





BANQUE CENTRALE DU LUXEMBOURG

EUROSYSTEM



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# FOREWORD

On 1st June 1998, a central bank came into being in the Grand Duchy of Luxembourg. The Banque centrale du Luxembourg (BCL) was founded at the same time as the European Central Bank (ECB). Its foundation represents the final outcome of long efforts in the context of the creation of the European Monetary Union (EMU). On the occasion of the 5th anniversary of the BCL, it seems useful to recall the role played by this young institution at a national, European and international level.

The BCL's contribution is important for the euro area and for the country. The Maastricht Treaty and the advent of the euro made the creation of a central bank necessary. The BCL is in charge of essential missions regarding monetary policy, the issuing of banknotes, financial stability, payment systems and even economic analysis.

The publication of this brochure is meant to present the BCL's tasks and the European and national context within which they have to be carried out. It also corresponds to the BCL's will to communicate and be transparent.

Luxembourg, 20 June 2003.

Yves Mersch  
Governor



# A LITTLE HISTORY

- 1803** Introduction of the franc germinal by the Emperor Napoleon, Luxembourg being the Water and Forests Department of the French empire.
- 1842** Luxembourg becomes a member of the German customs union (Zollverein). Introduction of the Thaler.
- 1848** Introduction of the franc for administrative and official documents.
- 1856** Creation of the Banque Internationale à Luxembourg (BIL) which obtained the authorisation to issue banknotes.
- 1873** Foundation of the Banque Nationale du Grand-Duché de Luxembourg, first rough sketch of a Luxembourg central bank. It also obtained the right to issue banknotes (in Thalers and in Francs, then in Marks).
- 1881** The Banque Nationale ended its activity.
- 1914** Banknotes issued by the BIL became the legal currency.
- 1918** A grand-ducal decree used, for the first time, the expression “Luxembourg franc”.
- 1922** Economic union with Belgium, the first step towards monetary cooperation. Parity was established between the Luxembourg franc and the Belgian franc.
- 1935** Monetary agreement with Belgium. Belgian coins and banknotes became legal tender in Luxembourg.
- 1944** Luxembourg becomes a founding member of the International Monetary Fund (IMF) and of the World Bank.
- 1970** The Werner Report provided for the creation of a single European currency in the long-term.
- 1983** Creation of the Luxembourg Monetary Institute (IML), responsible, in particular, for the supervision of the financial sector and for issuing currency.
- 1992** The Maastricht Treaty provided for a single European currency and for the creation of a central bank in Luxembourg.
- 1998** On 1 June, creation of the BCL, simultaneously with that of the ECB.



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# THE BANQUE CENTRALE DU LUXEMBOURG AND THE EUROSYSTEM

The laws of 22 April 1998 and 23 December 1998 established the BCL. The State is the only shareholder of the BCL. Its nominal capital amounts to 25 million euros. Bank of the banks, the BCL opened accounts for all the banks present in Luxembourg (178 in april 2003).

## **An independent central bank: what for?**

The BCL is a public institution. Its independence is provided for by its founding law and by the Maastricht Treaty. This independence takes several forms: personal, institutional, operational and financial. The first consecrates the Governor's independence as being a member in his personal capacity of the Governing Council of the ECB. It is materialised by the awarding of a long mandate(6 years) which is renewable. The second applies not only to

the Governor as a member of the Governing Council, but also to the decision-making bodies of a National Central Bank (NCB) which shall not request nor accept instructions from third-party institutions and organs –European or national – or from national governments. The two other forms must ensure that an NCB will be able to acquire sufficient technical and financial means to allow the NCB to perform the missions which are part of its duties.

The justification for this independence mainly rests on the postulate of the neutrality of money in the long term. In other words, it is supposed that in the long term, there is no arbitrage between inflation and growth. In the short term, the effects of monetary policy are more marked for production than for prices. In the long term, however, the effects on production fade away and the effects on prices remain. Thus, in the long term, an eco-



nomy will not benefit from increased growth, but will have to confront increased inflation.

Any temptation to use monetary policy in order to boost the economy in the short term must be avoided, because this could have negative effects on inflation in the mid or long term. This is why monetary policy has to be entrusted to an independent central bank. Governments, which are regularly subject to elections, could be tempted to obtain positive short-term effects without being concerned about the long-term effects.

Finally, monetary policy has no influence on the short-term volatility of prices and its effects on prices can also be observed after a certain lapse of time.

