures for GR refer to 1999 instead of 2000. Figures for IT, UK and NL refer to 2004 instead of 2005.

Source: Eurostat

CHART 30: EDUCATIONAL ATTAINMENT (PERCENTAGE OF THE POPULATION AGED 20-24 HAVING COMPLETED AT LEAST UPPER SECONDARY EDUCATION)



Source: Eurostat

In addition to R&D expenditure, another structural indicator in the area of innovation and research is the percentage of the population aged 20 to 24 who have completed at least an upper secondary education. In Luxembourg, this share stood at 71.2% in 2005, slightly below the average for the EU15 and well below the 85% target (see chart). According to Eurostat data, educational attainment has worsened somewhat in Luxembourg since 2000.

The OECD takes the view that "there is considerable scope to improve education achievement and attainment, which are below the OECD average, especially for children of immigrants and low socio-economic backgrounds. While much has been done to help these children cope with Luxembourg's trilingual education system, more could still be done. There are other reforms that would improve education outcomes, notably reducing selection at early ages and avoiding widespread recourse to grade repetition"[10].

Completion of the Internal Market

The completion of the Internal Market is an important area of economic reform. Luxembourg has achieved considerable progress. Indeed, the Luxembourg authorities have reduced the "transposition deficit" (directives which have not been transposed into national law) from 4.6% in 2000 to 2.5% (42 directives) at the end of 2006. However, this result remains below the intermediate target of 1.5%. The European Commission concluded, on the basis of its "Internal Market Scoreboard" (November 2006) that Luxembourg's "performance is still poor", while acknowledging that Luxembourg has "made very good progress over the past six months"[11].

Conclusion

The Commission concludes in its assessment of the Luxembourg reform programme that "Luxembourg is making very good progress on implementation of its National Reform Programme and of the actions agreed by the 2006 Spring European Council, but there is still room for improvement regarding the weaknesses identified in 2005". The Commission issued no formal recommendation to Luxembourg. However, this box showed that Luxembourg still faces important challenges as far as the following areas are concerned: employment rate, research, education and completion of the internal market.

[10] *See OECD "OECD Economic Surveys - Luxembourg", volume 2006/9 - July 2006, p. 8, 2006*
[11] *European Commission, IP/07/126, 1 February 2007*

1.2.9 Economic growth and macroeconomic projections

Since the finalisation of the previous projection exercise, Luxembourg's economy has fared better than expected. Real GDP growth in 2006 is currently estimated at 6.2%, which is 0.9pp above our December projections. The overall positive surprise stems mainly from buoyant activity in the financial services sector which showed up via a strong contribution to net exports. However, growth has probably peaked in the first quarter of 2006 and, although it remained above trend estimates, it has steadily moderated since then. In fact, growth dropped to 5.0% in year-on-year terms in the fourth quarter of 2006. The carry-over effect on annual real GDP growth in 2007 can be estimated at 2.0%.

Short-term indicators point to a further decline in growth in the first quarter of 2007. In the context of the more moderate developments observed on the financial markets, the annual increase in fees earned by banks (other than the interest margin) has dropped to a mere 7.1% in the first quarter of 2007, compared to 28% a year earlier. This effect is likely to be partially offset by the more upbeat mood in the manufacturing sector, where confidence indicators have recently rallied to a level close to their all-time highs.

Overall, the outlook for the international environment has largely remained unchanged. Compared to the previous exercise, the growth profile and dynamics for both world GDP and world trade have been only marginally adjusted. After the exceptional dynamism observed in 2006, the forecasts of international institutions generally concur that economic activity is likely to slow in 2007, although it should remain above its long-term average. The weakening of the U.S. economy would be largely offset by the emerging economies, in particular South-east Asia, as well as the growth revival both in Japan and in the euro area. As regards the euro area in particular, economic growth has firmed since the pick-up that started in the second half of 2005. Real GDP growth was recorded at or above potential growth estimates, and was not interrupted by the hike in indirect taxation in Germany in 2007Q1. At 2.9% in 2006, real GDP growth reached its highest level since 2000 and the projected slowdown should only be moderate. According to the recent Eurosystem projections, economic growth is expected in a range between 2.3% and 2.9% in 2007 and between 1.8% and 2.8% in 2008.

On the back of the very favourable international environment, growth in Luxembourg's export markets was particularly dynamic in 2006. World demand growth, although it is expected to decelerate, should be above its long-term average both in 2007 and 2008.

On the basis of this analysis and especially in the euro area context, it seems appropriate to revise upwards Luxembourg's real GDP growth projections for 2007 to a range between 4.7% and 5.3%. In line with growth in the euro area, economic growth should further decelerate somewhat in 2008. These projections are based on assumptions of a more balanced growth scenario. Slowing exports, on the back of the lower expansion of world demand, should be partially offset by the acceleration in domestic demand. In this respect, private consumption growth will benefit from the favourable employment developments and prospects, as well as the growth in real wages. According to the European Commission's bi-annual investment surveys, companies in the industrial sector have also announced a strong expansion of their investment projects in 2007 (see chart 31). Capital expenditures in that sector are set to increase at around 27%, the highest rate observed since 2001. Finally, public consumption and investment are also expected to accelerate in 2007.

TABLE 15: PROJECTIONS OF INTERNATIONAL INSTITUTIONS
(IN ANNUAL PERCENTAGE CHANGES, RESPECTIVELY IN PERCENTAGE POINTS)

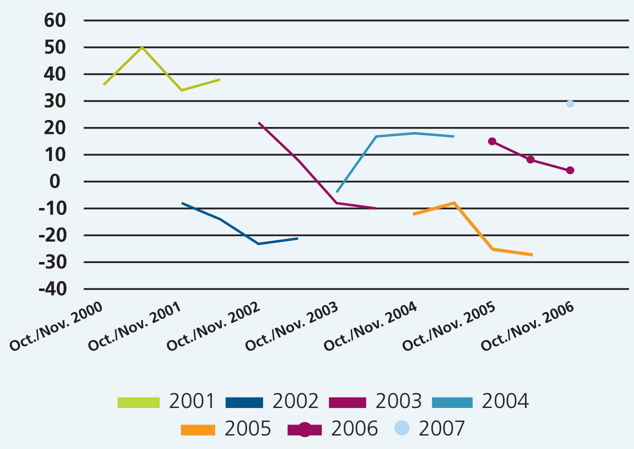
	2006	2007	2008	2009
World Trade (EC)	9.2 (-0.3)	7.1 (+0,1)	7.6 (+0,3)	-
World GDP (EC)	5.2 (+0.1)	4.8 (+0.2)	4.8 (+0,1)	-
Euro area GDP (EC)	2.7 (+0.1)	2.6 (+0.5)	2.5 (+0,3)	-
Euro area GDP (Eurosystem)	2.9	2.3 - 2.9	1.8 - 2.8	-
World demand for Luxembourg	8.7 (-0,3)	5.8	6.0 (+0.2)	6.1
Oil in $/bl[1]	65.4 (-0,1)	65.0 (+0.4)	69.9 (+2.7)	69.6
Exchange rate $/€[2]	1.26	1.34 (+0.06)	1.36 (+0.08)	1.36
Short-term interest rate	3.1	4.2	4.5	4.4
Long-term interest rate	3.8	4.2	4.3	4.3

[1] *Revisions in $/bl*
[2] *Revisions in $/€*
Sources: European Central Bank, European Commission

Turning to wage developments, negotiations are apparently still based on cautious behaviour by the social partners, probably because the conjunctural pick-up was mostly driven by the financial services sector, with the expansion more muted in most other sectors of the economy. The unemployment rate also seems entrenched at a fairly high level and government measures decided in 2006 still restrain wage growth. Among these measures, the contribution of the automatic wage indexation mechanism to nominal wage increases has been virtually fixed up to 2009. Furthermore, the negotiated wage levels in the government sector will be frozen for the years 2007-2008. The projections also incorporate planned increases in the minimum wage, 1.9% in 2007 and a further rise in 2009. The acceleration of wages in 2009 reflects the assumption that real wages in the public sector will be increased again.

In 2007, inflation dynamics are likely to moderate despite the very favourable demand conditions. Headline inflation should drop to around 2.1% for the NICP and to 2.4% for the HICP, as the contribution from the energy component will be virtually neutral. However, headline inflation excluding energy has been on a steady rise since the end of 2004, and

CHART 31: BI-ANNUAL INVESTMENT SURVEYS IN THE INDUSTRIAL SECTOR (EXPENDITURES AT CURRENT PRICES, IN ANNUAL PERCENTAGE CHANGES)[1]



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

it should accelerate further in 2007 as its path will be partially conditioned by exceptional hikes in public tariffs. The mild drop in non-energy inflation in 2008 with a stabilisation afterwards is unchanged from previous projections and hinges on several factors. A moderation in the impact of the government measures on inflation is expected. Wage projections also remain largely unchanged. Finally, although the output gap is gradually closing, the baseline scenario does not yet correspond to that of an overheating economy, neither in the euro area nor in Luxembourg. In this respect, imported inflation from the neighbouring countries is also expected to remain fairly moderate.

TABLE 16: MACRO-ECONOMIC PROJECTIONS AND REVISIONS COMPARED TO DECEMBER 2006 (IN ANNUAL PERCENTAGE CHANGES, RESP. IN PERCENTAGE POINTS)

	June 2007				Revisions		
	2006	2007	2008	2009	2006	2007	2008
Real GDP	6.2	4.7 - 5.3	4.1 - 5.1	4.0 - 5.0	0.9	0.8	0.3
HICP	3.0	2.4	2.5	2.2	-	0.2	0.2
HICP energy	7.9	-0.3	1.5	-0.1	-0.1	-1.0	-0.2
HICP excluding energy	2.3	2.8	2.6	2.5	-	0.4	0.2
NICP	2.7	2.1	2.1	2.0	-	0.2	0.1
NICP excluding energy	2.1	2.3	2.1	2.1	-	0.4	0.1
Contribution of indexation to nominal wages	2.1	2.3	2.1	2.5	-	-	-
Compensation per employee	2.3	3.9	3.7	4.2	-1.6	0.3	-
Employees	4.0	3.7	3.4	3.3	0.2	0.5	-
Unemployment rate	4.5	4.6	4.7	4.6	-	-0.1	-0.1

Source: BCL

Structural unemployment and potential growth

What is the level of structural unemployment in Luxembourg? What is the potential growth rate of the Luxembourg economy? These two questions are related by Okun's law, one of the classic pillars of macroeconomics. In 1962 Arthur Okun estimated potential output by supposing that it was limited by the availability of labour inputs. He suggested the following relationship:

$$(U - U^*) = -\alpha(y - y^*)$$

On the left, U denotes the observed unemployment rate and U* the structural unemployment rate. On the right, y denotes the logarithm of observed output (GDP) and y* that of its potential level (their difference represents the output gap as a percentage of potential output). The main idea of Okun's "law" is that unemployment and output fluctuate around their "structural" levels and that these fluctuations are related. Okun deduced the level of potential output y* in the US by assuming U* took the value 4% and the coefficient α was 1/3.

However, this shortcut to measure potential output suffers from several limitations. First, it does not consider the lag with which the labour market reacts to changes in output. Second, it assumes that unemployment fluctuates around a fixed equilibrium level. Today structural unemployment is more commonly considered a variable that changes with time, typically as a result of structural reforms. Therefore, it is more appropriate to replace the constants U* and y* in the previous equations with variables (often approximated by the trends in the observed series). In this case, the two expressions in parentheses on the right and left of the equation sign can be interpreted as deviations from trend (cyclical components of unemployment and output). Thus, a more up-to-date version of Okun's law will relate unemployment cycles to output cycles and include past terms of the output gap to capture lagged adjustment.

$$(U_t - U_t^*) = -\alpha_0(y_t - y_t^*) - \alpha_1(y_{t-1} - y_{t-1}^*)$$

However, this expression is not enough to deduce the potential growth rate without an estimate of the structural unemployment rate. The latter is generally supplied by the Phillips curve, the other classic pillar of macroeconomics (along with Okun's law). The Phillips curve postulates an inverse short-term relationship between inflation (of prices or of wages) and the level of unemployment. In other words, it implies the existence of a level of unemployment that can stabilise inflation. This concept of structural unemployment is called NAWRU (Non-Accelerating Wage Rate of Unemployment) when inflation is measured by wages and NAIRU (Non-Accelerating Inflation Rate of Unemployment) when inflation is measured by prices. The European Commission uses the NAWRU to measure structural unemployment when estimating potential output (which it then uses to cyclically adjust public sector deficits). In the December 2006 Quarterly Report on the Euro Area, the Commission provides a discussion of the NAWRU and estimates for each member state. According to the Commission forecasts, between 2006 and 2008 structural unemployment should fall in Germany and France, level off in Belgium but increase in Luxembourg, where it should rise from 4% in 2005 to 4.5% in 2008[12].

Since 2001, the BCL regularly estimates the NAIRU for Luxembourg to calculate potential output by the Apel-Jansson[13] method. This approach differs from that of the Commission in several ways. First, the Phillips curve and Okun's law are estimated simultaneously, providing a joint analysis of fluctuations in inflation, output and unemployment to better separate trend from cycle in the latter two series. Instead, the Commission method estimates the Phillips curve in isolation (assuming productivity is exogenous) and then uses the NAWRU concept to estimate the output gap. Second, the Commission uses the Eurostat harmonised unemployment rate. In Luxembourg, this rate ignores unemployment among cross-border workers (who by now represent 40% of salaried employment). To allow for cross-border workers, BCL estimates use a regional unemployment rate that weights unemployment in each of the surrounding regions according to the share of its residents in Luxembourg's employment. However, in order to allow a comparison with the Commission results, estimates in this text box are also based on the harmonised unemployment rate[14]. Third, BCL estimates include additional variables in the Phillips curve using the following (more general) specification:

$$\Delta^2 w_t = \rho(L)\Delta^2 w_{t-1} + \eta(L)(U_{t-1} - U_{t-1}^*) + \omega(L)z_t$$

where $\rho(L)$, $\eta(L)$, and $\omega(L)$ denote polynomials in the lag operator L. This specification, drawn from the "triangle" inflation model[15], assumes that inflation in wages (w_t) is driven by three factors: inertia (past inflation), capacity constraints (gap between unemployment and its structural level) and supply shocks in variables such as oil prices, import prices, and the effective exchange rate (included in the vector z_t). One limitation of the Commission approach is that it neglects this last source of inflation, which can be important in an economy as small and as open as Luxembourg. In this case, the impact of external factors may erroneously be attributed to movements in the NAWRU. However, our conclusions are substantially in line with those of the Commission, confirming the sharp rise in structural unemployment since 1999. This conclusion is unchanged when inflation is measured by wages (NAWRU) or by the national index of consumer prices (NAIRU). Unlike the Commission method, the Apel-Jansson approach also provides an estimate of the α parameter in the Okun's law relation. Results for Luxembourg suggest that a 1% increase in the output gap (over two years) generates a fall of the harmonised unemployment rate around 0.1 percentage points (the conclusion is similar when using the national

12 See also Denis, C., D. Grenouilleau, K. McMorrow, et W. Roeger (2006) "Calculating potential growth rates and output gaps - a revised production function approach", European Economy Economic Paper No. 247.
13 See BCL Working Paper No. 4 for more details.
14 Results are qualitatively unchanged when harmonised unemployment is replaced by regional unemployment.
15 Gordon, R.J. (1997) "The time-varying NAIRU and its implications for economic policy", Journal of Economic Perspectives, 11(1):11-32

unemployment rate). As a basis of comparison, Okun assumed that in the US the impact would be 0.3 percentage points. It seems logical that this link is weaker in Luxembourg, especially, because the estimate is based on harmonised unemployment, which neglects the important contribution of cross-border workers to the labour market in Luxembourg. It should be noted that such a reduction in unemployment would only be a transitory phenomenon that would disappear, with the output gap, when output returns to its potential level in the medium term. In other words, unemployment rates below the structural level are not sustainable: Okun's law only relates the cyclical components of unemployment and output.

TABLE 17: HARMONISED UNEMPLOYMENT, NAWRU AND NAIRU

	Harmonised unemployment rate	Hodrick-Prescott Trend	NAWRU European Commission	NAWRU BCL	NAIRU BCL
1999	2.4	2.8	2.7	2.6	2.5
2000	2.3	3.0	2.9	2.6	2.6
2001	2.1	3.1	3.0	2.9	2.6
2002	2.8	3.3	3.3	3.1	2.9
2003	3.7	3.6	3.5	3.3	3.4
2004	5.1	3.8	3.9	4.0	3.9
2005	4.5	4.1	4.0	4.0	3.9
2006	4.7	4.3	4.2	4.1	4.1
2007	4.6[a]	4.5	4.4	4.5	4.4
2008	4.4[a]	4.7	4.5	4.7	4.6

[a] Harmonised unemployment in 2007-2008 are European Commission forecasts.

Sources: European Commission, BCL estimations

The table compares the harmonised unemployment rate (in the first column) with its trend as extracted by the Hodrick-Prescott filter (a simple statistical method to separate trend from cycle). The Commission estimate of the NAWRU appears in the third column, and the BCL estimates of the NAWRU and the NAIRU in the two remaining columns. According to all four measures considered, structural unemployment in Luxembourg increased regularly since 1999. Turning to cyclical fluctuations, in 1999 observed unemployment was below all the measures of structural unemployment (a sign of inflationary pressures). Between 2000 and 2001, the gap increased as observed unemployment fell and structural unemployment rose. Observed unemployment only rose in 2002, moving towards the new level of structural unemployment. This suggests that the increase in observed unemployment was more structural than cyclical (and therefore more persistent). In 2003, the gap changed sign, with observed unemployment exceeding structural unemployment to generate a positive gap.

Looking ahead, the Commission forecasts expect the positive gap to stabilise in 2006, fall in 2007 and turn slightly negative in 2008. BCL estimates are not significantly different for 2006 and 2007, but project a greater negative gap in 2008, suggesting possible inflationary pressures. BCL projections of harmonised unemployment in 2007 and 2008 are slightly more pessimistic (4.7% both years). However, using the BCL projections does not change the conclusion: observed unemployment should soon be below its structural level due to the rise in the latter.

TABLE 18: OUTPUT GAP AND POTENTIAL GROWTH

	Real GDP (bn EUR)	Linear Trend	Hodrick-Prescott	Harvey-Jaeger	Kuttner	Apel-Jansson	Production Function
		Output Gap Estimates					
2002	23.42	2.4%	2.0%	1.7%	1.8%	1.7%	1.2%
2003	23.74	-1.1%	-1.0%	-0.8%	1.1%	-0.1%	-1.7%
2004	24.60	-2.4%	-1.7%	-2.0%	0.2%	-3.5%	-2.1%
2005	25.57	-3.3%	-2.1%	-2.2%	-0.7%	-4.6%	-2.3%
2006	27.16	-2.1%	-0.4%	-1.2%	-1.3%	-4.0%	-0.5%
2007	28.52	-2.1%	0.1%	-0.6%	-1.5%	-2.2%	0.3%
2008	29.84	-2.4%	0.3%	-0.4%	-1.2%	0.0%	0.8%
2009	31.17	-2.9%	0.3%	-0.2%	-0.6%	1.3%	1.1%
	Revisions	**Revisions to output gap since last estimates in 2006**					
2002	0.2%	0.4%	0.3%	-1.2%	-0.4%	-1.0%	0.4%
2003	-0.5%	-0.3%	-0.4%	-0.9%	-0.5%	-0.3%	-0.4%
2004	-1.1%	-0.9%	-1.1%	-1.5%	-0.5%	-2.3%	-1.1%
2005	-1.1%	-0.9%	-1.3%	-1.0%	-0.4%	-2.3%	-1.5%
2006	0.5%	0.7%	0.0%	0.4%	-0.2%	-1.5%	-0.2%
	Real GDP growth	**Potential growth estimates**					
2002	3.8%	5.0%	4.5%	5.3%	4.1%	4.4%	4.6%
2003	1.3%	5.0%	4.4%	3.9%	2.1%	3.2%	4.3%
2004	3.6%	5.0%	4.4%	4.9%	4.6%	7.2%	4.1%
2005	4.0%	5.0%	4.4%	4.2%	4.9%	5.0%	4.1%
2006	6.2%	5.0%	4.4%	5.1%	6.8%	5.6%	4.3%
2007	5.0%	5.0%	4.4%	4.4%	5.2%	3.2%	4.2%
2008	4.6%	5.0%	4.4%	4.4%	4.3%	2.4%	4.1%
2009	4. 5%	5.0%	4.4%	4.3%	3.9%	3.2%	4.1%
	Average real growth	**Average potential growth**					
since 1981	4.7%	5.0%	4.7%	4.9%	4.9%	4.9%	4.7%
since 2001	3.6%	5.0%	4.5%	4.5%	4.1%	4.6%	4.4%

Sources: STATEC data, BCL calculations

The European Commission uses its NAWRU estimates to calculate potential output in member countries by the production function method. This approach is also implemented by the BCL, but distinguishing between cross-border employment (whose trend is extracted by the HP filter) and resident employment (whose structural level is determined by the HP trends of the participation rate and of the unemployment rate). Table 18 provides an update of the results using the different methods applied at the BCL.

Last time these estimates were published, in BCL bulletin 2006/1, they were based on data as available in June 2006. At that time, the different methods all agreed that the output gap turned negative in 2005 and would remain negative (with the exception of one method) through 2008. Following revisions to national accounts data (in particular, growth in 2005 and 2006 was higher than initially anticipated) two observations merit attention. First, the trough of the cycle has moved back into the past (now five of six methods find a negative output gap already in 2003 and place the trough in 2005). Second, a marginally positive output gap is already detected in 2007 for two of the methods, a result confirmed in 2008 and in 2009, when three methods register a positive output gap.

