THE GOVERNOR'S MESSAGE[1]

1 Finalised mid-April 2014.

In 2013 the euro area experienced a fragile economic recovery, which started in the second quarter, and inflationary pressures were substantially lower compared to the year before. The transmission of the Eurosystem's monetary policy has, to a certain extent, improved due to a receding financial fragmentation.

Against this backdrop, the Governing Council decided to reduce the interest rate on the main refinancing operations twice to the historically low level of 0.25% and to extend the fixed rate tender procedures with full allotment for the main refinancing operations at least until mid-2015.

In July the Governing Council, for the first time, provided forward guidance on the direction of the key interest rates of the European Central Bank (ECB), indicating that these rates would remain at their current or lower levels for an extended period of time. This decision aimed to reinforce the message that the ECB would continue its accommodative stance with regard to its monetary policy in the euro area and, hence, to help anchor market expectations in this respect. The guidance provided by the Governing Council is in line with the overall subdued outlook for inflation over the medium term.

The year 2013 also witnessed major advances in the area of banking supervision and economic governance. On 15 October, the Council of the European Union adopted the Regulation establishing the Single Supervisory Mechanism (SSM). This mechanism, which will place the monitoring of credit institutions in the euro area and other EU countries that wish to join under the aegis of the ECB, will enter into force on 4 November 2014.

Before assuming its new role as supervisor, the ECB initiated a comprehensive assessment of 128 banks considered to be important from a systemic risk point of view. These banks, six of which are located in Luxembourg, represent about 85% of the banking system of the euro area. This exercise aims to increase the transparency of banks' balance sheets, to strengthen banks that would prove to be undercapitalised and, thus, to reinforce confidence in the banking system.

A new series of euro banknotes, the «Europa» series, also was launched in 2013. This series, whose first note, that of 5 euro, started to be circulated throughout the euro area on 2 May 2013, has new features which ensure improved security. Other denominations will be announced and introduced over time, in principle annually.

At the national level, 2013 has been marked by a cyclical upturn. While economic growth in the euro area continued to contract in 2013, the national accounts published in early April 2014 indicate that the Gross Domestic Product (GDP) in volume terms grew by 2.1 % in Luxembourg (compared to -0.2 % in 2012). However, while the Luxembourg economy continued to generate jobs at an annual rate of around 2%, the unemployment rate continued to increase, reaching a little over 7 % at the end of the year. The national inflation rate, as measured by the National Consumer Price Index (NCPI), reached an annual average of 1.7 % in 2013, well below the average annual rate of 2.7% the year before. The average annual inflation rate measured by the Harmonised Index of Consumer Prices (HICP) also reached 1.7% in 2013 against 2.9% in 2012. By way of comparison, the average annual inflation rate measured by the HICP for the euro area stood at 1.4% in 2013 compared to 2.5% in 2012.

Regarding public finances, the Luxembourg public administrations presented a very small surplus in 2013 according to the latest data published. A large surplus of 1.5% of GDP, which is generated by social security, continued to compensate for the large deficit of the central government (the latter reaching 1.6% of GDP in 2013). The updated data should not fundamentally change this assessment. Hence, fiscal consolidation efforts are needed, especially in light of the loss of tax revenue linked to electronic commerce from 2015 onward and the expected deterioration of the pension system accounts over the medium term. In addition, given the decline of the Luxembourg economy's potential growth and the strong increase in unit labour costs over the last decade, the implementation of reforms to improve the competitiveness of the Luxembourg economy is needed. Such reforms must be performed with equity and solidarity in mind.

As part of the implementation of the "Fiscal compact" in Luxembourg, which had to be transposed into national law by 1 January 2014, the ECB issued a negative opinion on the Government's proposal to entrust fiscal surveillance to the BCL. In its opinion on the draft law on the coordination and governance of public finances, the ECB considers that entrusting such a task to a national central bank could undermine the independence of the latter. Therefore, the Government amended the draft law, recommending the establishment of a separate body. However, the recommendation by the ECB to grant the BCL unconditional, timely and automatic access to all public finance statistics to enable it to ensure the monitoring of fiscal policy for monetary policy purposes has not yet been implemented by the Government.

The establishment of a framework for an authority institutionally responsible for macro-prudential supervision is also underway. A draft law passed by the Government provides for the establishment of a Systemic Risk Committee, which would consist of the Member of the Government responsible for the financial centre (Chairman), the Governor of the BCL, the Director General of the *Commission de surveillance du secteur financier* (CSSF), and the Director of the *Commissariat aux assurances*. In the absence of the Minister responsible for the financial centre, the Governor of the BCL would chair the committee. The secretariat would be provided by the BCL, under the authority of its Governor. The establishment of such a committee is the result of a recommendation of the European Systemic Risk Board (ESRB) to appoint an authority responsible for the conduct of macro-prudential policy in each country starting in July 2013.

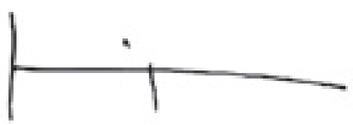
In Luxembourg, the implementation of the Single Supervisory Mechanism has led to an enhanced cooperation between the BCL and the CSSF. While the ECB will be responsible for the direct supervision of the most important credit institutions, it will work closely with the national competent authorities to monitor other credit institutions. In Luxembourg, the competent authorities are the CSSF and the BCL, the latter being responsible for liquidity surveillance. A representative of the BCL is a non-voting member of the ECB's Supervisory Board.

The implementation of the Single Supervisory Mechanism will entail new functions for the BCL, which raises the issue of the adequacy of the available resources with regard to the required tasks. It should be noted that the BCL, unlike the CSSF, does not receive mandatory contributions from banks to cover costs in this area.

More generally, it is clear that, particularly in response to the financial crisis, the BCL's existing missions have intensified and have become more complex. In addition, new missions were and will still be added. The human resources of the Bank are quantitatively insufficient to be able to ensure the full and effective execution of all these missions, which also require significant investments. This assessment is corroborated by the external auditor of the BCL, who – already on several occasions – recommended to the Bank to quantitatively increase its human resources to address the new challenges.

This issue falls within the broader context of the largely insufficient capital base of the Bank[2] given the size of its balance sheet, the volume and value of its operations, and the costs related to human resources and to the required technological resources. A significant strengthening of the Bank's capital is imperative for it to be able to fulfill its current and future missions in full, including financial, independence. This is also the conclusion of the external auditor of the Bank, who noted that the Bank's extremely low capital base relative to its overall volume of operations constitutes a great vulnerability for the Bank.

To conclude, I would like to thank my two colleagues in the Executive Board and all the BCL staff for their strong commitment. They all contribute to the goal of excellence that the BCL has endeavoured to achieve.



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2 Cf. p. 78.