The corollary of this independence is an obligation to inform the public (hence some degree of accountability

with regard to the set objectives). This information is given by speeches and publications such as quarterly bulletins or working papers. Moreover, the BCL is bound by law to publish an annual report which is transmitted to the Government and the Parliament.

### **Who runs the BCL?**

The decision-making bodies of the BCL are the Council and the Executive Board.

The Council is composed of 9 members: 3 members of the Executive Board, appointed by the Grand Duke on the proposal of the Government, and 6 members appointed by the Government. The Director General chairs the Council (as Governor). The Council's powers include the approval of the annual budget and the annual accounts and fixing the BCL's business policy.



The Executive Board is the management authority of the BCL. It is composed of the Director General and two Directors. It works out measures and takes those decisions which are necessary to achieve the BCL's missions.

The members of the two decision-making bodies are appointed for 6 years. Their mandate is renewable.

The Governor takes part, in his personal capacity and independently, in decision-making within the ECB's Governing Council of which he is a member.

### **Eurosystem and BCL: what division of roles?**

In accordance with the Treaty on European Union, the BCL is an integral part of the European System of Central Banks (ESCB), as are the NCBs of the

14 other countries of the European Union (EU) and the ECB. The nominal capital of the ECB is held entirely by the NCBs of the Member States of the EU.

As all the Member States of the EU have not yet introduced the euro, it is necessary to distinguish between the ESCB and the Eurosystem which groups together the ECB and the NCBs of the 12 countries which have adopted the euro (Austria, Belgium, Germany, Greece, Finland, France, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain). The main objective of the Eurosystem, and of the ESCB, is to maintain price stability. To achieve that end, a single monetary policy is implemented within the euro area. As soon as all the EU countries have adopted the euro, the Eurosystem and the ESCB will be one and the same thing.

The monetary policy of the euro area is defined by the ECB Governing Council

# WHAT IS THE MAIN MISSION OF THE BCL?

in which each of the Governors of the NCBs of the euro area and the members of the Executive Board of the ECB has a seat. The ECB Executive Board is composed of the President and the Vice-President of the ECB and of four other members who are appointed by the Heads of State or of Government of the Member States which have adopted the euro.

Monetary policy is decided by the ECB and implemented by the NCBs on a decentralised basis (but in identical conditions throughout the euro area). The BCL contribution is important, because it transfers on average more than 10% of the liquidity of the euro area to its counterparties.

The ECB must be consulted on any draft European or national legislation in its fields of competence (monetary issues, payment means, monetary and financial statistical data collection, payment systems...). The ECB may

give opinions on its own initiative. The NCBs participate directly in this consultation process and in the preparation of the ECB's opinions.

## **What is the main mission of the BCL?**

The basic tasks to be carried out by the ESCB, as laid down by the Treaty, are:

- to define and implement the monetary policy of the Community;
- to conduct foreign exchange operations consistent with the provisions of Article 109 of this Treaty;
- to hold and manage the official foreign reserves of the Member States;
- to promote the smooth operation of payment systems.

The BCL's main task is to contribute to the fulfilment of the ESCB's missions.



It also provides services to public institutions, to the financial sector and to the national economy as a whole. In general, it opens accounts only to monetary and financial institutions, but it is not a commercial bank. Thus, it is not possible for an individual to open an account or to ask for a loan.

### **What is the main objective? Price stability!**

The basic mission of the Eurosystem is to maintain price stability. In this context, the Governing Council adopted a monetary policy strategy providing for a quantitative definition of price stability. The main reference is the Harmonised Index of Consumer Prices (HICP). The annual increase of this index shall be below 2% in the medium term and over the whole euro area. The fact that price stability is defined with regard to the whole euro area implies that the Governing Council does not take decisions

according to the inflation rates existing in the different countries.

In order to be able to take decisions on the basis of information which is as exhaustive as possible, the Governing Council bases them on two pillars. The first pillar gives a role to money, defined by a monetary aggregate called M3, whose components and counterparties are followed closely. The second pillar consists of the analysis of a vast range of economic and financial indicators which may indicate the future development of prices. By choosing to make public the references which lead up to its decisions, the Eurosystem strengthens the credibility of its action.