However, it is difficult to draw firm conclusions regarding the situation in 2009, since the different methods often contradict each other. The linear trend anticipates a growing negative output gap, since its potential growth estimate is higher than projected growth over 2008 and 2009. The Hodrick-Prescott filter finds a positive output gap starting in 2007 increasing gradually. The Harvey-Jaeger model, which is methodologically similar to the HP filter, finds a negative output gap that diminishes very slowly and persists through 2009. The Kuttner model, which takes account of inflation developments, also finds a persistent negative output gap which increases in absolute value (projected growth below potential growth) until 2007. The Apel-Jansson model, which takes account of both inflation and unemployment developments, finds that the negative output gap is rapidly reabsorbed and a positive gap appears in 2009. Finally, the production function method agrees with the HP filter results, anticipating a positive output gap in 2007 and an increase thereafter. The agreement between these two methods could reflect the fact that the production approach uses the HP filter to extract trend participation in the labour market, trend unemployment and the trend contribution of cross-border workers.

In conclusion, the different methods give a clear signal that the negative output gap is being reabsorbed, in other words growth observed in 2006 was higher than potential and this situation could well be prolonged through 2009. However, it is not yet clear whether GDP in 2007 has reached its potential level (zero output gap), nor whether it will have reached it in 2009.

The uncertainty underlined by divergent results across different methods is exacerbated by uncertainty from the data. In fact, the output gap estimates have been substantially revised compared to the estimates published in 2006. The Apel-Jansson method suffered revisions around two percentage points of GDP. The Hodrick-Prescott, Harvey-Jaeger and production function estimates have all been revised by more than one percentage point. These revisions are not only due to revisions in the underlying data, but also to new projections and an increase in the horizon to include 2009.

Potential growth estimates have also been revised. Average growth since 1981 is unchanged so the linear trend estimate of potential growth has not changed. However, according to the HP filter, potential growth since 1981 has increased by 0.1 percentage points. The estimates from other methods have also changed but in different directions. Potential growth should be relatively constant over 2007-2009 according to four of the six methods considered. The linear trend is based on the assumption that potential growth is constant, but for the HP filter, the Harvey-Jaeger model and the production function approach this result is more significant. The Kuttner and Apel-Jansson models anticipate greater fluctuations in potential growth (this is natural since these two methods also take into consideration fluctuations in other variables such as inflation and unemployment). However, looking across methods and across periods, medium-term potential growth between 4% and 5% remains plausible.

TABLE 19: DECOMPOSING POTENTIAL GROWTH (PRODUCTION FUNCTION APPROACH)

		Contributions to potential growth			Labour contribution decomposition	
	Potential Growth	Total Factor Productivity	Capital	Labour	Residents	Cross-border workers
1995	4.4	1.0	1.1	2.3	0.7	1.6
1996	4.4	0.9	1.1	2.4	0.7	1.7
1997	4.6	0.8	1.3	2.5	0.7	1.7
1998	4.6	0.7	1.4	2.6	0.8	1.7
1999	5.1	0.6	1.8	2.7	0.9	1.8
2000	4.9	0.6	1.5	2.8	1.0	1.8
2001	4.8	0.5	1.6	2.7	0.9	1.7
2002	4.5	0.4	1.6	2.4	0.7	1.7
2003	4.3	0.4	1.5	2.3	0.6	1.7
2004	4.0	0.5	1.4	2.2	0.5	1.7
2005	4.0	0.5	1.3	2.2	0.5	1.7
2006	4.2	0.6	1.3	2.3	0.6	1.7
2007	4.1	0.6	1.3	2.2	0.5	1.7
2008	4.0	0.6	1.4	2.1	0.4	1.6
2009	4.0	0.6	1.4	2.0	0.4	1.6

Sources: STATEC data, BCL calculations

Following an ECOFIN Council decision in July 2002, the European Commission favours the production function approach, especially because it allows a decomposition of growth into the contributions of labour, capital and total factor productivity (TFP). However, the Commission must apply this method to harmonised data across countries and, therefore, cannot take into account country specifics. In particular, the Commission calculates the labour contribution from unemployment and participation rates collected from the harmonised Labour Forces Survey, which is limited to residents. As a result, the important contribution to growth from cross-border workers in Luxembourg may contaminate the TFP estimate, since this is calculated as a residual, cumulating any measurement errors in the other variables. The following table provides a growth accounting exercise for Luxembourg, according to the BCL implementation of the production function method. This approach is not necessarily preferable to the others, but allows for an additional decomposition of the labour contribution into contribution of residents (both nationals and immigrants) and cross-border workers.

Over the whole period considered, the contribution of TFP was clearly less than those of capital and labour. In addition, the TFP contribution fell gradually until 2003. On the other hand, TFP has given some signs of recovery since 2004. The contribution of capital reached a peak around 1.8 percentage points in 1999 and then fell to 1.3 points in 2005-2006. In 2008 and 2009, capital accumulation should allow this source of potential growth to slightly raise its contribution. Finally, labour has always been the most important source of potential growth, reaching a peak near 3 percentage points in 2000. Since then, this source of growth has fallen and should be only 2 percentage points in 2009. The additional decomposition of the labour contribution reveals that cross-border workers account for two thirds to three quarters of this contribution. This result is hardly surprising given that since 1995 resident employment grew by only 1.7% on average (mostly thanks to immigration) while employment of cross-border workers grew by 7.7%. Between the peak in 2000 and the latest observation in 2006, the contribution of cross-border workers has fallen by 0.1 percentage points, while the contribution of resident workers has fallen by almost 0.5 points.

This analysis confirms that the structural reforms laid out in the Lisbon agenda remain crucial for sustaining growth in Luxembourg. Improved functioning of markets for goods, services and capital can favour innovation and thereby raise the TFP contribution to growth. However, labour has traditionally played the major role in Luxembourg, and its contribution has fallen by nearly a third since 2000. Thus, it is also important to improve the functioning of the labour market to bolster the labour contribution. The fall in this source of growth can be largely attributed to resident employment, underlining the need for the reforms proposed by the European Commission and the OECD to promote labour market participation among women and older workers. In Luxembourg, these groups of the population have low participation rates in international comparison, a phenomenon that could lower potential growth rates in the future in the wake of the ageing population.

1.2.10 Public finance

1.2.10.1 Budgetary policy overview

A shift towards a more rigorous budgetary policy occurred last year. On 2 May 2006, the Prime Minister announced new measures such as higher indirect taxes and social contributions for long-term care, the suspension of the indexation to prices of most family allowances and a rescheduling of the next indexation of pensions to real wages. The freeze in real terms of public sector wages in 2007 and 2008 as well as a closer monitoring of investment expenditure were also announced. Most measures were to be implemented in 2007 and were, therefore, embedded in the 2007 budget, adopted by the Parliament in December. The budget was based on a general government deficit calculated in line with ESA 95 methodology and equal to 0.9% of GDP in 2007. The eighth update of the Stability Programme, published in November 2006, confirmed the more cautious budgetary course. In this update, the authorities targeted a gradual convergence to budgetary balance, which was anticipated for 2009.

According to the public sector accounts published in April 2007, this target was already reached in 2006. The general government balance was actually in surplus by 0.1% of GDP, in spite of the fact that most consolidation measures were not implemented before 2007. As shown below, this improvement should not lead to fiscal complacency as it may rest on shaky foundations.

1.2.10.2 General government revenue

The revenue ratio decreased markedly in 2006, but this reflects an exceptionally high rate of growth of nominal GDP. Expressed in nominal terms, total general government revenue increased by 7% in 2006, after 10.5% in 2005. The significant increase in total revenue in 2006 benefited from the impact of an exceptionally high dividend paid by Arcelor-Mittal which affected both dividend taxes and central government's property income. In addition, personal income taxes were extremely buoyant due in part to the non-indexation of tax brackets. Some deterioration on the revenue side should be recorded in 2007 reflecting the unwinding of the Arcelor-Mittal windfall recorded in 2006. These developments may be dampened by strong corporate taxes and buoyant social contributions owing to the resilience of the economic recovery and to the impact of the consolidation measures announced by the Prime Minister in 2006. The revenue ratio should remain stable thereafter.

TABLE 20: GENERAL GOVERNMENT REVENUE (AS A PERCENTAGE OF GDP, UNLESS OTHERWISE INDICATED)

	Official data April 2007						BCL projections June 2007		
	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Direct taxes	15.2	15.2	14.7	13.2	14.0	13.2	13.0	13.2	13.4
Payable by households	*7.9*	*7.2*	*7.3*	*7.4*	*8.0*	*8.1*	*7.8*	*8.0*	*8.2*
Payable by corporations	*7.3*	*8.0*	*7.4*	*5.8*	*6.0*	*5.1*	*5.1*	*5.2*	*5.2*
Indirect taxes	13.6	12.9	12.7	13.7	13.7	12.8	12.6	12.5	12.3
Social contributions	11.8	11.7	11.8	11.8	11.7	11.0	11.1	11.1	11.2
Other revenue	4.1	3.9	3.5	3.4	3.4	3.6	3.5	3.5	3.4
Total revenue	**44.6**	**43.8**	**42.7**	**42.1**	**42.7**	**40.6**	**40.2**	**40.3**	**40.3**
Nominal increase in total revenue (%)	**3.9**	**4.6**	**3.8**	**3.9**	**10.5**	**7.0**	**7.0**	**7.9**	**7.2**

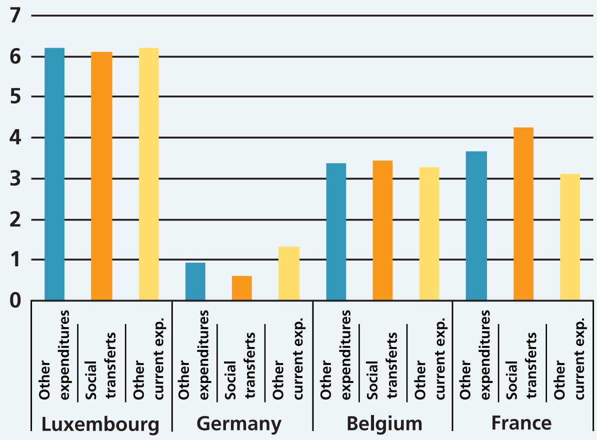
Sources: IGF, IGSS, STATEC, UCM, BCL calculations

1.2.10.3 General government expenditure

The expenditure ratio experienced a pronounced decline in 2006. This reflected the impact of the extremely high rate of nominal GDP growth recorded in 2006 rather than actual expenditure restraint. Although expenditure growth decelerated in 2006 - it reached 6% compared to 8% or more from 2001 to 2005 - it was still much higher than in the three neighbouring countries, as illustrated in the following chart. In addition, to a certain extent it reflected lower public investments, which decreased both in nominal terms and as a share of GDP.

Total expenditure should increase by 7% in 2007, boosted by extra outlays stemming from the implementation of the Kyoto protocol and by purchases of land by the central government. Expenditure growth should recede somewhat in 2008 but should rebound in 2009 due to the biennial adjustment of pensions and among other factors to the assumed impact of a new public sector wage agreement. In spite of these developments, the expenditure-to-GDP ratio should decrease over the projection horizon.

CHART 32: GENERAL GOVERNMENT CURRENT EXPENDITURE IN LUXEMBOURG AND THE THREE SURROUNDING COUNTRIES: GROWTH RATES (AS %)



Source: Eurostat

Note: The chart focuses on current expenditure. Capital expenditures are more volatile due to temporary effects.

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

	Official data April 2007						BCL projections June 2007		
	2001	2002	2003	2004	2005	2006	2007	2008	2009
Social transfers	19.5	20.2	21.0	21.5	21.2	20.0	19.9	19.7	19.8
Public investments	4.3	5.0	4.6	4.3	4.7	4.1	3.9	3.9	3.9
Consumption expenditure(1)	11.2	11.3	11.4	11.6	11.7	11.0	10.8	10.7	10.7
Subsidies(2)	1.7	1.7	1.7	1.7	1.8	1.7	1.7	1.7	1.7
Other expenditure	1.9	3.4	3.5	4.2	3.7	3.8	3.8	3.6	3.6
Total expenditure	**38.5**	**41.7**	**42.3**	**43.3**	**43.0**	**40.5**	**40.1**	**39.6**	**39.6**
Nominal increase in total expenditure (%)	**8.8**	**10.0**	**7.9**	**8.0**	**8.1**	**6.0**	**7.0**	**6.2**	**7.3**

Sources: IGF, IGSS, STATEC, UCM, BCL calculations.

Notes:

(1) Compensation of employees and intermediate consumption.

(2) Disregarding capital transfers.

The expenditure ratio recorded in 2001 was negatively affected by a one-off transaction, namely the sale of a licence to a satellite company. This explains the marked decrease in the "Other expenditure" item in 2001. The nominal growth rates displayed in the last row of the table smooth out the impact of this transaction, which amounted to 1.9% of the 2001 GDP.

1.2.10.4 General government net lending or borrowing

The general government recorded a slight surplus in 2006, for the first time since 2003. The improvement was due to a deceleration of total expenditure growth, which was below the average of the 2001-2005 period, and to the impact of the Arcelor Mittal dividends. Without this latter windfall, the general government balance would have slightly deteriorated because corporate tax receipts plummeted in 2006, while revenues from VAT and taxes on energy stagnated.

The general government surplus is projected to remain unchanged in 2007 and to increase to 0.7% of GDP in 2008 and 2009. With the revenue-to-GDP ratio expected to remain stable over the projection horizon, all the improvement in the budget balance compared to 2007 should stem from a decline in the expenditure share of GDP.

The cyclically adjusted balance would barely improve from 2006 to 2009. It would even deteriorate in 2009, in particular due to the assumed public sector wage agreement and the biennial adjustment of pensions to real wage developments.

The fiscal situation projected by the ESCB is significantly more favourable than the one envisaged in the November 2006 update of the Stability Programme. This discrepancy is mostly attributable to a significant overestimation of the 2005 and 2006 deficits in November 2006, with an associated base effect in the ESCB projections. Compared to the Stability Programme data, the ESCB projections indicate more sustained expenditure growth for 2007-09 but a more dynamic behaviour of revenue over the same time horizon.

TABLE 22: GENERAL GOVERNMENT NET LENDING (+) OR NET BORROWING (-) (AS A PERCENTAGE OF GDP)

	2001	2002	2003	2004	2005	2006	2007	2008	2009
	Actual balance (net lending (+) or net borrowing (-))								
	Official data April 2007						**BCL projections June 2007**		
General government	**6.1**	**2.1**	**0.4**	**-1.2**	**-0.3**	**0.1**	**0.1**	**0.7**	**0.7**
of which central government	2.9	-0.5	-1.3	-2.7	-1.5	-1.5	-1.6	-1.0	-1.0
of which local governments	0.1	0.1	0.0	-0.1	-0.4	0.0	0.0	0.1	0.1
of which social security	3.1	2.4	1.8	1.6	1.6	1.7	1.7	1.7	1.6
Stability Programme	--	--	--	--	**-1.0**	**-1.5**	**-0.9**	**-0.4**	**0.1**
BCL projections December 2006						**-1.3**	**-1.0**	**-0.6**	--
	Cyclically adjusted balances								
BCL projections June 2007 (1)	5.6	1.2	0.3	-1.0	0.2	0.4	0.2	0.7	0.4
Stability Programme estimate	--	--	--	--	-0.2	-1.3	-0.5	-0.1	0.9

Notes:

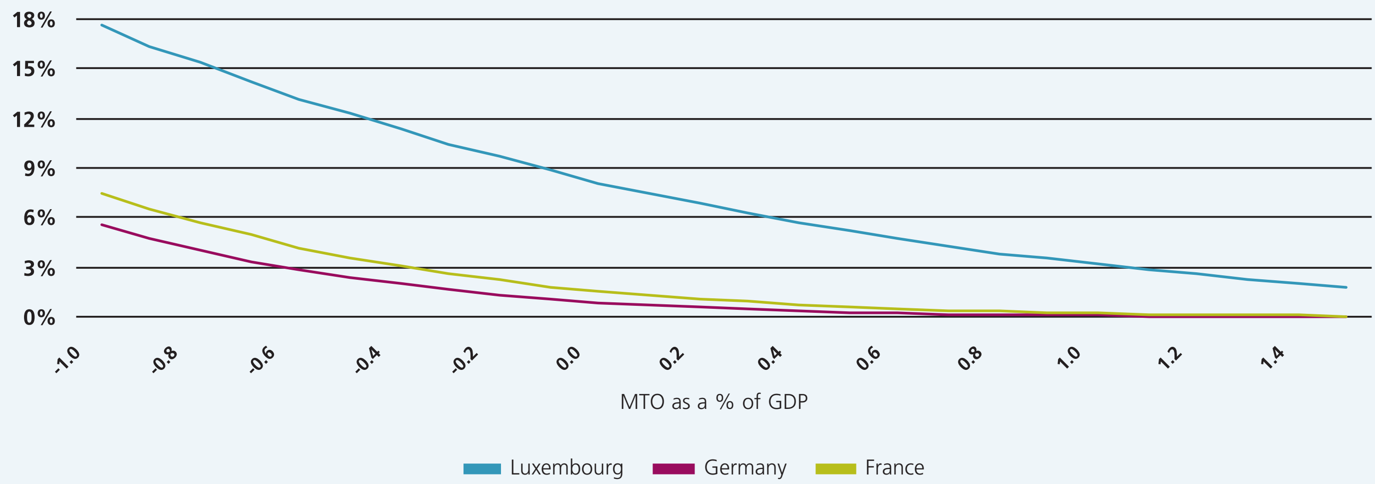
(1) These cyclically adjusted balances are based on a disaggregated Hodrick-Prescott approach.

Sources: STATEC, 8th update of the Luxembourg Stability Programme, BCL calculations

The high volatility of macroeconomic conditions is a major source of risk to the fiscal projections as highlighted by fiscal developments in 2006. The risks are further exacerbated by the de-linking of several taxes from macroeconomic tax bases. Additional risks relate to the fiscal impact of a pending statement by the European Court of Justice on the tax deduction of mortgage interest charges paid by cross-border workers and to the possible introduction of a higher solidarity levy on direct taxes in January 2008. In addition, in the May 2007 address on the social, economic and financial situation of the country, the Prime Minister hinted at new measures related to corporate income taxes and at the possible introduction of tax credits for specific income groups. Finally, the ongoing discussions at the European level of registration taxes ("droit d'apport") and VAT on electronic commerce could turn out to have a major budgetary impact. On the expenditure side, government investments are difficult to be forecast, due to volatility in the implementation of investment programmes and uncertainties surrounding the forthcoming wage negotiations in the public sector.

The slight surplus recorded in 2006 should not lead to complacency. The improvement of the fiscal situation is moderate and rests on an exceptionally favourable macroeconomic context, buoyant financial markets and the Arcelor Mittal windfall. The November 2006 Stability Programme aims to achieve a cyclically adjusted surplus of 0.9% of GDP, while the medium-term objective is a deficit of 0.8% of GDP. This medium-term objective should be more ambitious. As illustrated in the chart above, only a structural surplus in excess of 1% of GDP would ensure compliance with the 3% of GDP reference value in a context characterised by fiscal instability. In fact, the Luxembourg economy exhibits high cyclical volatility and is also confronted with many non-cyclical sources of fiscal volatility, especially on the revenue side. An additional factor of instability is the frequent revision in public finance statistics. In this context, the medium-term objective should be much more demanding than in countries like Germany and France, where the volatility of fiscal balances is less pronounced. Moreover, room for manoeuvre is required in order to address long-term sustainability issues - in particular, in the pension and healthcare systems - identified, inter alia, in the European Commission's Sustainability Report. In this context, the authorities should strictly comply with the November 2006 update of the stability programme and even pursue further fiscal adjustment in the event of continued favourable macroeconomic conditions. A structural surplus of at least 1% of GDP should be reached in 2009 at the latest, and such a balance should become the new medium-term objective.

CHART 33: PROBABILITY THAT THE 3% OF GDP REFERENCE VALUE WILL BE BREACHED IN THE COURSE OF A GIVEN YEAR, CONDITIONAL ON THE MEDIUM-TERM OBJECTIVE TARGETED (AS % OF GDP)



Sources: Eurostat, STATEC, BCL calculations

Notes: For a given medium-term objective, the probability is inferred starting from a normal distribution centered on this MTO and with the standard deviation of the general government balances recorded over the 1991-2006 period. This exercise is repeated for each of the three selected countries. By assumption the targeted MTO is complied with on average, the deviations from the MTO being symmetric. These deviations could stem from macroeconomic conditions or from other sources of budgetary volatility such as the decoupling of tax bases from cyclical developments. The standard deviation of fiscal balances recorded over the 1991-2006 is deemed sufficiently representative.

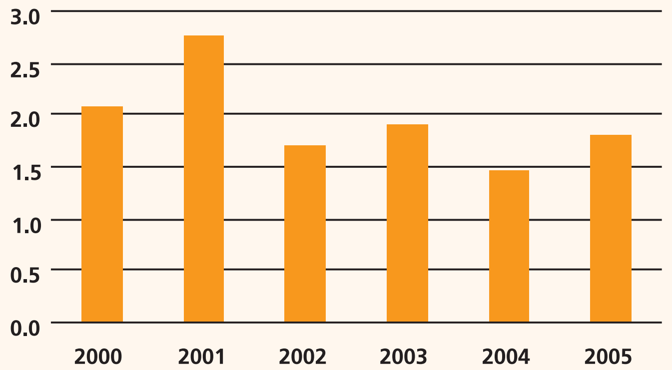
Pension reform in Luxembourg: some insights

Favourable short-term indicators, but serious challenges in the future

The short-term fiscal indicators of the private sector pension regime are extremely favourable, as indicated in the next chart. Surpluses of about 2% of GDP allowed this regime to accumulate significant reserves reaching 22% of GDP in 2005.

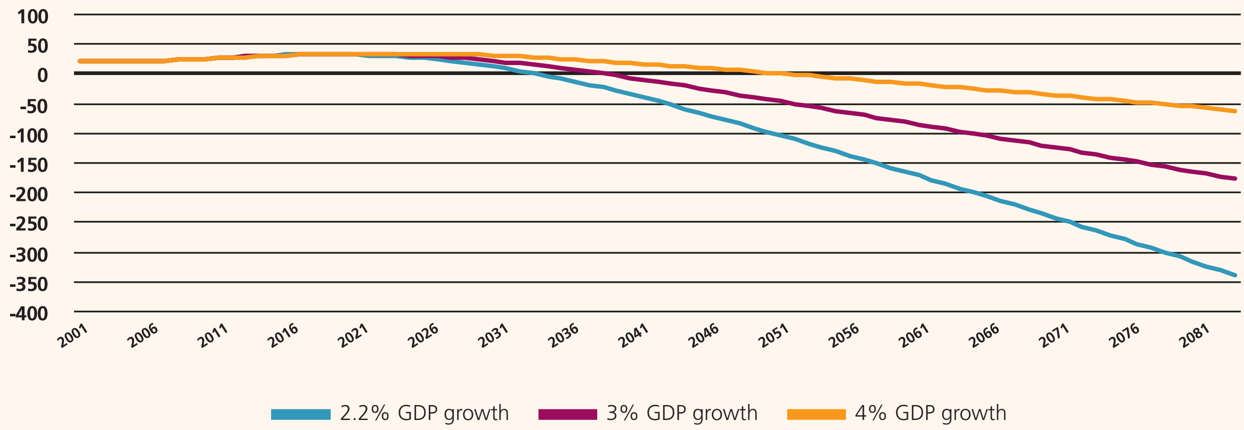
However, long-term indicators depict a distinctively darker picture. As illustrated in the chart below, the baseline scenario, which is based on the assumption of a 3% GDP growth rate from 2010 onwards, would result in sizeable net liabilities of the pension regime equal to about 200% of GDP around the end of the projection horizon. Net liabilities would even reach 350% of GDP under a 2.2% growth scenario. Liabilities would be of a much lesser magnitude under a 4% growth scenario, but the latter would require the participation of more than one million cross-border workers to the labor force at the end of the horizon, namely about ten times more than at the current juncture.

CHART 34: THE BUDGETARY SITUATION OF THE PRIVATE SECTOR PENSION REGIME: FISCAL BALANCES (% OF GDP)



Sources : IGSS, STATEC

CHART 35: LONG-TERM PROJECTION OF THE BUDGETARY SITUATION OF THE PRIVATE SECTOR PENSION REGIME: PENSION RESERVES (+) OR LIABILITIES (-) UNDER ALTERNATIVE GDP GROWTH SCENARIOS (% OF GDP)



Notes: The underlying assumptions are spelled out in BCL Working Paper n°23. The macroeconomic, financial and demographic assumptions as well as the number of cross-border workers were updated at the beginning of May 2007. The June 2007 macroeconomic projections made by BCL are used for the 2007-2009 period, which means that the growth scenarios illustrated in the chart do not apply before the 2010-2085 horizon. It is further assumed that the net number of immigrants will be equal to 4 000 a year over this horizon. The number of cross-border workers is the "residual" variable, which ensures that total employment grows in line with the rates of GDP growth selected in the different scenarios and with productivity growth - by assumption 2% a year - over the same 2010-2085 period.

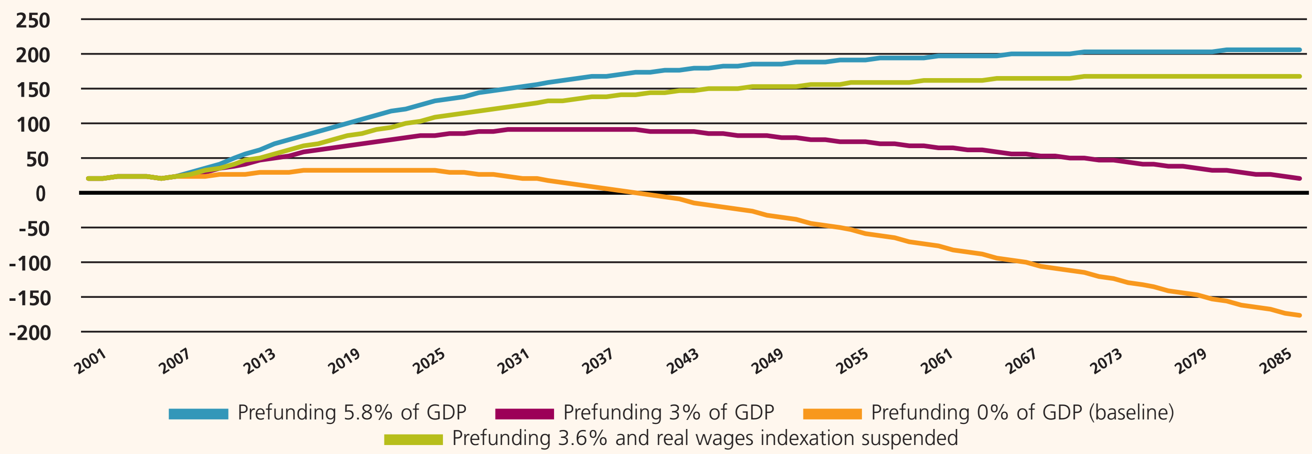
Sources: IGSS, STATEC, BCL calculations

These results should, of course, be interpreted with caution. They should be viewed as attempts to outline the major trends at stake over a long-term horizon rather than as firm predictions, as many uncertainties lie ahead. However, in spite of several shortcomings, long-term projections are clearly required, especially in a country like Luxembourg, where short-term indicators are distorted by the large inflow of cross-border and foreign workers recorded over the last decade. This evolution gave way to a steep increase of social contributions not matched by commensurate increases on the expenditure side. This mismatch explains most of the aforementioned surpluses, which are bound to disappear unless high economic growth and the associated inflow of cross-border workers are sustained over all the projection horizon. These developments will unfold over a long period of time, underlining the need for a long-term projection horizon that will encompass the life cycle of all the cross-border workers currently employed.

What should be the next steps forward?

Pension reform should be implemented as soon as possible in Luxembourg. The financial situation of the pension regime faces pronounced deterioration in the future, if policy remains unchanged. In addition, delayed adjustment would be extremely costly, as it would require much higher social contributions (at least 40% of gross income around the end of the projection horizon under a wait-and-see strategy, compared to the current 24%), or much lower pensions. This calls for immediate action. As indicated in the chart below, only a prefunding effort equal to about 6% of GDP - namely a permanent increase in revenue or decrease in expenditure by 6% of GDP - would guarantee the advent of a stable, self-sustained equilibrium, in which investment income would be sufficiently high to offset the additional expenditure induced by ageing. Such an equilibrium would ensure convergence to a steady-state level of reserves equal to about 200% of GDP. As explained in BCL Working Paper n° 23, this equilibrium would also comply with the present value budget constraint over an infinite time horizon. The Working Paper also highlighted that high reserves would protect the pension system from adverse macroeconomic developments, what represents a very desirable feature in a small, open economy like Luxembourg. Any prefunding effort lower than 6% of GDP, for instance 3% of GDP as illustrated in the chart, would result in a systematic drift away from the steady-state equilibrium, which means that long-term sustainability would not be achieved and that the pension regime would not be shielded from adverse macroeconomic developments.

CHART 36: LONG-TERM PROJECTION OF THE BUDGETARY SITUATION OF THE PRIVATE SECTOR PENSION REGIME: PENSION RESERVES (+) OR LIABILITIES (-) UNDER ALTERNATIVE PREFUNDING SCENARIOS AND CONDITIONAL ON A 3% GDP GROWTH RATE (% OF GDP)



Sources: IGSS, STATEC, BCL calculations

The prefunding effort could rest on the implementation of a combination of measures. In the Luxembourg context, the following illustrative steps could be envisaged:

- Temporary suspension of the biennial indexation of pensions to real wage developments, for instance from 2009 to 2017 as illustrated in the chart above. In this case, the residual prefunding effort could decline to 3.6% of GDP and the corresponding equilibrium reserves to 170% of GDP.

- Better management of pension reserves. The real returns achieved in the recent past are very low, as they reached 1% only on average over the 1997-2005 period due to a short-term investment bias. The Government Pension Fund in Norway achieved a real return higher than 4% over the same period. Had Luxembourg have achieved the same return, pension reserves would have reached 28% of GDP instead of 22% at the end of 2005. The discrepancy (6% of GDP) is equivalent to approximately three quarters of a yearly pension bill.

- Recalibration of the formula used to calculate individual pensions, in order to raise the effective retirement age closer to the legal age (65 years). A device currently used to encourage later retirements ("augmentation échelonnée") should be reinforced. By contrast, other components of the pension formula (the so-called "majoration proportionnelle") should be adjusted downwards in order to guarantee that the new calibration is financially neutral for individuals who retire at 65.

Artist: Zora Palova
Title: Bluee
Material: glass
Format : width 106 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.

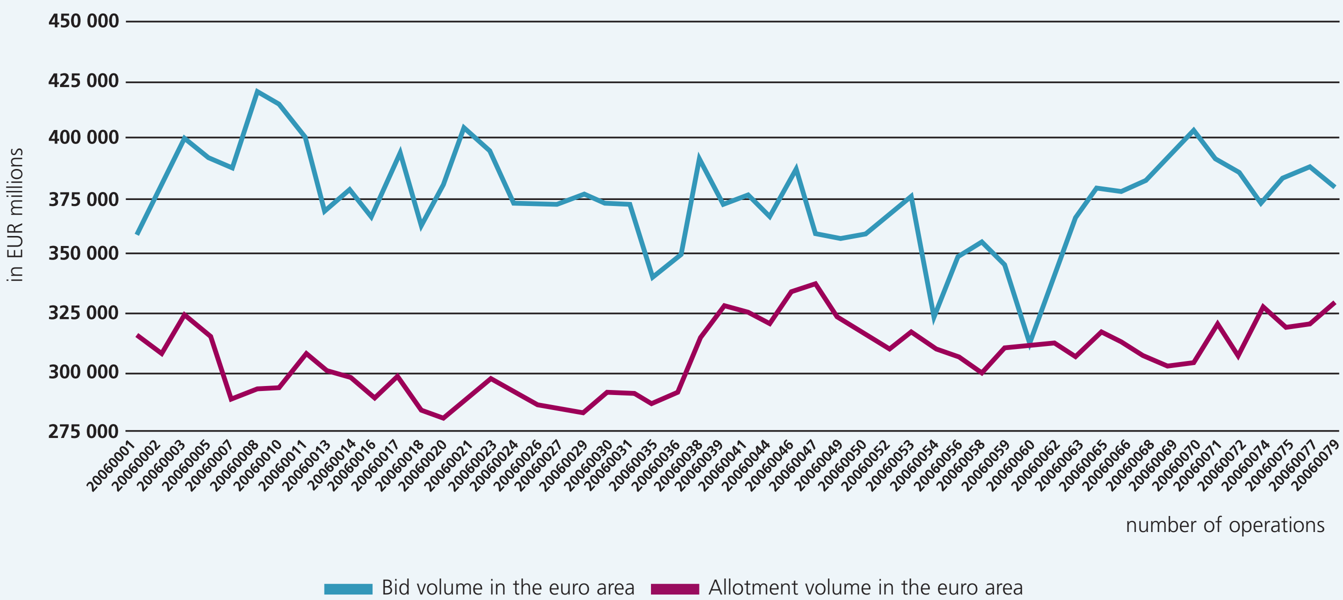
Open market operations are divided into:

- 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.

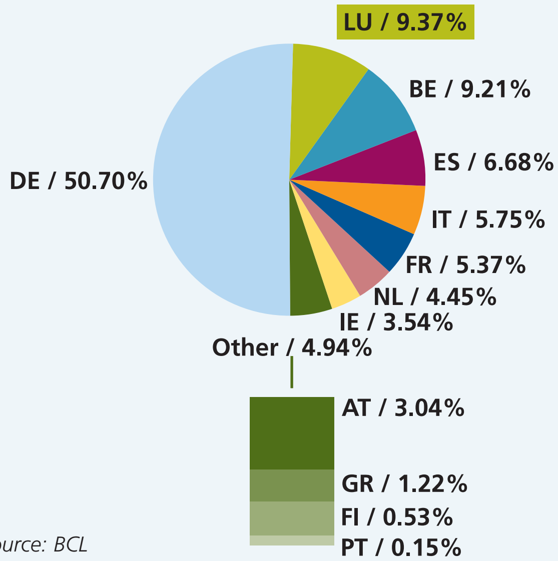
CHART 1: MROS IN 2006 - BID AND ALLOTMENT VOLUME IN THE EURO AREA



Source: BCL

In 2006, Luxembourg ranked second in the allotment volume behind Germany with, on average, 9.37% of the total euro area volume. This ranking was confirmed during the first months of 2007, when Luxembourg's allotment volume amounted to 10.33%.

CHART 2: MROS IN 2006 - AVERAGE ALLOTMENT SHARE IN THE EURO AREA



Source: BCL

Compared with 2005, the average percentage allotted in Luxembourg increased from 7.82% to 9.37%.

The volume allotted to Luxembourg in MROs increased by 26.7% in 2006 in comparison with 2005 (from 1180 through 1496 bln euro). In the euro area, this figure increased only by 6%.

In 2006, the number of counterparties participating in MROs increased in Luxembourg to 23 banks in comparison with 20.5 in 2005, 20 in 2004, 19 in 2003 and 18 in 2002. In the euro area, the number of participating counterparties rose, on average, from 51 in 2005 to 377 in 2006. 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 2007, the average number of participating counterparties in MROs remained stable with 22 banks in Luxembourg.

CHART 3: MROS IN 2006 - AVERAGE BID AND ALLOTMENT VOLUME IN THE EURO AREA

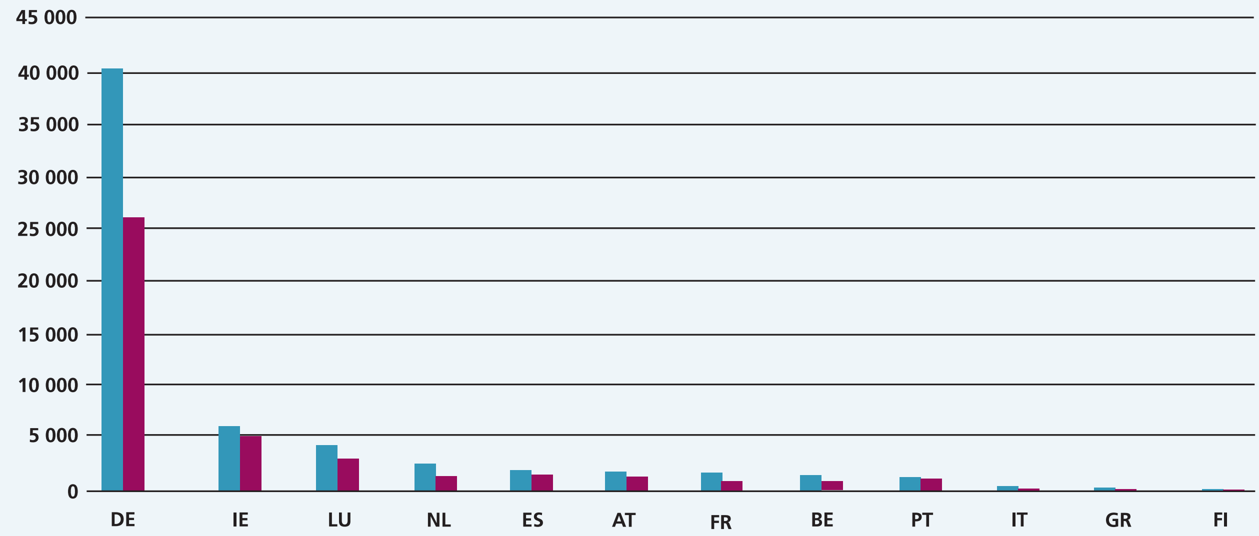
	DE	LU	BE	ES	NL	FR	IT	IE	AT	GR	FI	PT
BID	190 722	32 357	31 391	26 062	23 718	22 428	19 739	11 541	10 616	4 008	1 757	537,2
Allotment	155 705	28 763	28 269	20 509	13 655	16 493	17 646	10 866	9 333	3 734	1 639	474,3

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 2006 (with 6.74% of the allotment volume in 2006). The average number of participating counterparties was 9 in 2007 in comparison with 7 in 2005.

CHART 4: LTROS IN 2006 - AVERAGE BID AND ALLOTMENT VOLUME IN THE EURO AREA



Offre	40 023	5 673	4 149	2 228	1 832	1 603	1 409	1 408	1 276	686	440	411
Adjudication	2 580	4 967	2 696	918	1 137	1 129	555	640	1 201	380	375	197

Source: BCL

In December 2006, the ECB's Governing Council decided to raise the allotment amount from €40 billion to €50 billion for each LTRO.

- Fine-tuning operations

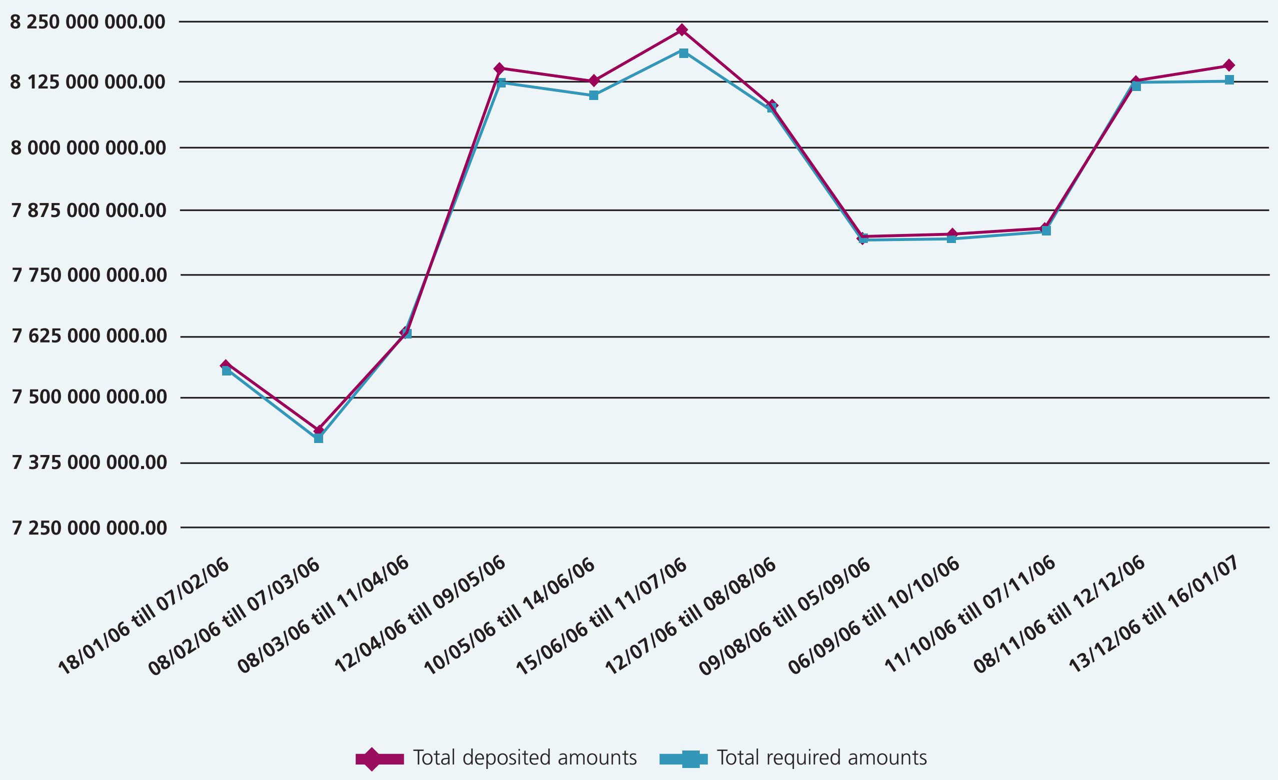
Short-term rate fluctuations increased during the final days of the reserve maintenance periods. This reflects the fact that, as the allotment of the last MRO during a reserve maintenance period now occurs eight days before its end, the risk of a liquidity imbalance is thereby increased. In order to restore neutral liquidity conditions, the ECB carried out eleven 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 and three in 2004.

The ECB also improved its communication by announcing these operations and their estimated amounts beforehand.

Minimum reserve system

From 18 January 2006 until 16 January 2007, the average amount of minimum reserves held by credit institutions in Luxembourg was estimated at €7.920 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

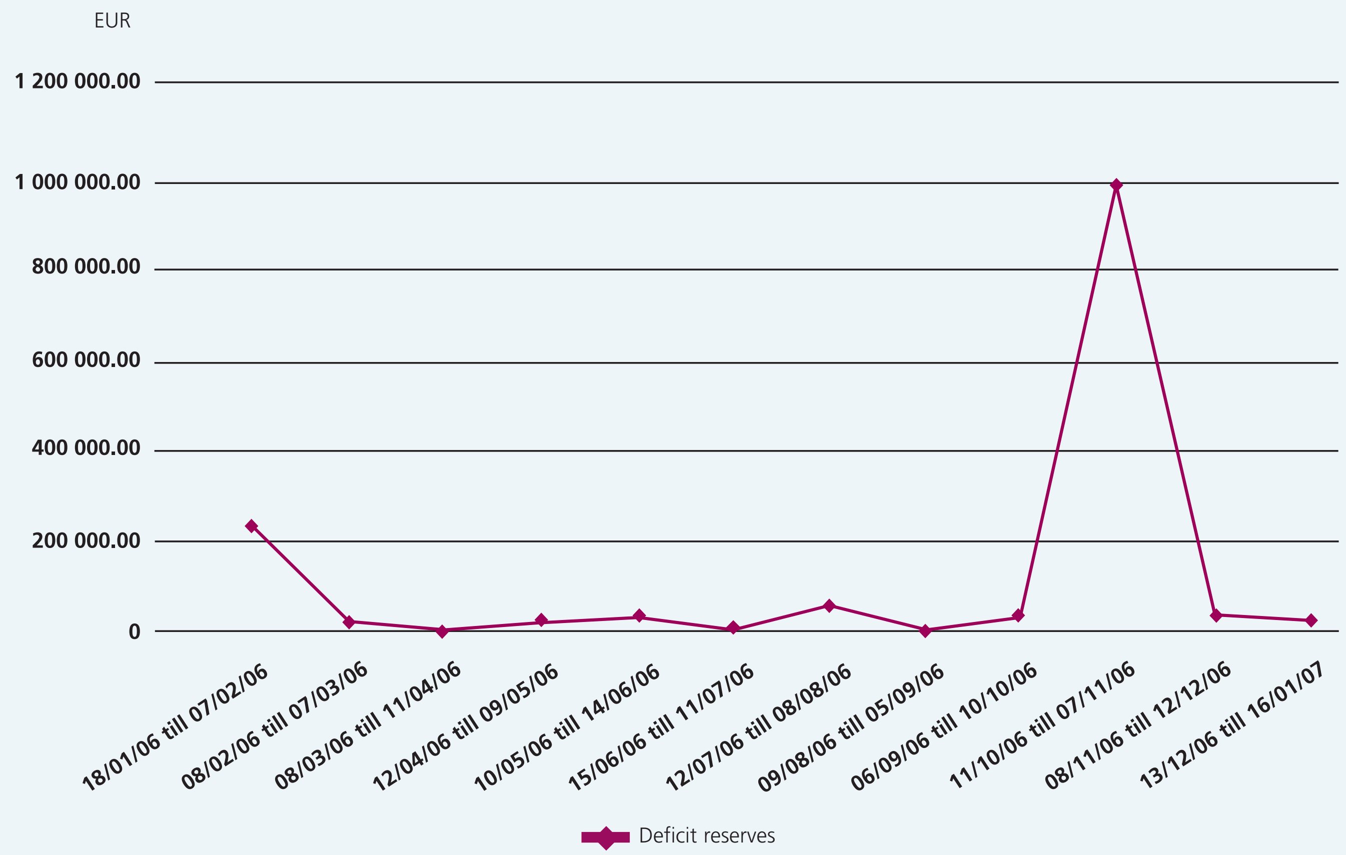
Changes in the remuneration rate in 2006

The rates at which minimum reserves were remunerated increased from 2.30% to 3.30% in 2006.