### **How does monetary policy affect the economy?**

In order to reach its objective, the central bank does not influence prices directly, but through the

interest rate. The single monetary policy is thus based on the setting of the short-term interest rate and of the volume of liquidity granted to credit institutions and in consequence to individuals and to the economy as a whole. Actually, changing the interest rate applied to commercial banks, decided by the Governing Council of the ECB, affects the conditions offered to the banks' own clients. To avoid the risk of inflation (or deflation), one of the tools used by the ECB is the volume of liquidities. Thus, the reduction (increase) of the liquidity provision may discourage (encourage) financial actors to resort to credit which has become more (or less) costly.

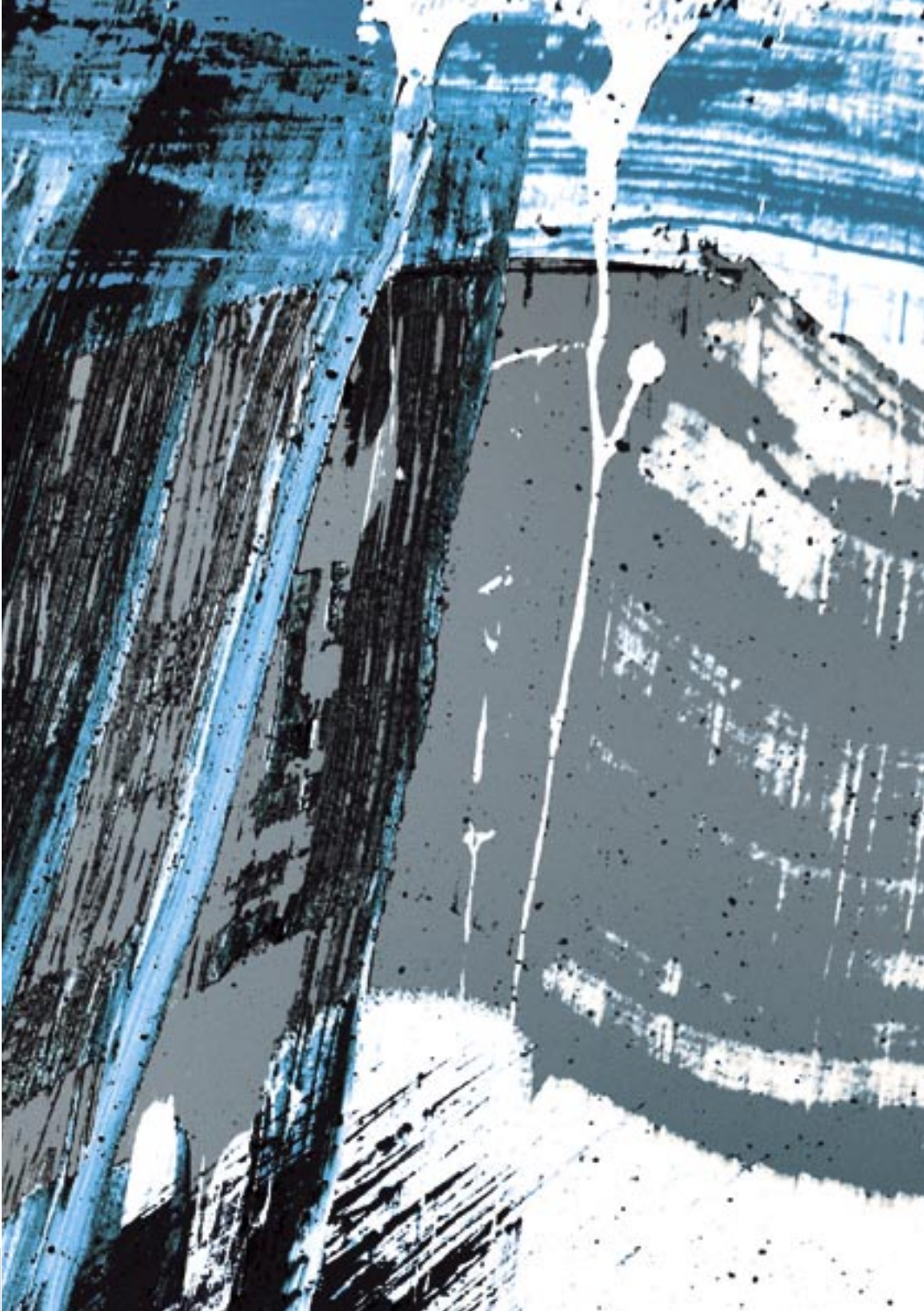
The price stability objective is justified, in particular, by the following economic mechanisms:

In an environment of price stability, the market allocates its resources more

efficiently. A large degree of price volatility effectively makes the calculation of the future development of prices more uncertain. This uncertainty increases the probability of a non-efficient allocation of resources.