Periods	18/01/06 07/02/06	08/02/06 07/03/06	08/03/06 11/04/06	12/04/06 09/05/06	10/05/06 14/06/06	15/06/06 11/07/06	12/07/06 11/07/06	12/07/06 08/08/06	09/08/06 10/10/06	11/10/06 07/11/06	08/11/06 12/12/06	13/12/06 16/01/07
Rate (%)	2.30%	2.31%	2.56%	2.58%	2.57%	2.81%	2.80%	3.04%	3.03%	3.30%	3.30%	3.57%

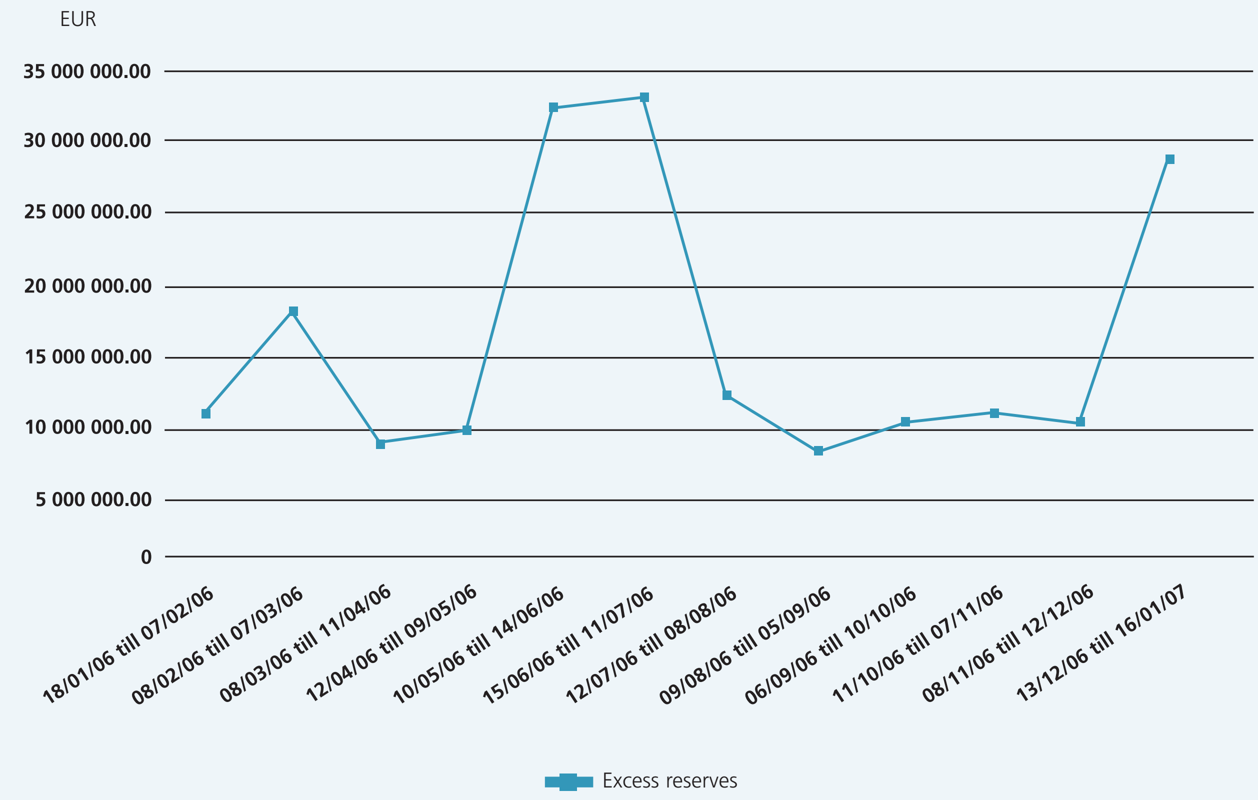
Counterparties paid seven sanctions for not respecting minimum reserve requirements in 2006, compared with five in 2005.

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.

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%, previously 0.1492%; an additional €12.6 million has been transferred to the ECB. As at 31 December 2006, the total market value of the ECB's reserves (including accrued interest) managed by the BCL corresponded to €117.6 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 Value at Risk 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.

- **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 consist of the following:

- 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

The transactions are executed by the portfolio managers, 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[1] unit 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.

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: Liquidity Portfolio, Domestic Reserves Portfolio, Pension Fund Portfolio and Investments 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 abovementioned risk constraints (see section 2.3.2). As of 31 December 2006, the total market value (including accrued interest) amounted to €1,447.8 million.

In 2006 the share of this portfolio invested in fixed income securities with maturity above three years was reduced from 33% to 19%, whereas the percentage of bonds with a one to three year maturity rose from 22% to 36%. Moreover, by the end of 2006, variable rate and fixed rate bonds with maturity under one year represented 45% of Portfolio 1, same level as of 31 December 2005.

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 of 31 December 2006, the total market value (including accrued interest) amounted to €3,693.3 million.

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

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 of 31 December 2006, the total market value (including accrued interest) of this portfolio in foreign currencies amounted to €117.6 million.

Pension Fund Portfolio

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

Investments Portfolios

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

The Bank belongs to the Eurosystem service providers. 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%	74%
1-3 years	36%	21%
3-7 years	17%	5%
> 7 years	2%	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 2006, the BCL was responsible for producing €10.2 million €100 banknotes for its own requirements. The production of these banknotes was entrusted to the specialised security printer *De La Rue International* in England.

According to an agreement with the Luxembourg government, the BCL is in charge of the production of Luxembourg's euro coins. Following an invitation to tender, the BCL put the Rahapaja Oy (Mint of Finland) in charge of the production in 2006 of 31.1 million coins for its own requirements. Following a renewed invitation to tender, the BCL signed an agreement with Monnaie de Paris for the production of 43.48 million Luxembourg euro coins dated 2007 in order to satisfy the demand for coins in 2007.

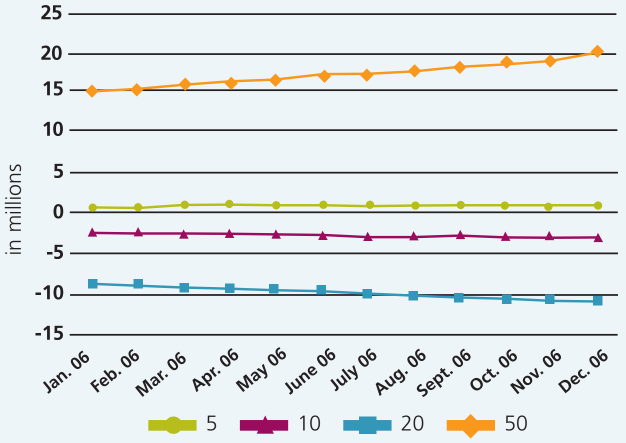
2.4.1 Circulation of banknotes and coins

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 2006 amounted to 19.32 million notes, compared with 20.88 million banknotes in 2005, a decrease of 7.4%. 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.

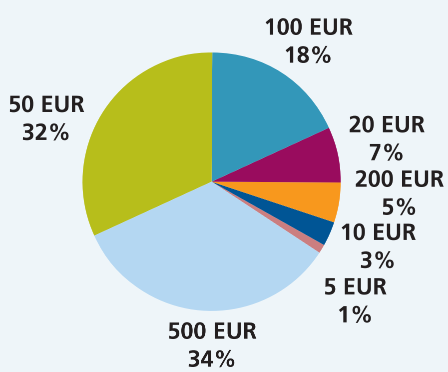
CHART 8: CHANGE IN THE NUMBER OF EURO BANKNOTES USED FOR EVERYDAY TRANSACTIONS PUT INTO CIRCULATION BY THE BCL



In comparison with other national central banks in the euro area, the BCL maintained its contribution to the total volume of banknotes put into circulation by the Eurosystem at 1.1%, like in December 2005.

In Luxembourg and in the rest of the euro area, the year 2006, like 2005, was marked by a steady demand for higher denominations. The total value of euro banknotes put into circulation by the Eurosystem increased by 11.5% and amounted to €628.24 billion at the end of 2006, with the following value breakdown by denomination:

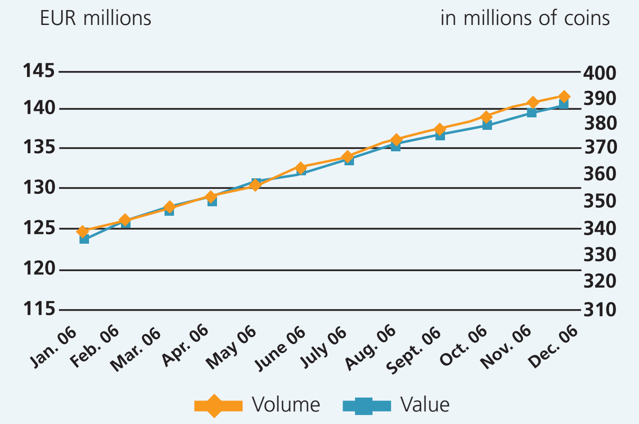
CHART 9: VALUE BREAKDOWN BY DENOMINATION OF EURO-BANKNOTES PUT INTO CIRCULATION BY THE EUROSYSTEM



Public demand for euro coins issued by Luxembourg has remained strong. The total value of the coins put into circulation increased by 14.5% in 2006, compared with 19.1% in 2005. The total value rose from €123.41 million to €141.29 million. The volume of Luxembourg's euro coins issued in 2006 increased by 49.74 million coins (more than 245 tons of metal), a rise of 14.6%, and amounted to 390.21 million coins at the end of 2006. This volume is equivalent to a total weight of 1,884 tons, i.e. 4.1 kg or around 848 coins, with a value of €308, for each inhabitant of Luxembourg. As in previous years, the country's coins continued to be much sought after by collectors.

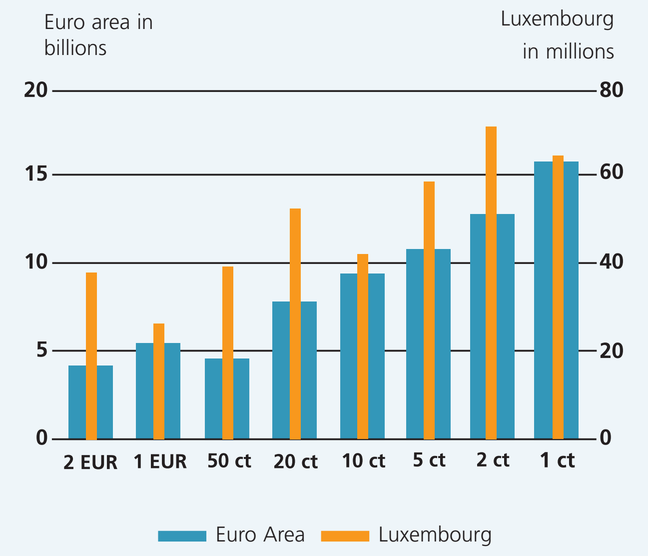
The average monthly volume of coins in circulation rose to 365.25 million. The following chart shows the changing volume and value of Luxembourg's euro coins in circulation throughout 2006. The demand for coins grew steadily in the year under review.

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 by 0.5% in 2006; Luxembourg contributes 0.6% 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 36.2 cent in comparison with an average of 26 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.

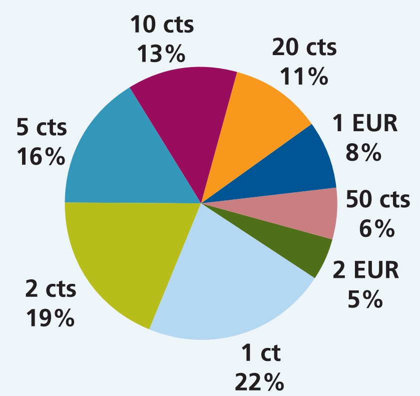
CHART 11: COMPARISON OF THE CIRCULATION VOLUME OF THE DIFFERENT EURO COIN DENOMINATIONS IN LUXEMBOURG TO THAT OF THE EURO AREA



Concerning Luxembourg's coins, the 2-cent denomination remained the most common in 2006. Compared with 2005, the ranking according to volume remained unchanged in 2006, 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 €16.64 billion at the end of 2005 to €17.88 billion at the end of 2006, whereas the total volume of coins reached 69.50 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 2006, the total value of Luxembourg francs not yet exchanged fell by 1.3%, from LUF 442 million to 436.2 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 (- 5.7%), while that of 1,000-franc banknotes fell by 2.5%. The volume of unreturned 100-franc banknotes only decreased by 0.3%. These figures show that collectors prefer the lower denominations. The return of banknotes in 2006 took the form of a nearly linear curve with a very marked fall in December 2006. The table below shows the total value of unreturned Luxembourg franc banknotes for the five last years.

At the end of 2006, a total volume of 890,244 Luxembourg banknotes and 63.1 million coins, with a total value of LUF 402.7 million, had still not been exchanged. Numismatic products and collector coins still not exchanged amounted to LUF 33.5 million.

Over 1,100 Belgian franc banknotes were returned and ceased to be exchangeable as of 15 December 2006. Luxembourg 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 - 60.50 million - remained nearly unchanged compared with the previous year. The volume of returned notes involved more than 1,700 lodgement operations registered and managed by the Cash Department. Furthermore, the number of withdrawals of euro banknotes by financial institutions exceeded 3,400 operations. These were likewise registered and managed by the Cash Department, and represented a decrease of 12.8% compared with 2005.

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 9,300 transactions were conducted over the counter in 2006, i.e. an average of 37.2 operations per working day. Some 300 transactions for professional numismatists were also carried out. All in all, the Cash Department registered and managed over 14,700 transactions concerning notes, coins and numismatic products.

The number of euro banknotes processed by sorting machines rose noticeably, by some 2.9%, from 57.96 million notes in 2005 to 59.66 million in 2006. The sorting machines carry out both authenticity tests and soiling tests. Nearly 15.4 million notes of all denominations had to be destroyed as they were unfit for circulation. The reject/destruction rate fell from 28% in 2005 to 25.8% of the total number of euro banknotes 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 48.7% 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 2006, as in 2005, 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 the Hereditary Grand Duke, marks the 25th birthday of the Hereditary Grand Duke Guillaume.

The BCL issued the following numismatic products in Luxembourg in 2006:

- The "2006 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 2006. The mintage is limited to 15,000 sets. This set is the second and belongs to a 7 set series dedicated to the different architectural eras as depicted on Luxembourg's euro notes.

- The "2006 Benelux set" contains the 2006 series of eight euro coins of the three Benelux countries struck in "Brilliant Uncirculated" quality. It also includes a cupronickel medal specially designed for the Benelux capitals - the theme of this set.

- The "2006 Proof set" features Luxembourg's nine euro coins (ranging from 1 cent to €2) plus the €2 commemorative coin, all struck in "Proof" quality and dated 2006. The mintage amounts to 2,000 sets.

- The silver-titanium "Banque et Caisse d'Epargne de l'Etat" coin, issued in February 2006 with a mintage amount of 7,500, is the first Luxembourg silver-titanium collector coin devoted to National Institutions. This coin has a face value of €10, is minted with a silver fineness of 925 and a titanium fineness of 999. Its diameter is 26 mm and its weight is 8 g.

- The silver-titanium "Conseil d'Etat" coin, issued in November 2006 with a mintage amount of 4,000, is the second Luxembourg silver-titanium collector coin devoted to National Institutions. This coin has a face value of €20, is minted with a silver fineness of 925 and a titanium fineness of 999. Its diameter is 34 mm and its weight is 13.5 g.

- The silver coin issued in January 2006 with a mintage of 5,000 is the country's fifth 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.

- The golden coin "Boar of Titelberg", issued in October 2006 with a mintage amount of 5,000, is the second Luxembourg golden collector coin in the "cultural History of Grand Duchy of Luxembourg" series. This coin has a face value of €5, is minted with a gold fineness of 999. Its diameter is 16 mm and its weight is 3.11 g - one tenth of golden ounce.

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

In the context of the work undertaken by the European System of Central Banks (ESCB), the BCL prepared the revision of the regulatory framework for Monetary Financial Institutions (MFI) balance sheet statistics and MFI interest rate statistics, with the aim to improve the availability of statistics in the euro area. The main objectives of these developments are the integration of new financial instruments, statistics on payments systems and information on securitization operations within the framework of money and banking statistics.

The BCL also participated in several committees and working groups of the Bank for International Settlements (BIS) and contributed to the data collection on international financial statistics undertaken by the BIS. In this context, the BCL will also participate to the 2007 Triennial survey on foreign exchange and derivative markets, foreseen for April 2007.

The BCL also provides data on the Luxembourg banking system to the International Monetary Fund (IMF) with the aim of publishing it in the IMF's monthly international financial statistics.

Finally, the BCL publishes monthly and quarterly aggregated balance sheet statistics of the Luxembourg credit institutions and money market funds in its bulletin and its website. In addition, the BCL publishes monthly statistics on interest rates applied by credit institutions on loans and deposits for households and non-financial corporations in Luxembourg and the euro area. The BCL also publishes various statistics on investment funds and other professionals of the financial sector as well as data on the employment in the Luxembourg financial sector.

2.5.2 Balance of payments statistics and international investment position

The BCL publishes quarterly statistics for the Luxembourg balance of payments as well as for the international investment position and reserve assets on its website and quarterly bulletin. Furthermore, BCL and STATEC provide, in a joint press release, information on the main features of in the balance of payments when publishing new data.

The BCL also participated in the IMF's annually coordinated portfolio investment survey (CPIS). The results of this survey are published on the BCL's website. In 2006, the BCL further improved the availability of statistics by publishing the net external position in quarterly intervals on its website.

Finally, the BCL continued development work relating to a new collection system for portfolio investments in order to comply with the ECB's guideline ECB/203/7.


2 EURO


Luxembourg


10€

2.5.3 Economic and financial statistics

During 2006, the BCL contributed to the ECB's work on the conceptual development of a new data collection system for financial intermediaries such as investment funds and financial vehicle corporations which are important intermediaries in financial and capital markets. Significant progress has been made in close cooperation with the Luxembourg fund industry through the Luxembourg Investment Fund Association (ALFI) during the last months of 2006. The ECB's Governing Council will adopt a regulation in the forthcoming months.

2.5.4 The IMF Special Data Dissemination Standard

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

In 2006, the Luxembourg institutions have finalised their statistical framework to fit this standard. The BCL has, in particular, put at the disposal of the interested public, respecting the publishing delays imposed by the SDDS, statistics on the analytical accounts of the BCL, the MFI sector, balance of payments (jointly with STATEC), the international investment position, external debt and reserve assets.

2.5.5 The other statistics

During the past 15 years the National Central Banks (NCBs) of the ESCB collected statistics on the different means of payment as well as the use of payment and securities settlement systems. These statistics are published on a yearly basis in the *Blue Book*.

The ECB, assisted by the NCBs, started work on the harmonisation of this data collection in 2006 with the intention of defining a new harmonised reporting framework in 2007.

2.6 Payment and securities settlement systems

2.6.1 Real-time gross settlement systems

The number of participants in LIPS-Gross[1], the Luxembourg's real-time gross payment system, remained unchanged in 2006 at 31.

2.6.1.1 LIPS-Gross activity in 2006

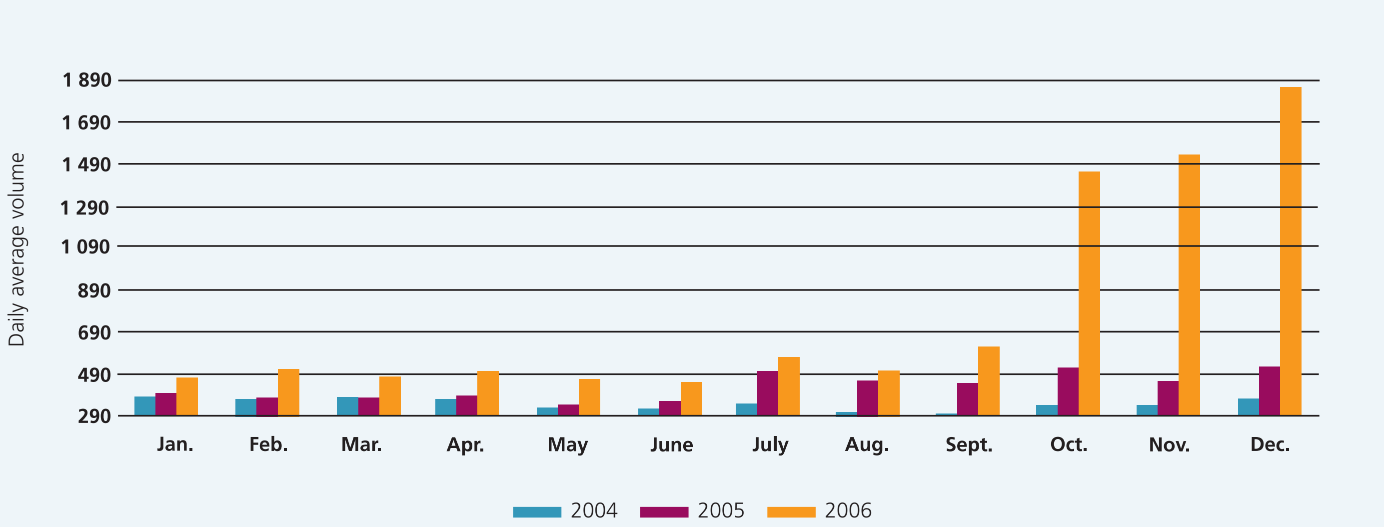
Domestic payments[2]

In 2006, LIPS-Gross participants exchanged 197,744 payments (compared to 109,567 in 2005) for a total value of €3,387 billion (compared to €2,736 billion in 2005). In comparison with 2005, the volume increased by 80% and the value exchanged rose by 24%. The average value per payment was €17 million.

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

The significant increase in volume during the last quarter is linked to the closing of LIPS-Net in October 2006. Parts of the transactions were transferred to LIPS-Gross for settlement.

CHART 13: DOMESTIC PAYMENTS: DAILY AVERAGE VOLUME



[1] Luxembourg Interbank Payment System - Gross Settlement
[2] Domestic payment: payment exchanged between two LIPS-Gross participants

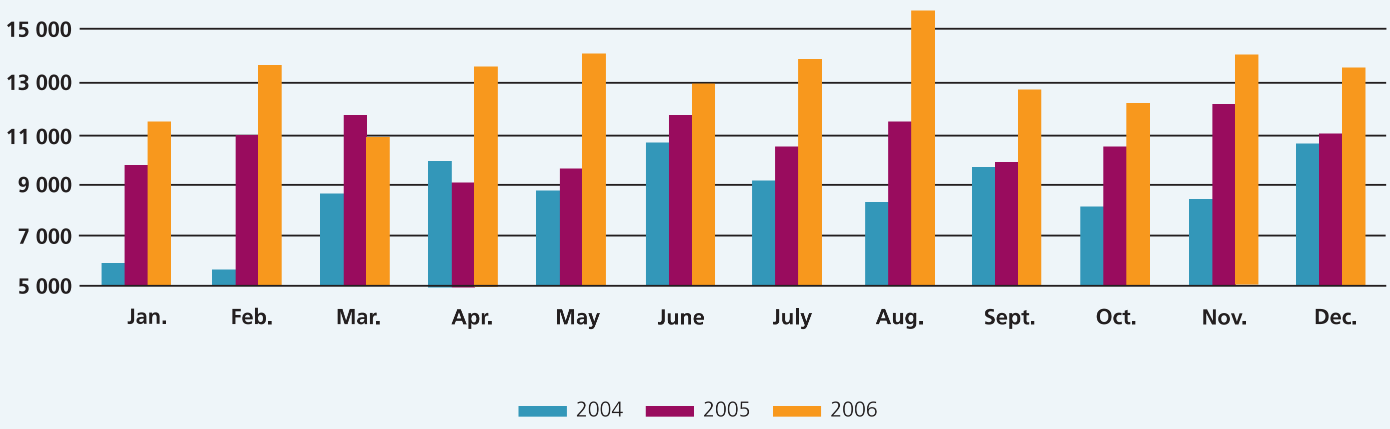
Cross-border payments[3]

In 2006, LIPS-Gross participants sent 473,199 payments to other countries in the EU (compared to 407,375 payments in 2005) for a total value of €4,491 billion (compared to €3,902 billion in 2005). On the other hand, they received 404,176 cross-border payments (compared to 382,732 payments in 2005) for a total value of €4,489 billion (compared to €3,907 billion in 2005). The average value per cross-border payment sent was €9.5 billion (decrease by 1%).

The average value per cross-border payment received was €11.1 billion (increase by 8.8%). The trend started in 2004 is confirmed in 2006: LIPS-Gross members receive less cross-border payments than they sent. The value of cross-border payments received remains higher than for payments sent.

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

CHART 14: DOMESTIC PAYMENTS: DAILY AVERAGE VOLUME



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

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

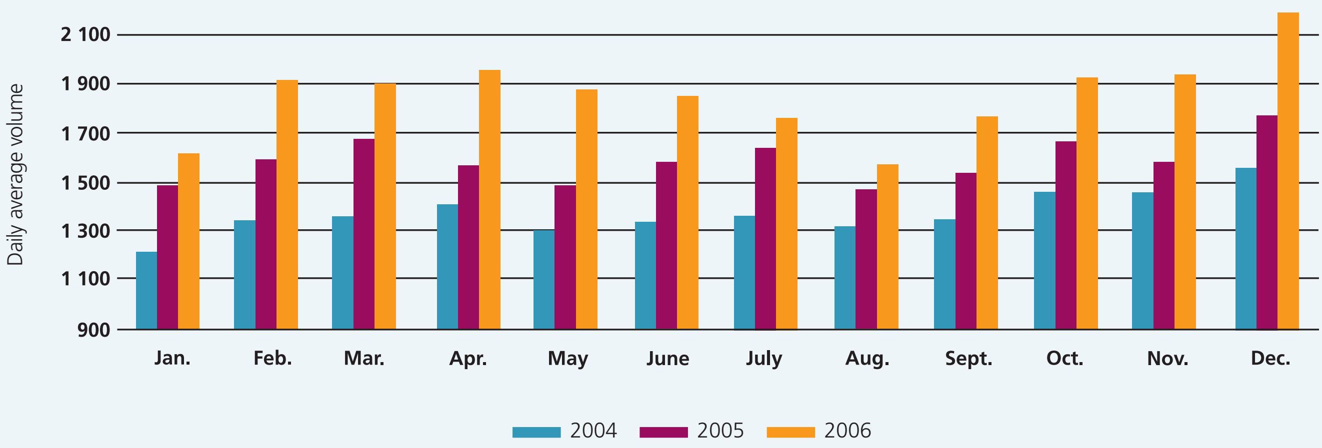
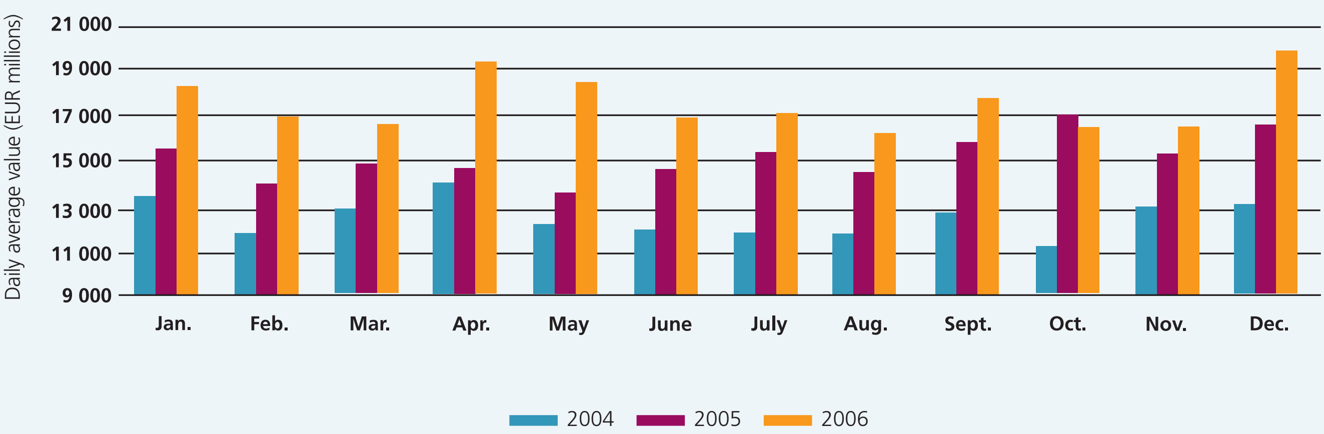


CHART 16: CROSS-BORDER PAYMENTS SENT: DAILY AVERAGE VALUE



In 2006, cross-border payments sent increased by 16% in volume and by 15% in value. This increase is mainly due to one participant.

Similarly to previous years, over 80% of the cross-border payments (whether in volume or in value) are transferred to five countries, among which the direct neighbouring countries.

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

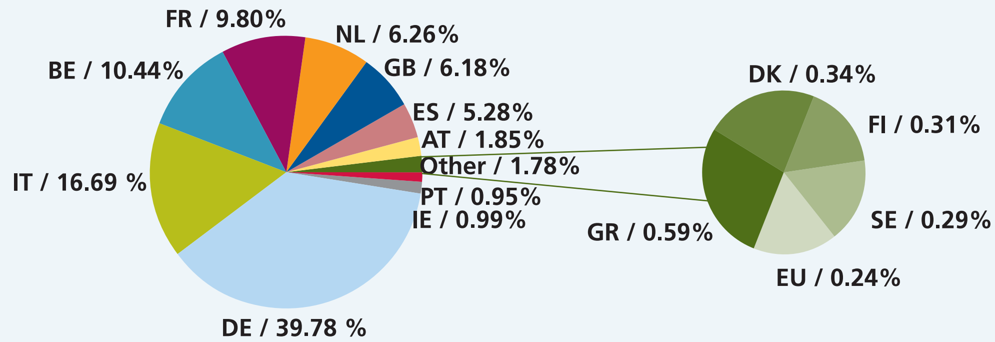
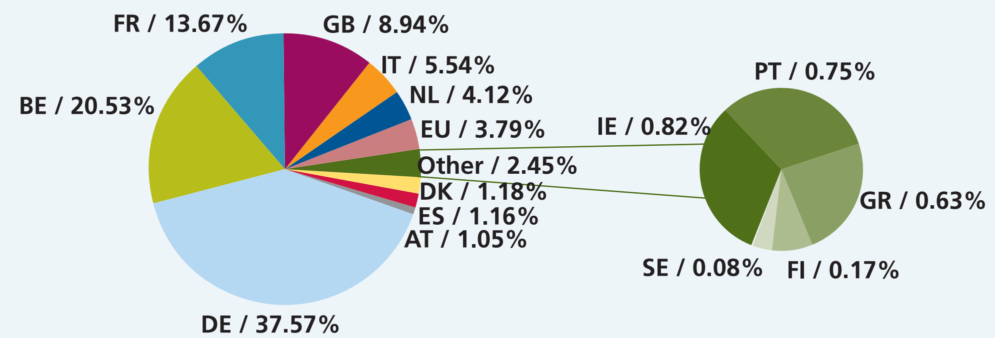


CHART 18: BREAKDOWN BY VALUE OF CROSS-BORDER PAYMENTS SENT



Aggregated figures for domestic and cross-border payments

In total, the number of payments processed in LIPS-Gross during the year 2006 has exceeded one million with 1 094 679 transactions. The peak day was 27 December with 6 957 transactions, an increase by 41% to the 2005 peak day.

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

TABLE 2: 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)	
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**
2006	775	(29.46%)	1 856	(70.54%)	1 585	(37.59%)	**4 216**
Change 2006-2005	**+81%**		**+16%**		**+6%**		**+20%**

TABLE 3: VALUE (IN EUR MILLIONS) OF PAYMENTS (DAILY AVERAGE)

	Domestic payments		Cross-border sent		Cross-border received		**Total send and received**
	Valeur	(% valeur sent)	Valeur	(% valeur sent)	Valeur	(% total value)	
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**
2003	13 281	(42.99%)	17 612	(57.01%)	17 602	(36.30%)	**48 496**
Change 2006-2005	**+24%**		**+16%**		**+15%**		**+18%**

LIPS-Gross compared with other systems connected to TARGET

In 2006, all the national RTGS systems processed a total of 64.2 million domestic payments (compared to 58.5 million in 2005) for a total value of €348,765 billion (compared to €324,089 billion in 2005). With 197,744 domestic payments totalling €3,387 billion, Luxembourg accounted for 0.31% of the total domestic volume and for 0.97% of the total domestic value.

In addition, 19 million cross-border payments (17.7 million in 2005) for a value of €184,777 billion (€164,812 billion in 2005) were exchanged during the year. Luxembourg contributed 2.49% to this volume and 2.43% to this value.

Availability of TARGET

The overall availability of TARGET increased from 99.83% in 2005 to 99.87% in 2006. TARGET's average availability figure is 99.71% over its 8 years of existence.

Coming from 99.94% in 2005, LIPS-Gross' availability reached 99.8% in 2006 because of two minor technical incidents and one more important incident which has caused a longer unavailability of the system. During the year 2006, LIPS-Gross' availability was 100% for 9 months. Since its launch, LIPS-Gross' average availability is 99.71%.

2.6.1.2 TARGET2

Eurosystem central banks and national banking communities went on with their development and preparation work for the launch of TARGET2.

The BCL issued its newsletter 2006/1 to inform the national banking community on several aspects of the project and on its developments. The third TARGET2 report, which was published in November 2006, provided additional and up-to-date information. The BCL organized four workshops in order to prepare the Luxembourg participants for the migration.

The SSP, the TARGET2 *single shared platform*, was developed and will be operated for the Eurosystem national central banks by three central banks. Deutsche Bundesbank will alternate with Banca d'Italia to operate the system; each of the two central banks can operate on their own from a primary and a secondary site. While payments are executed in one region, the other will act as back-up in case both sites in the other region become unavailable. Banque de France is in charge of the data warehouse processes and will develop the statistical and analysis tools. Each participating central bank will remain in charge of the commercial contacts with its national banking community.

TARGET2 governance is built upon 3 levels. The Governing Council of the ECB (Level 1) makes the final decisions on TARGET2 whereas Level 2, which comprises participating national central banks' representatives, is the functional owner of the system. Level 3, which includes Deutsche Bundesbank, Banca d'Italia and Banque de France, operates the system.

About one thousand financial institutions will participate directly in TARGET2 once the migration is completed and offer indirect access to a vast number of banks around the world. TARGET2 will be the preferred settlement engine for most European ancillary systems.

In order to respond to their requirements, the SSP will also operate during the night. Hence, securities settlement systems and cash settlement engines can settle directly their night-time batches in TARGET2.

Next to standards setting for the system's access and for payment messages, TARGET2 offers optimization tools for liquidity management to the participants through the intraday liquidity pooling feature by means of a virtual account or the consolidated account information.

The launch of TARGET2 will be phased; the current RTGS systems will migrate to the SSP in three migration windows. The BCL, and its participants, will migrate in the first window on 19 November 2007. The other countries will follow three to six months later; all the participating central banks will hence participate in TARGET2 on 19 May 2008. Nevertheless, a contingency migration window is foreseen on 15 September 2008.

2.6.2 The interbank netting system LIPS-Net

LIPS-Net, the national automated compensation system for domestic cheques and credit transfers, started operations in 1994 as the substitute for a manual clearing house.

2.6.2.1 LIPS-Net termination

Considering the limited scope for increasing its activity, insufficient economies of scale as well as integration prospects at the European level[4] , the managers of the SYPAL-GIE, the system's owner, decided to terminate LIPS-Net's operations in October 2006.

Luxembourg banks exchange and compensate cheques, whose volumes have been on the decline in the past years, bilaterally since 1 July 2006.

Credit transfers and standing orders are now processed on the pan-European STEP2 platform operated by the Euro Banking Association (EBA). Luxembourg participants will, thus, be able to benefit from economies of scale and from the coverage of a European system for retail payments.

2.6.2.2 LIPS-Net transactions in 2006

At the time of termination, 13 credit institutions were connected to the network. This figure had remained unchanged since 2004.

Payments exchanged from 1 January to 9 October 2006 exceed 10 million operations. The average daily volume was 55,150, an increase of 1% compared to 2005.

[4] The European financial sector is preparing the Single Euro Payment Area (SEPA), which is to be implemented by the end of the year 2010.

The total value exchanged for compensation in 2006 came close to €45 billion. The average daily value processed was €235 million, a decrease by 5%.

On 3 May, the system processed a peak of 133,587 operations, an increase of 10% compared to the 2005 peak day.

Credit transfers

In 2006, the daily average number of credit transfers exchanged in the national compensation amounted to 54 784 operations (increase of 1.5% compared to 2005) for a daily average amount of around €199 million (decrease of 1% compared to 2005).

Cheques

The declining trend in cheques clearing, which started in 2001 with the disappearance of the Eurocheque guarantee, was confirmed during the first half of the year.

The daily average number of cheques exchanged was 400 (down from 500 in 2005) for a daily average value amounting to €7.7 million (coming from €9.43 million in 2005). However, the average value per cheque was rather stable, from €19,022 in 2005 to €18,926 in 2006.

Inter-bank settlement for debit and credit cards transactions

In contrast to customer payment operations, inter-bank settlement operations for debit and credit card transactions are less numerous (0.17% of the total volume in 2006 and 0.22% in 2005) but represent a significant part of the values exchanged for compensation (13% en 2006 and 15% in 2005).

2.6.2.3 Luxembourg participants in STEP2

The bulk of the Luxembourgish credit transfer and standing order transactions are processed in the pan-European system STEP2 since 9 October 2006.

From October to December 2006, Luxembourg's participants sent 54,000 operations for a value of €81 million on a daily average. Domestic transactions accounted for 77% in volume (close to 42,000 operations) and 71% in value (€58 million).

2.6.3 The general framework of eligible collateral in the Eurosystem credit operations

2.6.3.1 The list of eligible assets

All credit operations of the ECB and the national central banks are effected "on the basis of adequate collateral"[1]. Consequently, each counterparty of the Eurosystem guarantees the credit received from a Eurosystem central bank by providing assets as collateral. These assets have to fulfill specific eligibility criteria defined by the Eurosystem, which are published in the document entitled "The implementation of monetary policy in the euro area" available on the ECB's website.

In 2006, the Eurosystem took the final steps in its work to replace its two categories of eligible assets[2] by a single list of eligible assets applicable for the whole of the euro area. This single list, valid as of 1 January 2007, comprises two different asset classes, marketable assets (securities) and non-marketable assets (in particular, credit claims). The inclusion of non-marketable assets has required the development by each NCB of appropriate handling procedures, as well as the development and implementation of a euro area wide credit assessment framework.

In this context, the Governing Council has accepted, amongst 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 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 that is like those offered in neighbouring countries[3].

2.6.3.2 Eurosystem as a user of securities settlement systems

Selection of depositories[4] at the domestic level

In order to meet the requirement of "adequate collateral"[5], 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. In this context, the Governing Council approved in 2006 a new arrangement for the safekeeping of international securities in global bearer note form, the so-called "New Global Note" (NGN) arrangement, developed by Clearstream Banking Luxembourg (CBL), Euroclear Bank, and other market participants. The NGN arrangement is compliant with the user standards, provided that the respective NGN is safekept by an institution that has been positively assessed against these standards by the Eurosystem.

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 in PT1 a depository located elsewhere in the European Union. The Eurosystem foresees two ways for such cross-border use of collateral. Counterparties may use

- the CCBM[6]; 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 European Union, direct links make available securities issued in PT2 a system of another European Union 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.
Links have to be approved by the Governing Council beforebeing used for the collateralisation of central bank credit operations. In 2006, Luxembourg counterparties had the possibility to use 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.

[1] Article 18 of the Statute of the ESCB and the ECB, article 22 of the founding law of the BCL.

[2] These are the tier 1 assets (debt instruments fulfilling uniform euro area wide eligibility criteria specified by the Eurosystem) and tier 2 assets (complementary assets). Tier two assets that do not fulfill the eligibility criteria for the Single List will become ineligible in the course of the year 2007.

[3] For more detailed information on these specific provisions see section 3.3.1

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

[5] Article 18 of the Statute of the ESCB and the ECB, article 22 of the founding law of the BCL.

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

Securities settlement in central bank money

Given the need of further financial market infrastructure integration, the Governing Council decided in 2006 to evaluate the possibility to provide efficient settlement services for securities transactions in central bank money. Both securities and cash settlements would be processed on a single technical platform through common procedures. The service will be called TARGET2-Securities, as synergies will be sought, in particular, with the Eurosystem's future TARGET2 payment system. As a first step, central securities depositories and other market participants were consulted about the new service. After discussing the respective market reactions, the Eurosystem has started to prepare a detailed feasibility study on the project.

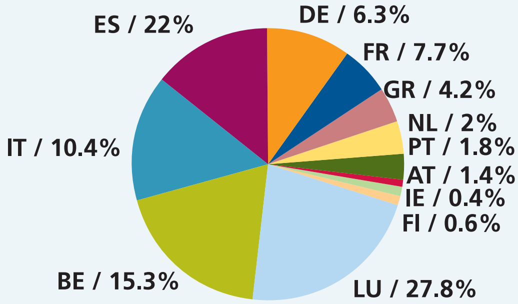
2.6.4 Correspondent Central Banking Model (CCBM)

The objective of the CCBM is to enable counterparties of the Eurosystem to use securities on a cross-border basis, even if there is no eligible link between the national depository and the foreign depository in which the counterparty holds securities. For this purpose, in 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, on the one side, 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 it receives from 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.

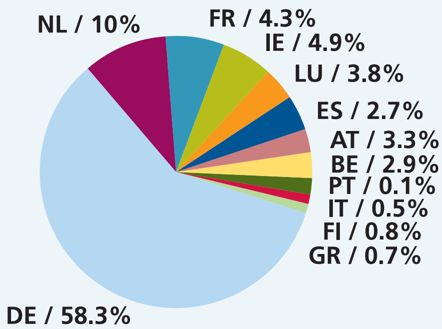
As in previous years, the usage of the CCBM has remained very disparate in 2006. The most active correspondent central banks have been those from Luxembourg (27.8%), Spain (22%), Belgium (15.3%), and Italy (10.4%). The most active home central banks have been those from Germany (58.3%), United Kingdom (10.8%), the Netherlands (7%), and from Ireland (4.9%). The cross-border use of tier 2 assets has remained marginal.