Moreover, long-term interest rates take account of anticipated inflation. If markets anticipate a major degree of inflation, this inflation becomes part of a premium. This premium generates an increase of the long-term interest rates and, all other things being equal, makes investment more costly. Thus, price stability permits an anchoring of anticipations, lowering long-term interest rates, thus promoting growth and employment.

The limitation of monetary erosion encourages the maintenance of the purchasing power of economic agents, promoting consumption, investment and indirectly growth and employment.





Monetary policy, which is directed on the mid-term, smoothes external shocks (shocks on which a specific economic area has no direct control, e.g. oil crisis) and thus contributes to a reduction in the volatility of growth and employment.

### **Instruments of monetary policy**

The BCL carries out operations on financial markets (open market operations). This means in practice that it grants credits against securities provided as collateral by the counterparties of the BCL, i.e. credit institutions of the Luxembourg financial centre. The interest rate for the main short-term credits is the most important monetary policy signal. The Eurosystem also offers to credit institutions the possibility of longer-term credits and, also, a day-to-day loan or deposit system.

The only regulatory instrument used by the BCL is the imposition on credit institutions of mandatory reserve requirements which must be deposited on a BCL account. By increasing or lowering the reserve requirements, the ECB and the NCBs have an influence on the credit institutions refinancing needs from their NCB.

### **Financial stability**

Price stability and financial stability are two inseparable poles. Price stability, by anchoring the anticipations of agents and so reducing the volatility of markets, contributes to financial stability.

Conversely, financial instability may jeopardise price stability by altering the various channels at work during the monetary transmission mecha-



nism. For example, the bursting of a speculative bubble may contribute to a deflation process through the deterioration of the wealth effect (effect causing a variation in household consumption according to the value of the assets they hold). Likewise, an exchange crisis may generate a depreciation of the exchange rate which increases imported inflation. While central banks' intervention following financial crises is controversial, essentially because of moral hazard considerations, it is beyond doubt that their prior intervention is crucial.

The missions of the ESCB regarding stability are twofold: to contribute to policies initiated by the competent authorities with regard to the prudential supervision of credit institutions and to the stability of the financial system and promote the smooth functioning of payment systems.

Besides its European activities, the BCL has set up macro-prudential indicators which record the general development of the Luxembourg financial system.

Because of the systemic importance of payment and settlement systems in this field, the law has in principle entrusted the provisional surveillance to the Commission de surveillance du secteur financier (CSSF) and by way of exception to the BCL. Thus, the BCL is legally responsible for the supervision of the payment systems in which it takes part.

## **Other services provided by the BCL**

### **Issuing of banknotes**

The BCL is in charge of issuing and circulating banknotes and of circulating coins, on behalf of the Finance



# OTHER SERVICES PROVIDED BY THE BCL

Ministry which issues them. Banks of the financial centre receive coins and banknotes from the BCL in view of the withdrawals and deposits made by their own clients.

The counterfeiting of money is a serious offence and is strictly punished by law. In this respect, a European Counterfeit Monitoring System (CMS) has been set up. The BCL contributes to this system through the quick detection of forgeries.

## Payment systems

A payment system is a set of instruments, procedures and, in general, of fund transfer systems between banks, aimed at easing the circulation of money. TARGET is a payment system handling payments of large amounts in euro. Each monetary policy operation within the Eurosystem must be performed through TARGET. This

system offers a high quality service for the execution of these operations. TARGET is a real-time gross settlement (RTGS) system. An RTGS system allows the processing of payments on a one-by-one basis in real time. TARGET has been operational within the ESCB since 1999. The BCL is the technical and settlement agent of the Luxembourg TARGET component.

There is also a mass payment system handling a high number of operations involving small amounts in the form of transfers and cheques. The BCL is the settlement agent of this compensation system.

Moreover, the BCL has chosen Clearstream Banking Luxembourg S.A. as Luxembourg's central custodian of securities deposited by the counterparties as collateral. Within Clearstream, it also manages securities deposited by non-resident parties for the account of other ESCB central banks.

The BCL also sees that payment systems comply with existing international standards and recommendations.