CHART 19: CORRESPONDENT CENTRAL BANKS IN 2006
CCB-2006



Source: ECB

CHART 20: HOME CENTRAL BANKS IN 2006
HCB-2006



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

After publication of the "Report on Market Disaster Recovery in Case of Large Scale Disruption" in the 2006 Financial Stability Review of the BCL, work has been continued with the objective to create operational crisis prevention and operational crisis management groups dedicated to the financial sector.

2.7 Financial stability

2.7.1 Macroprudential surveillance

The BCL assesses regularly financial stability conditions from a macroprudential point of view based on quantitative information stemming from the prudential and statistical reporting of financial institutions established in Luxembourg. Besides this regular analysis, the BCL works on specific ad-hoc topics with a focus on potential risks to financial stability. These analyses have been published in the BCL's Financial Stability Review in April 2007.

The regular macroprudential analysis points to a sound banking sector supported by a globally favourable outlook of the macroeconomic environment and of financial markets. High profitability and comfortable solvency ratios strengthen the Luxembourg banking sector's capacity to weather adverse shocks. Profits have been underpinned by higher banking income and lower impairment charges. Despite a declining cost-to-income ratio, banks should aim for continued cost containment in order to stay competitive at the international level.

Due to its high interbank activity, the Luxembourg banking sector is exposed to risks of contagion via the interbank market. Credit risk to the non-banking sector seems to be contained. Direct market risks also seem to be contained, though indirect market risks may stem from the negative impact on banks' commission revenues by a potential downturn in financial markets.

Despite the currently favourable environment for the banking-sector, potential risks could, inter alia, emerge from a disorderly unwinding of global imbalances, a macroeconomic downturn or a downturn in financial markets.

Besides the compilation of its own macroprudential indicators, the BCL participated in the compilation exercise of the IMF's financial stability indicators.

In 2006, the BCL elaborated a quarterly vulnerability index which aims to measure, based on micro- and macroeconomic variables, the vulnerability of the Luxembourg banking sector. Another specific working paper compares the value added of the Luxembourg banking sector to the value added of the other sectors of the economy. Further, the BCL analysed the potential impact of banks' liquidity management regimes on the financial stability.

As a member of the European system of central banks, the BCL participates to the Banking Supervision Committee (BSC), the Working Group on Macroprudential Analysis, the Working Group on Developments in Banking and the Task Force on Crisis management. The BCL also participates in the work of the European Commission's Committee of European Banking Supervisors (CEBS).

Adequate crisis prevention and management requires an ongoing cooperation and exchange of information between relevant authorities in normal and in stress times. In line with international recommendations, the BCL is strongly committed to the elaboration of national and international agreements in this field. At the national level, the BCL submitted in 2006 a proposal to change its organic law including the instauration of an interinstitutional cooperation mechanism of relevant authorities under the chairmanship of the BCL.

2.7.2 The oversight of payment and securities settlement systems

In 2006, the BCL has pursued its oversight mission, aiming at promoting the smooth operation of payment and securities settlement systems, and hence the stability of the financial infrastructure.

BCL's oversight is addressed to the operator and technical agent of LIPS-Gross, the real-time gross payment system, as well as to the securities settlement system operated by Clearstream Banking Luxembourg. LIPS-Net, the net retail payment system ceased its activities in October 2006. As a consequence, the BCL has withdrawn its notification to the European Commission and stopped its oversight activities in relation to this system.

As regards LIPS-Gross, the payment system will stop operating in November 2007 and will be replaced by TARGET 2. This migration will also have repercussions on BCL's oversight. Indeed, TARGET 2 will be centrally overseen at the level of the ESCB as regards its central activities. The BCL will, however, still be in charge of overseeing the decentralized activities of TARGET 2.

The oversight of BCL is based on information of general, statistical, financial and risk nature as provided on a regular basis by operators and technical agents. This information is complemented through direct contacting of the operators and technical agents as well as on-site inspections.

As a member of the European system of central banks, the BCL has also contributed to the work in the field of oversight of the Payment and Settlement Systems Committee (PSSC). In this context, LIPS-Net and LIPS-Gross have been subject to a joint harmonized oversight by the central banks of the ESCB and the European central bank. Moreover, discussions have taken place in the PSSC on a potential framework for the oversight of cards and other payment instruments. Finally, the BCL has contributed to the working out of a methodology for the oversight of TARGET 2 as well as to a preliminary assessment of the centralized and decentralized activities of the future TARGET 2. A complete assessment of the TARGET 2 system will be completed before its launch.

Artist: Kimmo Pyykkö
Title: Witch doctor
Material: wood
Format : height 210 cm
BCL Collection

3. EXTERNAL ACTIVITIES

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

The BCL President, being also Alternate Governor of the IMF, attended the Annual Meeting of the IMF and the meetings of the International Monetary and Financial Committee.

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 2006, 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 10.4% 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 2006, the BCL was instrumental in granting credits of € 13.6 million related to IMF operations and was reimbursed to the tune of € 27.8 million.

At the end of 2006, Luxembourg held 72.1% of its SDR allocation (67.4% in 2005) following the accumulation of net interest received on the SDR account and on the reserve position. As at 31 December 2006, the amount recorded on the SDR account was SDR 12.2 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 Activity at the European level

3.2.1 The enlargement of the EU

The accession Treaty between the EU and the future Member States Bulgaria and Romania was signed in Luxembourg on April 25, 2005 and became effective on January 1, 2007. The same day the Bulgarian and Romanian central banks joined the ESCB and their respective governors became members of the General Council of the ECB.

3.2.2 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, 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. Thus, the EFC examines the stability programmes of the euro zone Member States and the convergence programmes of the Member States that have not yet adopted the euro. The EFC also drafted a report on Information Requirements in EMU. It furthermore, carried out work on interpretation and application of the price stability criterion in relation to enlargement of the euro area. It was confirmed that the reference value for inflation is calculated as the average of the three best-performing member states plus 1.5 percentage points. 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 session, but also meets in restricted composition. It is worth noting that the ECB participates in the Eurogroup Working Group, where it represents the Eurosystem.

3.2.3 The Committee on monetary, financial and balance of payments statistics

In the area of the missions of the Statistics Office of the European Community (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 in this committee together with National Statistical Institutes. The BCL contributed actively to the various working groups and Task Forces with specific objectives.

3.2.4 Consultative Committees

3.2.4.1 The Statistics Committee

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

3.2.4.2 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.

During 2006, the Commission has been informed and consulted on the definition of the new reporting framework for financial intermediaries other than MFIs.

3.2.4.3 The Balance of Payments Consultative Commission

The Balance of Payments Consultative Commission, established in 2001, assists the BCL in its task of collecting statistical data for the compilation of balance of payments and international investment position data. It looks after the efficiency of the organization of the collection procedures taking into account the burden lying on the reporting agents.

In 2006 the Commission has been consulted extensively on the necessary measures for the development of a new collection system for portfolio investments and contributed to the development of the new reporting framework as set out by BCL circular 2006/196.

3.3 National Activities

3.3.1 Legal developments

The Luxembourg Government deposited on 26 October 2006 a draft law, no 5627, on markets in financial instruments. The main purpose of the draft law is to implement into national law Directive 2004/39 of the European Parliament and of the Council of 21 April 2004; it also contains an article 172 amending the organic law of the Banque centrale du Luxembourg of 23 December 1998.

That article amends three points of the organic law.

The first point of article 172 relates to the creation of a register of pledges on claims held with the BCL. This new article 22-1 of the organic law aims at ensuring the efficient implementation of the rules of the Eurosystem accepting credit claims as security for loans granted by the national central banks as from 1 January 2007. The text foresees that pledges of claims in favour of the BCL, not necessarily requesting a specific notification in the future, will be recorded in a register held with the BCL. The entry in the register of a pledge on a claim in favour of a central bank of the Eurosystem renders the pledge effective against third parties. The law of 5 August 2005 on financial collateral arrangements remains applicable for any aspects not specifically dealt with by the new article 22-1.

Several Eurosystem central banks use a register but the operational conditions still differ at this stage. Article 22-1 is directly inspired by a provision adopted in Belgium; its aim is to ensure the practical effectiveness of pledges provided to the BCL. Contrary to the Belgian legislation and in line with the opinion of the ECB, the Luxembourg draft law applies not only to domestic claims but also to claims used in a cross-border Eurosystem context.

Pending the entry into force of the new law, the BCL has adapted its general terms and conditions as from 1 January 2007. These changes have been communicated to the Bank's counterparties - the banks of the financial centre - and published on its website. Pledges of claims are subject to the notification to the debtor requirement.

The second point of the reform concerns provisions relating to immunity. The new provisions follow a recommendation addressed by the ECB in 2004 to the governments of the Member States of the Euro area. They will also avoid the type of incidents that have underlined the need to protect the assets held with the Bank against measures that could affect the continuity of its services of public interest.

Finally, the third point relates to the enlargement of the exchange of information between the BCL on the one hand and specialised national public sector authorities on the other hand, namely the Commission for Supervision of the Financial Sector (CSSF), the Insurance Commission (Commissariat aux assurances) and the Central Services for Statistics and Economic Studies (Statec).

The ECB, consulted by the Government on 26 October 2006, issued an opinion on 11 December 2006. In general, the ECB welcomed the draft but suggested some amendments that have been taken into account by the Government since 13 December 2006. Its proposals for amendments relate: (i) to the extension of the scope of application of the law to the situations where the BCL acts as the agent for other Eurosystem central banks for the cross-border collateralisation of credit claims in the framework of Eurosystem credit operations (paragraph 2.4 of the ECB opinion); (ii) the extension of the immunity from seizure for accounts held with the BCL containing assets of foreign central banks or foreign States (paragraph 3.3 of the ECB opinion); and, (iii) the reinsertion of provisions relating to professional secrecy applicable to the ESCB (paragraph 4.2 of the ECB opinion).

It can be said that article 172 only concerns certain aspects of a necessary reform of the organic law of the BCL, notably in the area of statistics, financial stability, oversight of payment and securities settlement systems, or in the area of means of payment. The draft law, thus, contains only some provisions of a preliminary draft law submitted by the Bank to the Government in February 2006.

The BCL considers that it is important that the present reform takes place in view of a more general reform of its organic law and has transmitted its observations on the draft law to the Government in January 2007.

3.3.2 External Committees

3.3.2.1 The Economic Committee (Comité de conjoncture)

The Economic Committee 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 courses, essentially, on the areas within its activities, such as monetary policy and strategy, payment and clearing systems, instruments to and strategy of maintaining financial stability, as well as on aspects of the European institutions. The respective courses are also held outside the BCL, if the availability of the instructors so requires.

The BCL, being a shareholder of the Agence de Transfer de Technologie Financière (ATTF), established in 1999, also intends to share Luxembourg's financial expertise with developing countries, thus, the BCL held a seminar for branch managers of the *People's Bank of China*, in June 2006.

In September 2006, the BCL gave a new presentation for Indian top managers, on the occasion of a visit organised by the *Administrative Staff College of India* and the *Maastricht School of Management*.

Furthermore, the BCL has intensified its cooperation with the new University of Luxembourg.

3.3.5 External events

3.3.5.1 Conferences and international meetings

The Governor of the Banque centrale du Luxembourg attended the General Assembly of the IMF and the World Bank in Singapore from September 16 to 18.

He further took part in the semi-annual meetings of the ECOFIN Council of Ministers.

In May 2006, the Governor of the BCL attended the 14th annual meeting of central bank governors from French-speaking countries, organised by the central bank of Bulgaria in Sofia. End of June, he participated in the annual general assembly of the Bank for International Settlement in Basle.

Otmar Issing, former member of the Governing Council of the ECB, was the speaker at the fourth *Pierre Werner lecture*, organised in the premises of the BCL, in October. The topic of the conference was "*Politics and behaviour of politicians: About the difficulties of a long-term orientation of politics*". In this context, Mr. Issing emphasised the necessity of the independence of modern central banks. Professor Issing was awarded the honorary distinction of "*Grand Officier de l'Ordre de Mérite*" by Prime Minister Jean-Claude Juncker.

In the context of the "*Bridge-Forum Dialogue*"- platform, the President of which is the Governor of the BCL, and which represents a platform for interdisciplinary debate, composed by executives of the European institutions and leaders of the Luxembourg business community, two conferences were held with the active participation of the BCL. First, the President of the Czech Republic, Mr. Vaclav Klaus, held a conference on the issue of "*Some doubts about the EU's Ever-Closer Future*" in March, and Mr. Jacques Berrot, Vice-President of the European Commission, and Mr. Robert Goebbels, former minister for the Economy in Luxembourg, now deputy to the European Parliament, dealt with the issue of "*The Transport Policy of the EU*", in October 2006.

On the invitation of the G7 Group, the Governor of the BCL took part in the debate on the state of world and European economies, on the monetary policy of the euro-zone and on financial stability, in November 2006.

In January 2006, the BCL was represented at the 3rd reunion of the Euro-Mediterranean seminars in Nafplion, jointly organised by the ECB and the Bank of Greece, where the central banks of the Eurosystem meet with countries from the Mediterranean which are not members of the euro-zone. The BCL has further taken part in the 3rd high-level seminar between Eurosystem and the central bank of Russia, held in Dresden in October 2006, as well as in the third joint seminar of EMEAP (Executives' Meeting of East Asia-Pacific Central Banks) and Eurosystem in Sydney in November 2006. Simultaneously to the latter seminar, the Governor of the BCL participated in the meetings of the Committee on the Global Financial System. The debates in said committee dealt with the emerging economies and global inflation, global imbalances and financial stability, regional financial cooperation and financial intermediation. In December 2006, the Governor of the BCL attended the 3rd high-level seminar between Eurosystem and the central banks of Latin America, held in Madrid and jointly organised by *Banco de España* and the ECB. That seminar dealt with the topics of Monetary and Financial Consequences of Globalisation, of Monetary Policies and of the Accumulation of International Reserves.

The Governor of the BCL, finally, attended a seminar organised jointly by Banco de España and the IMF on the issue of: "*Central Bank Modernisation and Banking Reforms*".

3.3.5.2 Bilateral events

In September 2006, the Governor, Mr. Yves Mersch accompanied the Prime Minister, Mr. Jean-Claude Juncker, on his official visit to the Democratic Republic of Laos and to the Kingdom of Cambodia.

In October 2006, the BCL was visited by the President of the Republic of Benin, Mr. Yayi, accompanied by an official delegation.

In March 2006, a delegation from the Federal Republic of Nigeria, headed by the Foreign Minister and a director of the central bank, paid a visit to the BCL.

A delegation from French Polynesia, as well as from the "Indonesian Institute for Banking Development" were further guests received at the BCL in 2006.

On December 5, 2006, finally, the State Duma of the Federal Assembly of the Russian Federation sent a delegation of its Credits and Financial Markets Committee to Luxembourg to be received by the BCL.

Other events helped to strengthen the cooperation with certain central banks.

In February 2006, a delegation from the central bank of Cap Verde, headed by Governor Augusto de Burgo, effected a working visit with BCL and other public institutions in Luxembourg.

The Governor of the BCL, on the other hand, paid a working visit to the central bank of Romania, on the invitation by its Governor, Mr. Isarescu. He gave, on that occasion, a speech for the Romanian banking community on the subject of "Inflation targeting and macroeconomic adjustment". A working relationship has been established with the Romanian Banking Institute of which the *Banque Nationale de Roumanie* is the main shareholder. The Institute has asked for a cooperation with the BCL on a colloquium in Bucharest on financial integration.

In August 2006, the Banque centrale de Malte visited the BCL, with a view to gathering information on the functionalities of the cash service system of the BCL.

BCL was present at the 60th anniversary of the central bank of Macedonia, in October 2006.

Further visitors included the central bank of Finland, for a working visit in Luxembourg on December 1 and 2, and Mr. Illmars Rimsevics, Governor of the central bank of Latvia.

3.3.5.3 Relationship with the Luxembourg Parliament

The Governor of the BCL presented the opinion of the bank on the state budget motion in the Chamber of the Deputies.

In May 2006, the BCL organised presentations with regard to the activities of Eurosystem and of the BCL for the members of the Conseil d'Etat du Luxembourg, as well as for the deputies of the Finance and Budget Commission of the Luxembourg Parliament. On the occasion of a visit to the ECB, the deputies concerned were given the opportunity to exchange ideas with Mr. Trichet, president of the ECB, and other members of the Governing Council.

3.4 Communication Activities

3.4.1 Annual Reports

The BCL, according to its statutes, publishes each year a report on its activities. The report is available in French and English.

3.4.2 Periodical Bulletins

Beside its presentations on the economic and financial situation in Luxembourg, and bulletins issued on current topics, the following papers and analyses have been published:

Financial Stability Review

- *What crisis management might be all about.*
- *Report on Market Disaster Recovery in Case of Large Scale Disruption.*
- *Résumé non-technique du cahier d'études : "Peut-on parler de bulle sur le marché immobilier au Luxembourg ?".*
- *Résumé non-technique du cahier d'études : "la sensibilité de l'activité bancaire aux chocs macroéconomiques : une analyse en panel sur des données de banques luxembourgeoises".*

Bulletin No 2006/1

- *L'évolution récente des prix immobiliers au Luxembourg est-elle exceptionnelle ?*
- *Grenzübergreifende Pendlerströme in der Grossregion : ein Erklärungsversuch.*
- *La fiabilité des estimations de l'écart de production*
- *Résumé non-technique du cahier d'études : "La rigidité des prix : une comparaison internationale sur base des prix internet".*
- *Résumé non-technique du cahier d'études : "La transition de la répartition à la capitalisation : application au régime général de pension luxembourgeois.".*

Bulletin No 2006/2

- *La position extérieure globale du Luxembourg en fin décembre 2005.*
- *Elasticité de l'impôt sur les traitements et salaires : une estimation basée sur l'examen de cas types.*
- *Analyse long terme du compte de profits et pertes des établissements de crédit luxembourgeois.*
- *Résumé non-technique du cahier d'études : "Mesures de la production réelle et de la productivité du secteur bancaire luxembourgeois : une analyse en panel sur des données trimestrielles".*

The articles are published in their respective original language.

3.4.3 Working Papers

In its working papers, the BCL published the results of research conducted by its staff.

In 2006, six such papers were published:

N° 18 : *L'identité de Fisher et l'interaction entre l'inflation et la rentabilité des actions : l'importance des régimes sous-jacents aux marchés boursiers*, by Abdelaziz Rouabah, January 2006;

N° 19 : *New survey evidence on the pricing behavior of Luxembourg firms*, by Patrick Lünnemann et Thomas Y. Mathä, May 2006;

N° 20 : *Peut-on parler de bulle sur le marché immobilier au Luxembourg?* by Christophe Blot, May 2006;

N° 21 : *La sensibilité de l'activité bancaire aux chocs macroéconomiques : une analyse en panel sur des données de banques luxembourgeoises*, by Abdelaziz Rouabah, May 2006;

N° 22 : *Are internet prices sticky?*, by Patrick Lünnemann et Ladislav Wintr, June 2006;

N° 23 : *The transition from payg to funding: Application to the Luxembourg private sector pension system*, by Muriel Bouchet, July 2006.

3.4.4 The website

The website of the BCL **www.bcl.lu** providing information of general interest as well as about the organisation of the Bank and its services, offers also links to the ECB and other central banks of the ESBC.

Based on its search engine and its configurable mailing list, the site offers to each visitor a clearly structured information package, suitable for professional as well as private individuals.

The site provides for the diffusion of the BCL publications which can be viewed and downloaded under the sites "Publications" and "Medias et actualités". Such publications can also be obtained as hard copies, as long as stocks are available.

3.4.5 The library

The library, opened in 2005, uses the ALEPH library management system, as do a number of other central banks. The public has access to the library by previous request by e-mail to bibliotheque@bcl.lu or by fax to +352 4774 4910.

3.4.6 Press relations

In the course of 2006, six press conferences were held, in all, on the occasion of the presentation of the financial results of the BCL and of the numismatic program of the bank.

In total, 93 press releases were issued.

In October 2006, the BCL organised a seminar for representatives of the Luxembourg press on issues of monetary policies, payment systems, on the institutional aspects of the Eurosystem, and on financial stability.

All publications of the BCL can be viewed and downloaded on its website www.bcl.lu or obtained as hard copies, as long as stocks are available.

Artist: Lucien Wercollier
Title: Fraternité
Material: marble
Format : height 136 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
  Jacques F. Poos (as from 6 July 2006)
  Nico Reyland (until 1 June 2006)
  Michel Wurth

The government appointed Mr Jacques F. Poos as a new member replacing Mr Nico Reyland at the term of his mandate. The mandate of Mr Michel Wurth was renewed for a another six-year period.

During 2006, the Council held five meetings. Within the framework of monitoring the financial situation of the Bank, the Council approved the financial accounts as per 31 December 2005, the budgetary trends and subsequently, the budget and the organisation chart of the Bank for the 2007 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.

The Audit Committee

Created by the Council in 2001, the Audit Committee's objective is to assist the Council in its choice of the statutory auditor to be proposed to the Government, in specifying the scope of the potential specific controls to be performed by the statutory auditor and in the approval of the financial accounts by the Council. It is kept informed on the internal audit plan. It may invite the head of the internal audit unit and the statutory auditor of the Bank to participate in its work.

At its meeting on 14 December 2006, the Council renewed the mandates of the non-executive members of the Audit Committee for 2006: Messrs Pit Hentgen, Mathias Hinterscheid and Jacques F. Poos. Mr Yves Mersch is an *ex officio* member in his function as Governor of the Council. The Audit Committee is chaired by Mr Pit Hentgen.

The Audit Committee held three meetings in 2006.

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 tasks 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 the compliance with 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 nondiscrimination, 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.

The code has been revised at the end of 2006. With regard to the principle of independence, Governors may no longer accept benefits exceeding 200 € outside the scope of the ESCB. Participation in conferences, receptions or other events are subject to clear conditions. Governors should carefully handle personal invitations and their spouses or partners behave according to accepted standards in international relations.

4.2 The BCL staff

4.2.1 Quantitative evolution

During 2006, the BCL staff slightly increased by 2.46 % to reach a total of 208 members of staff on 31 December 2006 (including Executive Board members), equivalent to 193 full time positions and representing a 0.26 % increase compared to 2005. Staff members are of nine different nationalities, thus contributing to the diversity of the human capital and to its cultural enrichment.

On December 31, 2006, twenty-three staff members worked part-time:

- Part-time work (50%): 7 staff members
- Part-time work (75%): 6 staff members
- Leave for part-time work: 10 staff members

Finally, three staff members were on part-time parental leave and two staff members were on special leave.

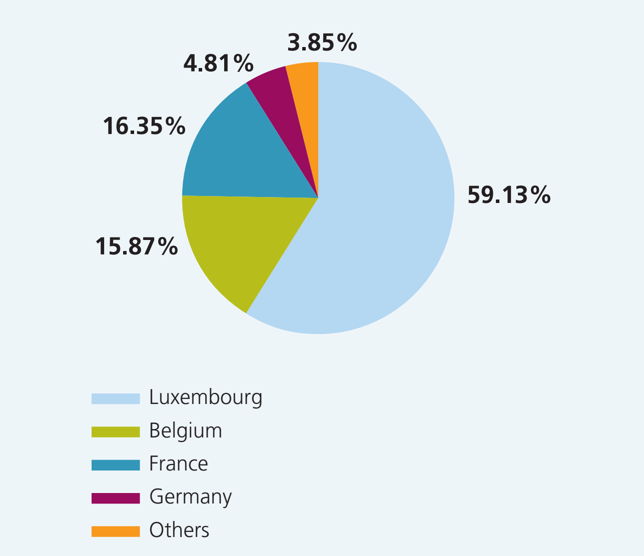
The average number of staff members working at the BCL in 2006 was of 206.5, compared to 205.5 in 2005.

The overall approved headcount ceiling for the year 2006 was of 214 full time equivalent positions. This ceiling was put up to 217 full time equivalent positions for the year 2007.

During 2006, nine staff members have left the bank; one of them enjoying his pensioning off. On the other hand, there have been fourteen new staff members joining the bank during 2006. The BCL received 294 spontaneous job applications and 193 applications for internships or student jobs.

The BCL offered internships for a period from six weeks to two months to eleven students attending university studies in relation with the bank's activities and furthermore, an internship of one year within the Monetary, Economic and Statistics Department to one PhD registered student.

CHART 1: STAFF MEMBERS BY NATIONALITY



The average age of BCL staff members has slightly increased from 38,47 years in 2005 to 38,76 years on December 31, 2006. On that date, the staff counted 34% females and 66% males.

CHART 2: DISTRIBUTION OF STAFF MEMBERS PER AGE GROUP

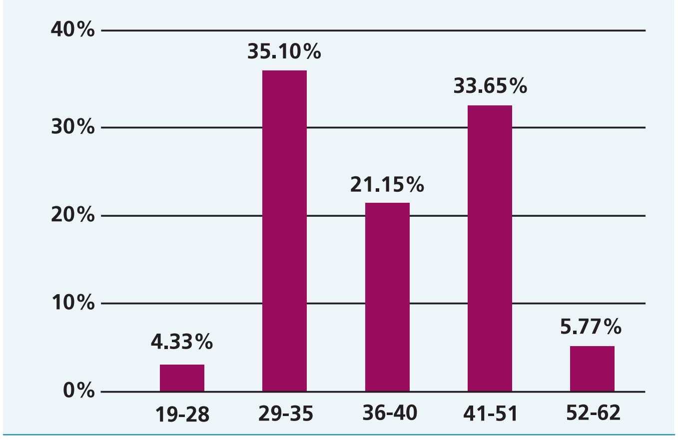
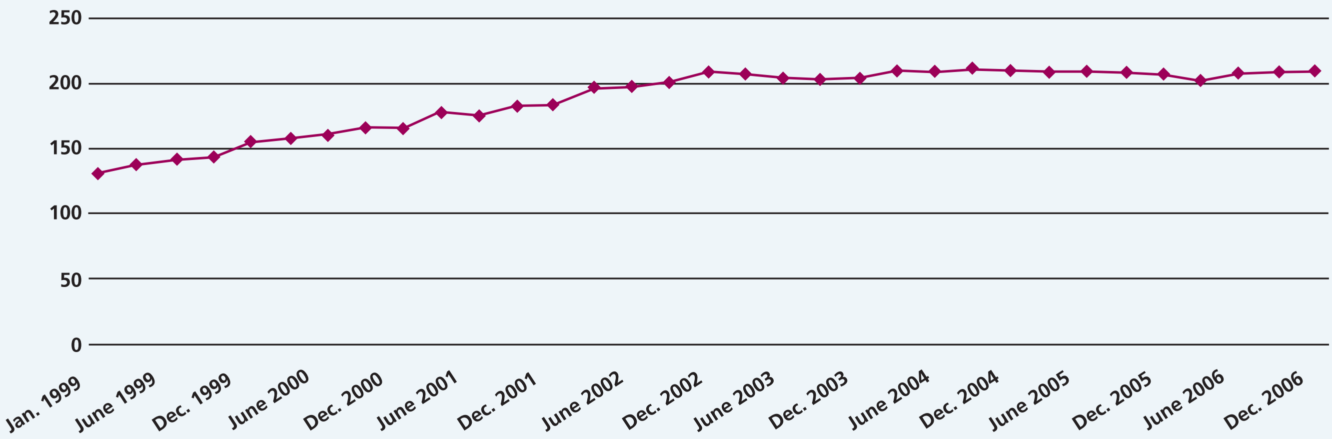


CHART 3: EVOLUTION IN STAFF NUMBERS SINCE 1 JANUARY 1999



4.2.2 Human resources management

In the framework of the human resources management tasks which had been identified in the action plan elaborated by the end of 2005, the year 2006 has focused on the elaboration of a new organizational structure for the bank and a provisional table of the resources allocated to every operational unit, deriving from the reorganization. In this context, and in accordance with the objectives to be reached within the scope of the development opportunities for staff members, staff members had been encouraged to express either their interest for a job vacancy or their wish for internal mobility to another administrative unit within the bank. The applications received had been carefully analyzed and the final allocation of human resources regarding the organizational structure will be decided at the beginning of the year 2007.

At the same time as this new organizational structure was elaborated, concrete considerations have been conducted in the context of a much more active human resources management. Actually, several opportunities potentially exploitable leading to such an active management have been identified. So, a special importance was laid on the notion of performance measurement of staff members in the context of career development. During 2007, these opportunities will be subjected to a critical examination in order to lead to a human resources management policy.

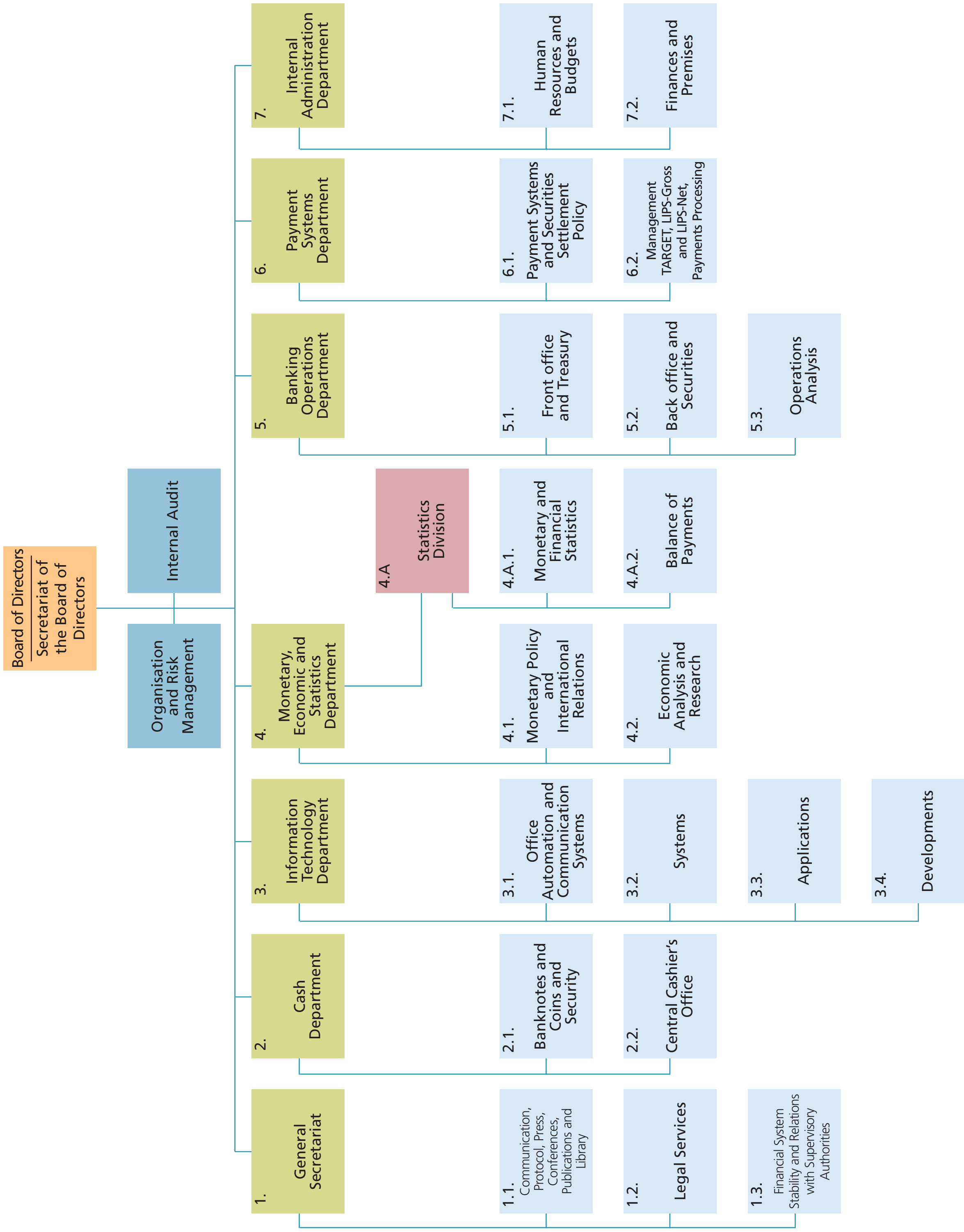
4.2.3 Staff training

Conscious of the importance of training for the staff members' personal development, as well as of its priority granted within the Banque centrale du Luxembourg, the BCL is willing to pursue its efforts in this context:

- In the framework of a more and more complex professionnal environment, training represents an essential part in all policy aiming at developing the knowledge and the competence of staff members. The BCL's training policy enables them to keep a high level of professional competence by ensuring the appropriateness between the staff members' competences and the bank's requirements. In order to consolidate these professional competences, all staff members are encouraged, beside a basic training program that all newly recruited staff members have to attend, to take part in external training sessions, especially those organized by other national central banks within the ESCB.

- Moreover, an attractive training policy can also play an important part as regards maintaining and attraction of high potential staff members. For this reason, training is considered as an investment in the future of the bank which intends to place itself as a centre of competence, or even excellence, whose performance generates the public's confidence.

The BCL's organisation chart



4.2.4 The Pension Fund

Article 14 of 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).

Paragraph 4(b) of this article provides that:

"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 BCL's pension fund, which started operating in 2001, is governed by a set of internal rules and two committees, one executive and one consultative. The executive committee is the Comité directeur composed 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 consultative committee is the Tactical Benchmark Committee.

Following the judgment of The Luxembourg Supreme Court of Justice, dated 20 April 2005, the Luxembourg pension funds have paid in the course of the first semester 2006 to the BCL's pension fund, in accordance with Article 35 of the Founding Law of 23 December 1998, the contributions they had received for all the agents in function as at 31 December 2005.

The Bank has met the representatives of social security bodies as well as civil servants and administrative coordination Administration. The aim is to reconcile the need for workers' mobility with the principles of financial independence of the Bank and its functional autonomy.

It has been agreed that a draft law amending the law of 28 July 2000 coordinating the different national 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 in order to insure the recognition of the BCL's pension fund as social security body.

Until now, the draft law is not yet available as articles not related to BCL's pension fund are still in debate.

4.3 Facilities

Works at the new premises located at 43, avenue Monterey, have been accomplished, at the end of 2006, in accordance with its budgetary and planning concept. The new building is operational since 1st of January 2007.

Concerning the bank's main building on boulevard Royal, the functioning of certain technical installations, notably the cogeneration, was upgraded to guarantee a satisfactory ratio of "return/consumption".

Preliminary works for the implementation of the waste management concept "Superdreckskëscht fir Betriiber" have been undertaken.

4.4 Accounting and the Budget

4.4.1 Accounting and Finance

BCL continued to strengthen its accounting system and its procedures in order to meet its internal quality standards and those of the Eurosystem. In 2006, booking of foreign currency operations were modified in the BCL's systems.
The Eurosystem requires the daily reporting of balance sheet data, according to harmonised rules.

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

The accounting systems were adapted to take into account modifications related to banknotes and numismatic activities.

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. In 2006, projects on harmonising techniques with the Eurosystem were continued.

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.

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 the future directions and actions to be taken.

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.
As per 1 January 2007, Bulgaria and Romania have joined the European System of Central Banks, and Slovenia acceded to the Eurosystem. Consequently, the BCL's key in those systems changed. The key in the European System of Central Banks changed from 0.1568% to 0.1575% and the key in the Eurosystem changed from 0.21933% to 0.22659%.

4.4.2 Budget

Every year in December, the BCL's Council approves the budget for the coming year. The 2006 budget was drawn up in accordance with the budgetary procedure which aims to manage the Bank's resources in a rational manner.

The budgetary orientations for the year 2006, which were approved by the Council, foresee that the structural charges shall not exceed the structural profits in order to ensure the financial balance of the accounts of the bank on a long term horizon. On the other hand, the non structural profits are added to the capital of the bank in order to increase the own funds of the Bank. The budgetary orientations for 2006 have been respected during the year.

The budget of the year 2006 included in particular a financial envelope allocated to cover the fees involved by the construction of the new Monterey building.

The operational costs for 2006 have stayed within the budgetary limit fixed by the Council.

The budget of the BCL reflects the corporate values of the Bank, which are:

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

As regards the budget for 2007, it reflects the implications of the reorganisation currently set up in the Bank.

4.5 The internal audit activities

The main activity of the internal audit function is to implement the internal control system. The Internal Audit unit reports directly to the President of the Bank. The scope of the internal audit is the rules and regulations prevailing in the Luxembourg financial center, as well as by the standards promoted by the Institute of Internal Auditors (IIA) and the ESCB Audit Policy.

The Internal Audit unit is charged to follow-up the recommendations issued during its audit activities. Based on the annual internal audit plan, comprising audit tasks that are coordinated by the Internal Auditor's Committee of the ESCB, as well as audit engagements on a national level, the Internal Audit unit performed, during the year 2006, various reviews of the production and storage of euro banknotes, own funds management, accounting, payments systems, information systems as well as in the context of different projects.

4.6 Financial statements as at 31 December 2006

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)

	2005	2006	Change in % 2006/2005
Total assets	43,907,910,680	52,445,571,857	19%
Banks' current accounts	6,810,321,790	9,741,868,456	43%
Claims on credit institutions	31,797,051,656	41,511,620,450	31%
Own funds(1), revaluation accounts administrative provisions and specific banking risks	531,760,240	583,121,841	10%
Net result of banking activities(2)	84,434,406	89,252,485	6%
Total net revenues	42,335,991	42,659,591	1%
Administrative expenses	29,236,695	30,181,332	3%
Net profit	2,601,176	7,309,279	181%
Cash Flow(3)	74,824,801	80,517,799	8%
Personnel	203	208	2%
BCL's part in the capital of the ECB	0.1568%	0.1568%	
BCL's part in the Eurosystem's monetary policy operations	**7.832%**	**9.214%**	

(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 Representatives

We have audited the accompanying financial statements of Banque centrale du Luxembourg, which comprise the balance sheet as per December 31, 2006, and the profit and loss account for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Directors' responsibility for the financial accounts

The financial statements are the responsibility of the Directors and are approved by the Council. The Directors are responsible for the preparation and fair presentation of these financial statements, in accordance with generally accepted accounting principles and those defined by the European System of central banks. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Responsibility of the réviseur d'entreprises

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 as adopted by the Institut des réviseurs d'entreprises. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial accounts. The procedures selected depend on the judgment of the réviseur d'entreprises, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the réviseur d'entreprises considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.

An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Directors, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements give a true and fair view of the financial position of Banque centrale du Luxembourg as of December 31, 2006, and of the results of its operations for the year then ended in accordance with generally accepted accounting principles and those defined by the European System of central banks.

DELOITTE S.A. March 2, 2007

Réviseur d'entreprises

Pascal Pincemin Vafa Moayed

Partner *Partner*

4.6.3 Balance sheet as per 31 December 2006

	Note	2006 EUR	2005 EUR
ASSETS			
Gold and gold receivables	3	35,923,514	32,207,057
Claims on non-euro area residents denominated in foreign currency	4	164,244,740	203,694,972
- Receivables from the IMF		47,085,746	63,001,000
- Balances with banks, security investments, external loans and other external assets		117,158,994	140,693,972
Claims on euro area residents denominated in foreign currency	5	37,207,591	31,704,438
Claims on non-euro area residents denominated in euro	6	1,301,410,536	1,037,748,672
- Balances with banks, security investments and loans		1,301,410,536	1,037,748,672
Lending to euro area credit institutions related to monetary policy operation denominated in euro	7	41,510,822,665	31,796,282,172
- Main refinancing operations	7.1	32,668,047,500	24,611,000,000
- Long-term refinancing operations	7.2	8,842,774,865	7,185,139,250
- Marginal lending facility	7.5	300	142,922
Other claims on euro area credit institutions denominated in euro	8	797,785	769,484
Securities of euro area residents denominated in euro	9	2,349,504,488	1,678,903,325
Intra-Eurosystem claims	10	5,314,683,608	7,876,701,417
- 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	5,217,769,359	7,779,787,168
Items in course of settlement		35	180
Other assets	11	1,730,976,895	1,249,898,963
- Tangible and intangible fixed assets	11.1	66,243,324	62,072,621
- Other financial assets	11.2	1,500,684,573	1,034,432,666
- Off-balance sheet instruments revaluation differences		2,426,000	0
- Accruals and prepaid expenses	11.3	130,924,829	108,605,281
- Sundry	11.4	30,698,169	44,788,395
Total assets		**52,445,571,857**	**43,907,910,680**

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

Balance sheet as per 31 December 2006

	Note	2006 EUR	2005 EUR
LIABILITIES			
Banknotes in circulation	12	1,269,044,800	1.141,736,320
Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	13	9,741,868,456	6,810,321,790
- Current accounts (covering the minimum reserve system)	13.1	9,741,868,456	6,810,321,790
Liabilities to other euro area residents denominated in euro	14	472,942,949	514,683,375
- General government	14.1	472,942,949	514,683,375
Liabilities to non-euro area residents denominated in euro	15	32,189,061	314,195,393
Liabilities to non-euro area residents denominated in foreign currency	16	37,757,173	47,455,312
Counterpart of special drawing rights allocated by the IMF	17	19,355,828	20,513,855
Intra-Eurosystem liabilities	18	39,811,803,645	34,202,831,350
- Net liabilities related to the allocation of euro banknotes within the Eurosystem	18.1	39,811,803,645	34,202,831,350
Items in course of settlement	19	12,605,068	9,735,110
Other liabilities	20	387,451,120	237,388,936
- Off-balance sheet instruments revaluation differences		2,940,000	1,205,990
- Accruals and income collected in advance		343,796,110	190,360,110
- Sundry		40,715,010	45,822,836
Provisions	21	461,392,192	412,064,679
Revaluation accounts	22	31,241,667	48,960,115
Capital and reserves	23	160,610,619	145,423,269
-Capital	23.1	25,000,000	25,000,000
- Reserves	23.2	135,610,619	120,423,269
Profit for the year		**7,309,279**	**2,601,176**
Total liabilities		**52,445,571,857**	**43,907,910,680**

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

4.6.4 Off-balance sheet as per 31 December 2006

	Note	2006 EUR	2005 EUR
Custody deposits	24	189,738,667,501	145,773,541,714
Commitments and similar instruments	25	1,700,000,000	1,900,000,000
Foreign currency reserve assets managed on behalf of the ECB	26	117,520,445	92,352,754
Forward transactions	27	274,612,652	101,625,000
Numismatic collection		180,767	125,249
		191,830,981,365	**147,867,644,717**

4.6.5 Profit and loss account for the year 2006

	Note	2006 EUR	2005 EUR
Interest income	28	1,378,860,061	868,636,311
Interest expense	28	(1,276,252,841)	(779,311,460)
Net interest income	**28**	**102,607,220**	**89,324,851**
Realised gains / (losses) arising from financial operations	29	4,954,221	10,643,464
Write-downs on financial assets and positions	30	(18,874,943)	(15,693,001)
Transfer to/from provisions for foreign exchange rate and price risks	21, 31	(54,336,253)	(46,032,505)
Net result of financial operations, write-downs and risk provisions		**(68,256,975)**	**(51,082,042)**
Fees and commissions income	32	11,605,170	9,723,673
Fees and commissions expense	32	(11,039,183)	(9,564,581)
Net result from fees and commissions	**32**	**565,987**	**159,092**
Income from participating interest	33	-	-
Net result of pooling of monetary income	34	(12,450,016)	(10,394,032)
Other income	14.1, 21.3, 35	20,193,375	14,328,122
Total net income		**42,659,591**	**42,335,991**
Staff costs	36	(19,751,606)	(18,753,866)
Other administrative expenses	37	(7,295,424)	(8,233,361)
Depreciation of tangible and intangible fixed assets	11.1, 38	(5,118,980)	(5,296,464)
Banknote production services	39	(840,406)	(714,270)
Other expenses	40	(2,343,896)	(6,736,854)
Profit for the year		**7,309,279**	**2,601,176**

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

4.6.6 Notes to the financial statements as per 31 December 2006

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 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 participating 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".