### **Economic and financial information**

The BCL has an important role in the collection, analysis and diffusion of economic and financial information. It is entitled to collect the necessary statistical information, either from the competent national authorities, or directly from economic agents. It has the right to check this information on the spot. The BCL collects from its counterparties of the Luxembourg financial centre elements for the analyses concerning the development of the markets and cooperates closely with the Service central de la statistique et des études économiques (STATEC), the statistics institution of the Luxembourg State.

It collects, analyses and publishes statistical information, especially in the monetary and balance of payments fields. It uses these statistics for its own analyses or for those of the Eurosystem. These statistics are essential for the preparation of European monetary policy, and also for good economic governance. The BCL contributes to the continuous improvement of the quality of statistics.

Beyond a simple statistical reporting of economic transactions between an economic area and the rest of the world, the payments balances (to be specific) present a major interest for economic policy. Imbalances of external payments have an impact on money supply and on exchange rates. In an interdependent world economy, the need for statistics of this kind is increasing daily. Balance of payments data are in particular useful for public authorities in formulating their policies.





The BCL publishes working papers drafted by its specialists, as well as information bulletins containing analyses of topical economic and financial issues. These research activities not only help with the preparation of monetary policy decisions, but also help to develop expertise in monetary, financial and economic issues.

Apart from managing its own communication policy, the BCL forwards the Eurosystem communication notably information from the ECB.

### **Financial asset management**

Besides managing its own reserves, the BCL also manages part of the exchange reserves of the Eurosystem. It may also offer its reserve management services to central banks which are not members of the ESCB or manage the cash reserves of international institutions. The BCL then puts its resources

and its know-how in terms of analysis and research at the disposal of those central banks and international institutions.

### **Services to the State**

Is the BCL the bank of the State? No, because the BCL is not, for example, in charge of the State's debt service, of collecting tax payments or of paying the salaries of civil servants. From a legal point of view, the BCL is specifically forbidden to grant an overdraft or a loan to the State. Nevertheless, the State has opened current accounts and restricted access deposits with the BCL. The BCL also puts into circulation the coins which the State issues. Finally, the BCL acts as the fiscal agent of the State towards the IMF and enters into its accounts the assets and liabilities of the Grand Duchy with regard to the IMF.



## **Role at the level of the Luxembourg financial centre**

The BCL, at different levels, maintains strong contacts with the economic agents of the financial centre. In view of its interest in the development of the financial centre, the BCL organises a number of working groups and consultative bodies, such as:

- The Statistics Committee;
- The Payment and Settlement System Committee;
- The Market Operations Committee;
- The Fiduciary Money Committee;
- The Legal Committee;
- The IT Committee.

# GLOSSARY

**Euro area:**

the area encompassing those Member States in which the euro has been adopted as the single currency. The euro area currently comprises Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

**European Central Bank (ECB):**

ensures that the tasks conferred upon the Eurosystem and the ESCB are implemented either through its own activities or those of the NCBs.

**European System of Central Banks (ESCB):**

is composed of the ECB and the NCBs of all 15 Member States.

**Eurosystem:**

comprises the ECB and the NCBs of the Member States which have adopted the euro. It represents the system which allows the ESCB to fulfil its tasks within the euro area.

**Founding law of the BCL:**

law of 23 December 1998 concerning the monetary status and the BCL.

**International Monetary Fund (IMF):**

international organisation whose seat is in Washington. It numbers 184 member countries (at the end of 2002). It was created at the end of the 1944 conference in Bretton Woods (USA) in order to promote international monetary cooperation and exchange rate stability, to facilitate economic growth and a high level of employment and to help member states to correct the imbalances of their balance of payments. Luxembourg is a founding member of the IMF.

**International reserves:**

assets and securities in foreign currency and gold held by central banks.

**Monetary aggregates:**

a monetary aggregate may be defined as being the sum of the 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 monetary aggregate M1 has been defined as currency in circulation plus overnight deposits. The monetary aggregate M2 comprises M1 plus deposits with agreed maturity of up to two years and deposits redeemable at notice of up to three months. The 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.

**TARGET (Trans-European Automated Real-time Gross settlement Express Transfer system):**

is 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 to allow cross-border transfers throughout the EU to move from one system to another.





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For more information : [www.bcl.lu](http://www.bcl.lu) and [www.ecb.int](http://www.ecb.int)  
See in particular the ECB Monthly Bulletin of January 1999.

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