The intra-system balances arising from the allocation of euro banknotes are adjusted in order to avoid significant changes in NCBs' relative income positions as compared to previous years. The adjustments are effected by taking into account the differences between the average value of banknotes in circulation of each NCB during a reference period 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 to finally result in an allocation of income on banknotes 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 in 2006. 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 from 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 agents 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 to 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 of 31 December 2006, BCL held 2,423.88 ounces of fine gold amounting to 1.2 million euro (2,063.73 ounces of fine gold amounting to 0.9 million euro as at 31 December 2005) and a top-rated gold bond issued by the International Bank for Reconstruction and Development purchased in 2002 and valued at 34.7 million euro (31.3 million euro as at 31 December 2005).

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 29 December 2006.

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

	2006 EUR	2005 EUR
Receivables from the IMF	47,085,746	63,001,000
Balances with banks, security investments, external loans and other external assets	117,158,994	140,693,972
	164,244,740	**203,694,972**

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 others 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 is valued at 115.3 million euro as per 31 December 2006 (71.7 million euro as at 31 December 2005), 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 per 31 December 2006, their value at market prices included an unrealised gain amounting to 0.3 million euro (unrealised loss amounting to 0.4 million euro as per 31 December 2005).

Balances with banks amounted to 1.9 million euro as per 31 December 2006 (68.9 million euro as per 31 December 2005).

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

	2006 EUR	2005 EUR
Balances with banks	10,959,298	6,711,897
Security investments	1,290,451,238	1,031,036,775
	1,301,410,536	**1,037,748,672**

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 per 31 December 2006, their value at market prices included an unrealised loss amounting to 15.5 million euro (unrealised loss amounting to 14.2 million euro as per 31 December 2005).

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:

	2006 EUR	2005 EUR
Main refinancing operations	32,668,047,500	24,611,000,000
Longer-term refinancing operations	8,842,774,865	7,185,139,250
Fine-tuning reverse operations	-	-
Structural reverse operations	-	-
Marginal lending facility	300	142,922
Credits related to margin calls	-	-
	41,510,822,665	**31,796,282,172**

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 operation 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 2,349.5 million euro as per 31 December 2006 (1,679 million euro as per 31 December 2005).

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 per 31 December 2006, their value at market prices included an unrealised loss amounting to 14.7 million euro (unrealised loss amounting to 16.2 million euro as per 31 December 2005).

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.

As per 31 December 2006, the share that the BCL held in the capital of the ECB is 0.1568%, which amounts to 9,660,235 euro, on a total of subscribed capital of the ECB of 5.565 billion euro (no change compared to 31 December 2005).

The share that the BCL held in the accumulated net profits of the ECB reflects the repayment of 0.9 million euro 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 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 per 31 December 2006, the claim of the BCL amounts to 87,254,014 euro (no change compared to 31 December 2005).

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 NCBs as well as the ECB. This claim amounts to 5.2 billion euro as at 31 December 2006 (7.8 billion euro as at 31 December 2005).
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 on the 2, boulevard Royal, the costs incurred in relation to the reconstruction

	Buildings EUR	Furniture and equipment EUR	Software EUR	Total EUR
Cost as per 1 January 2006	81,327,173	10,864,548	4,154,601	96,346,322
Disposals	-	(909,539)	-	(909,539)
Acquisitions	6,368,508	1,492,318	1,428,857	9,289,683
Cost as per 31 December 2006	**87,695,681**	**11,447,327**	**5,583,458**	**104,726,466**
Accumulated depreciation as per 1 January 2006	22,457,175	8,285,256	3,531,270	34,273,701
Disposals	-	(909,539)	-	(909,539)
Depreciation	3,689,882	1,059,993	369,105	5,118,980
Accumulated depreciation as per 31 December 2006	26,147,057	8,435,710	3,900,375	38,483,142
Net book value as per 31 December 2006	**61,548,624**	**3,011,617**	**1,683,083**	**66,243,324**

and transformation of the Pierre Werner building and the renovations made to the Siège Royal (main building). The building located on the avenue Monterey was completely written off in 2003, having been demolished in order to construct a new one. Construction of this new building was finished in 2006, as expected.

The Pierre Werner building and the avenue Monterey building 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:

	2006 EUR	2005 EUR
Other participating interests	216,994	216,994
Pension fund	83,271,152	78,219,526
Securities portfolio	1,417,196,427	955,996,146
	1,500,684,573	**1,034,432,666**

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

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 per 31 December 2006.

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 1,417.2 million euro (956.0 million euro as per 31 December 2005). Securities are valued at market prices. As per 31 December 2006, their value at market prices included an unrealised loss amounting to 12.8 million euro (unrealised gain amounting to 5.4 million euro as per 31 December 2005).

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 the commissions receivables, prepaid expenses (including salaries paid for January 2007) and other income receivable.

11.4 Sundry

	2006 EUR	2005 EUR
Withdrawals in advance	12,605,000	9,735,000
Others	18,093,169	35,053,395
	30,698,169	**44,788,395**

The sub-item "Withdrawals in advance" corresponds to the amount of euro banknotes ordered by the credit institutions as per 31 December 2006 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 central banks of the Eurosystem according to their weightings in the capital of the ECB, which totalled 1,269.0 million euro (1,141.7 million euro as per 31 December 2005).

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

	2006 EUR	2005 EUR
Current accounts (covering the minimum reserves)	9,741,868,456	6,810,321,790
Deposit facility	-	-
Fixed-term deposits	-	-
Fine-tuning reverse operations	-	-
Deposits related to margin calls	-	-
	9,741,868,456	**6,810,321,790**

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 operation 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 2006.

13.5 Deposits related to margin calls

This sub-item records deposits made by credit 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 2006.

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:

	2006 EUR	2005 EUR
Current account	84,691	567,560
Account related to euro coins issued by the Treasury	142,858,258	124,115,815
Fixed-term deposit	330,000,000	390,000,000
	472,942,949	**514,683,375**

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 6.2 million euro (4.3 million euro as per 31 December 2005), 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 SDR, converted to euro at the same rate as applied to the SDR assets, which should be returned to the IMF if SDR are cancelled, if the SDR Department established by the IMF is closed or if Luxembourg decides to withdraw from it. This liability, of unlimited duration, amounts to SDR 17.0 million, or 19.4 million euro as per 31 December 2006 (SDR 17.0 million, or 20.5 million euro as per 31 December 2005).

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 per 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 per 31 December 2006 amount to 5.4 million euro (5.6 million euro as per 31 December 2005).

Note 21 - Provisions

Provisions developed as follows:

	2006 EUR	2005 EUR
Provisions for banking risks	381,518,406	327,182,153
Provisions for pensions	7,823,786	7,680,870
Other provisions.	50,000	5,201,656
	461,392,192	**412,064,679**

21.1 Provisions for banking risks

Provisions for banking risks include the following items:

	2006 EUR	2005 EUR
Provision covering credit risk	178,365,669	141,982,925
Provision covering operational risk	10,925,000	11,150,000
Provision covering liquidity risk	14,318,659	13,523,377
Provision covering interest rate risk	200,000	200,000
	203,809,328	**166,856,302**
Provisions for general banking risks		
Provision for liabilities resulting from monetary agreements	32,341,954	32,341,954
Other provision for general banking risks	145,367,124	127,983,897
	177,709,078	**160,325,851**
	381,518,406	**327,182,153**

21.1.1 Provision covering credit risk

The provision for 178.4 million euro (142.0 million euro as per 31 December 2005) corresponds to:

- 4% of the BCL's own securities portfolio existing as per 31 December 2003 and still kept as at 31 December 2006 (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 2006, of the BCL's own securities portfolio and participations other than the participating interest in the ECB;
- 2% of firm commitments on stock exchange indexes existing as per 31 December 2006;
- 4% of the total amount lent by the Eurosystem as per year-end for monetary policy reasons multiplied by the capital key corresponding to the BCL.

Provision on stock exchange index was created in 2006. 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 the 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 created in order to face any future monetary liabilities has not change in 2006.

21.1.4 Other provision for general banking risks

In 2006, for prudence's sake and to safeguard its assets, the BCL transferred 17.4 million euro (17.0 million euro for the financial year 2005) 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:

	2006 EUR	2005 EUR
Provision for pensions	77,431,916	77,289,000
Provision for equalisation and financial risks	850,252	850,252
Provision for increase of PBO	1,541,618	1,541,618
	79,823,786	**79,680,870**

21.2.1 Provision for pensions

The pension 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 77.4 million euro as per 31 December 2006 (77.3 million euro as per 31 December 2005).

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.

21.2.2 Provision for equalisation and financial risks

This provision for equalisation and financial risks was intended to cover fluctuations in the pension fund's liabilities in its early years and/or to compensate for a lower return on assets. The provision was partially used but did not change in 2006.

21.2.3 Provision for increase of Projected Benefit Obligation

This provision was intended to cover the liability (Projected Benefit Obligation or PBO) for new agents or the changes of present value of potential payments taking into account individual parameters and the actuarial method used. The provision has not change in 2006.

21.3 Other provisions

A provision of 5.2 million euro has been created as per 31 December 2005, 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 was adopted. 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).

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 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 135.6 million euro (120.4 million euro as per 31 December 2005). This amount was increased by 2.6 million euro in 2006 following the allocation of profit for 2005 according to the decision of the BCL's Council and its Founding Law (Article 31).

The reserves were also increased by 12.6 million euro in 2006 by transfer of contributions from the Luxembourg pension funds. This received amount is made up of contributions and interests which should have been paied in 2001, according to the BCL's Founding Law (Article 35). In 2001, the BCL made an exceptional transfer from its reserves. This transfer was determined without considering the claim on the pension funds, which is used for the reconstitution of the reserves.

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 per 31 December 2006, the market value of these securities amounts to 189.7 billion euro (145.8 billion euro as per 31 December 2005).

Note 25 - Commitments and similar instruments

	2006 EUR	2005 EUR
Commitments and similar instruments	1,700,000,000	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 BCL on behalf of the ECB.

Note 27 - Forward contracts

BCL is engaged in bond and stock index futures. These instruments are mainly held for hedging purposes of interest rate risks related to the securities portfolio and for the purpose of adjusting the duration of the existing portfolio depending on market conditions.

As per 31 December 2006, the total liabilities related to these forward contracts amount to 274.6 million euro (101.6 million euro as at 31 December 2005). 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 10.0 million euro as per 31 December 2006 (5.0 million euro as per 31 December 2005).

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	
	2006	2005	2006	2005
IMF	1,521,372	2,394,911	-	-
Monetary policy	-	-	1,062,362,643	622,542,527
Intra-Eurosystem claims	-	-	173,380,646	148,403,622
Securities	4,460,338	2,762,511	134,366,145	89,498,935
Gold	366,298	406,745	-	-
Other	2,127,297	2,537,122	275,322	89,938
Total	**8,475,305**	**8,101,289**	**1,370,384,756**	**860,535,022**

Composition of interest expense

	Amounts in foreign currency EUR		Amounts in euro EUR	
	2006	2005	2006	2005
IMF	(726,090)	(529,901)	-	-
Current accounts (including minimum reserves) and deposits related to monetary policy operations	-	-	(226,747,634)	(146,465,831)
Liabilities related to the reallocation of euro banknotes in the Eurosystem	-	-	(1,039,347,699)	(625,344,817)
Other intra-Eurosystem liabilities	-	-	(35,255)	(26,768)
Interests on term deposits	-	-	(6,150,833)	(4,284,514)
Other liabilities	(1,573,198)	(1,707,550)	(1,672,132)	(952,079)
Total	**(2,299,288)**	**(2,237,451)**	**(1,273,953,553)**	**(777,074,009)**

The increase in interest results from an increase in amounts outstanding and 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 2006, they amounted to 23.6 million euro (17.4 million euro as per 31 December 2005) and to 18.6 million euro (6.8 million euro as per 31 December 2005) respectively, making a net income of 5.0 million euro (10.6 million euro as per 31 December 2005).

Note 30 - Write-downs on financial assets and positions

This item includes revaluation losses on securities for 15.9 million euro and on financial instruments linked to interest rates and market prices for 2.9 million euro in 2006 (15.5 and 0.2 million euro respectively in 2005).

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 commissions expense EUR	
	2006	**2005**	**2006**	**2005**
Securities	10,812,837	9,119,748	(10,932,676)	(9,488,128)
Others	792,333	603,925	(106,507)	(76,453)
Total	**11,605,170**	**9,723,673**	**(11,039,183)**	**(9,564,581)**

Note 33 - Income from participating interest

This item may include the dividend distributed by the European Central Bank.
No dividend was distributed in 2006.
In 2006, the ECB's income on euro banknotes in circulation amounting to 1,319 million euro 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 has been 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 NCBs' 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 in 2006).

Calculation of net monetary income allocated to the BCL:

		(EUR millions)
	2006	**2005**
Monetary income pooled by BCL	(45.2)	(31.9)
Monetary income reallocated to BCL	32.7	21.5
Retained monetary income by the ECB	0.0	0.0
Net result arising from the calculation of monetary income	**(12.5)**	**(10.4)**

Note 35 - Other income

Other income includes revenues of 6.2 million euro (4.3 million euro for 2005) that reflect the waiving by the State of Luxembourg of the interests due for 2006 on its term deposit with the BCL (see also Note 14.1) and the reimbursement of the claim on the Luxembourg pension funds for 0.2 million euro.

This item also includes the transfer from provision set up by the BCL in 2005 for 5.2 million euro. This provision was intended to cover the reimbursement 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. The Luxembourg pension funds paied these amounts in the first half-year of 2006.

Further included is the transfer from provision for pensions for 3.6 million euro after PBO's calculation as per 31 December 2006. This calculation took into account the cooperation agreement between the BCL's pension funds and other national organisations.

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 486,737 euro for the year 2006 (472,927 euro for the year 2005).

As per 31 December 2006, the BCL employed 208 persons (203 as per 31 December 2005). The average number of persons working for the BCL from 1 January to 31 December 2006 was 206 (206 for the year 2005).

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 72,289 euro in 2006 (71,082 euro in 2005).

Note 38 - Depreciation of tangible and intangible fixed assets

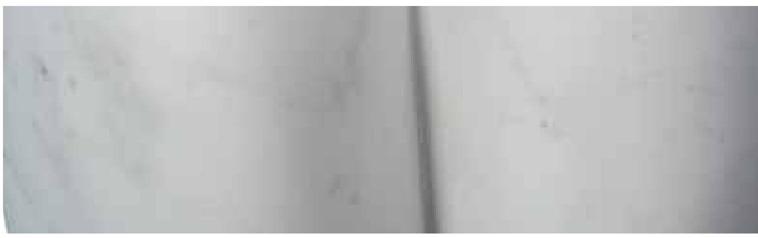
This item shows the depreciation applied on buildings, renovations on buildings, furniture and office equipment, computer hardware and software.

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

This item shows mainly the transfer to the administrative provisions (see Note 21.3 for 2006/2005 variation) and costs related to numismatic activities.



Artist: Richard Čermák
Title: Dvě Cesty ("Two roads")
Material: glass
Format: height 50 cm
BCL Collection

5. ANNEXES

5.1 List of BCL circulars published in 2006

- BCL Circular No 2006/193 of 21 March 2006 - 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 2006/194 of 18 April 2006 - 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 2006/195 of 2 May 2006 - surveys on foreign direct investment - 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 2006/196 of 14 July 2006 - 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 as well as to the financial services of the Postal and Telecommunications Services Company (giro accounts service).

- BCL Circular No 2006/197 of 7 August 2006 - Slovenia's adoption of the Euro, as from 1st January 2007: Impact over the statistical statements referring to the balance of payments - 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 2006/198 of 7 August 2006 - adoption of the Euro by Slovenia - sent to all credit institutions.

- BCL Circular No 2006/199 of 7 August 2006 - adoption of the Euro by Slovenia - sent to all Undertakings for Collective Investment in Transferable Securities (UCITS).

- BCL Circular No 2006/200 of 25 October 2006 - dates of submission of statistical reports to the BCL, and determination of the periods of holding minimum reserves in 2007 - sent to all credit institutions.

- BCL Circular No 2006/201 of 25 October 2006 - dates of submission of statistical reports to the BCL in 2007 - sent to all Luxembourg-based Undertakings for Collective Investment in Transferable Securities (UCITS).

- BCL Circular No 2006/202 of 19 December 2006 - collection balance of payments - set up date of the collection component for portfolio investments. - Amendments to the BCL Circular No 2006/196.

5.2 BCL Publications

BCL Working Papers

- Working Paper No 18, January 2006
L'identité de Fisher et l'interaction entre l'inflation et la rentabilité des actions: l'importance des régimes sous-jacents aux marchés boursiers, by Abdelaziz Rouabah.

- Working Paper No 19, May 2006
New survey evidence on the pricing behavior of Luxembourg firms, by Patrick Lünnemann and Thomas Y. Mathä.

- Working Paper No 20, May 2006
Peut-on parler de bulle sur le marché immobilier au Luxembourg?, by Christophe Blot.

- Working Paper No 21, May 2006
La sensibilité de l'activité bancaire aux chocs macroéconomiques : une analyse en panel sur des données de banques luxembourgeoises, by Abdelaziz Rouabah.

- Working Paper No 22, June 2006
Are Internet prices sticky?, by Patrick Lünnemann and Ladislav Wintr.

- Working Paper No 23, July 2006
The transition from payg to funding: Application to the Luxembourg privat sector pension system, by Muriel Bouchet.

External Publications of BCL Staff

- Etienne de Lhoneux, "The Eurosystem", in Legal Aspects of the European System of Central Banks, European Central Bank, 2005, pages 167-178.

- Patrick Lünnemann, "Price Changes in the Euro Area and the United States: Some Facts from Individual Consumer Price Data", with E. Dhyne, L. Álvarez, H. Le Bihan, G. Veronese, D. Dias, J. Hoffmann, N. Jonker, F. Rumler and J. Vilmunen, in Journal of Economic Perspectives, Vol. 20, No. 2, 2006, pages 171-192.

- Patrick Lünnemann, "Sticky Prices in the Euro Area: A Summary of NewMicro-Evidence", with L. Álvarez, E. Dhyne, M. Hoeberichts, C. Kwapil, H. Le Bihan, F. Martins, R. Sabbatini, H. Stahl, P. Vermeulen and J. Vilmunen, in Journal of the European Economic Association, Vol. 4, No. 2-3, 2006, pages 575-584.

- Thomas Mathä, "What Firms' Surveys Tell us About Price-Setting Behaviour in the Euro Area", with S. Fabiani, M. Druant, I. Hernando, C. Kwapil, B. Landau, C. Loupias, F. Martins, R. Sabbatini, H. Stahl, A. Stokman, in International Journal of Central Banking, Vol. 2, No. 3, 2006, pages 3-47.

- Thomas Mathä, "Sectoral and Aggregate Inflation Dynamics in the Euro Area", with F. Altissimo, L. Bilke, A. Levin and B. Mojon, in Journal of the European Economic Association, Vol. 4, No. 2-3, 2006, pages 585-593.
- Thomas Mathä, "The Euro and Price Differences of Individual Products in an Integrated Cross-Border Area", in Journal of Common Market Studies, Vol. 44, No. 3, 2006, pages 563-580.
- Thomas Mathä, "Comment on the Price-Setting Behavior of Austrian Firms: Some Survey Evidence", by C. Kwapil, J. Baumgartner and J. Scharler, ECB WP 464, March 2005, in OENB Workshop Volume, No. 8, 2006, pages 138-145.
- Muriel Nguiffo-Boyom, "Un indicateur de retournement conjoncturel pour la France: une application du modèle à facteur avec changements de régimes", in Economie et Prévision, No. 172, 2006-1, pages 101-114.
- Pierrard Olivier, "Nominal wage rigidities in a new Keynesian model with frictional unemployment", with V. Bodart, G. de Walque, H. Sneessens and R. Wouters, NBB Working paper research No. 97.

BCL Brochures

- "From the Werner report to the euro", Prof. Dr. Hans Tietmeyer, Pierre Werner Lecture 1, 2003.
- "Central Banks and Financial Stability", Baron Alexandre Lamfalussy, Pierre Werner Lecture 2, 2004.
- "Fiscal Policy in the Monetary Union", Pierre Werner Lecture 3, 2005.
- Brochure des produits numismatiques de la Banque centrale du Luxembourg, édition annuelle dont éditions 2005, 2006 et 2007.
- "The Banque centrale du Luxembourg in the European System of Central Banks", by Michael Palmer, May 2001.
- "In Memoriam Pierre Werner, 1913 - 2002. Un hommage", by Michael Palmer, August 2002.
- "Chronique de l'immeuble Monterey", by René Link, January 2007.
- "Exposition Monnaies grecques - Monnaies celtes", January 2007.
- BCL information material on the euro
- General conditions for the BCL´s operations

Paper copies of publications may be obtained at the BCL´s counters as long as stocks last and according to the BCL´s conditions. The BCL´s publications may be downloaded from the website www.bcl.lu.

5.3 Statistics series of the BCL

Statistical tables listed here under are available on the BCL's website www.bcl.lu ("Statistics") and are regulary 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 sheet of the Luxembourg MFIs (excluding the Banque centrale du Luxembourg)
2.2 Liabilities of the Luxembourg MFIs included in the euro area monetary aggregates
2.3 Liabilities of the Luxembourg banks included in the euro area monetary aggregates (1973 - 1990)
2.4 Liabilities of the Luxembourg banks included in the euro area monetary aggregates (1991 - 1998)

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 Luxembourg bank interest rates on LUF-BEF denominated deposits and loans - amounts outstanding (1980 - 1997)
3.4 Luxembourg bank interest rates on LUF-BEF denominated deposits and loans - amounts outstanding (1998 - 2002)
3.5 Money market interest rates
3.6 Government bond yields
3.7 Stock market indices
3.8 Exchange rates

11 International investment position of Luxembourg

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

Aquis 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**.