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BANQUE CENTRALE DU LUXEMBOURG

EUROSYSTEM

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THE GOVERNOR'S MESSAGE

As the Eurosystem has maintained its principal refinancing rate at historically low levels for a protracted period, it becomes increasingly evident that monetary stimuli by themselves do not suffice to impact in a decisive and sustained manner on the dynamics of European growth.

Faced with low rates across the entire yield curve, ample and perhaps even excessive liquidity, as well as real interest rates close to zero, monetary policy has exhausted its margin of manoeuvre. At this stage, monetary policy's price stability mandate may not be risked for what is undeniably a credibility issue, resulting from the difficulties in implementing unavoidable reforms. Procrastination in introducing such reforms will only entail bigger efforts in the future.

Will Luxembourg, where growth reached 4.5% in real terms in 2004, be able to escape from this logic? It cannot be overlooked that, parallel to this strong growth, both the public sector deficit and unemployment increased. Furthermore, this growth was accompanied by a decrease in investment as well as by price increases which, today, would make it impossible for our country to join the euro area.

A normal and desirable characteristic of a market economy is the process of adjustment to changing economic conditions. This implies the permanent adjustment of relative prices within each country and every sector, as opposed to a state of inertia. The rigidities affecting the mechanisms of price and wage determination are at the origin of relative price distortions which, as a consequence of external shocks, tend to become permanent and affect the future welfare of a nation.

An absence of reforms will result in higher inflation than in the other countries of the euro area, with negative interest rates leading, in particular, to the spoliation of small savings, and a loss of competitiveness. This will lead to an appreciation of the real exchange rate and adjustment will be imposed through the labour market, thus weakening the social fabric. Buoyant external demand for steel and financial services should not inspire complacency concerning our macroeconomic framework, especially since we are confronted by increasing competitive pressures.

Calls for protectionism and the ghosts of other old demons from our continent are increasingly being heard again. They constitute a real threat for a small, open, and insufficiently diversified economy. All forms of protectionism will weigh heavily on the economy's dynamism, sap investors' confidence and make access to such a closed market even more difficult. This is not only true for commodities and services, but also for employment. The social aspects of our market economy are a hardly won heritage of our history and contribute to the definition of our identity. Market forces and social protection should no longer be considered as incompatible, but the efficiency of both enhanced. The Nordic countries have understood this. They protect the individual, rather than employment, and allow the markets to function freely.

We need to overcome defensive reflexes inspired by fear and return to the values of those who rebuilt the country after the war. The participation rate should be raised and those who contribute to our wealth should be better integrated, not only rewarded by a salary.

Analysing the current situation and in the context of our international scenario, it seems justified to reduce the economic growth projections for the year 2005 to the 3.2% - 3.8% range. Within a more favourable European environment, international demand directed at Luxembourg could experience a further acceleration and result in an overall growth rate of about 3.9% in 2006.

As measured by the HICP, **Luxembourg's inflation rate** amounted to 3.2% on average in 2004, representing a substantial increase relative to the 2.5% rate of 2003. As a result, Luxembourg's inflation differential relative to the euro area and its neighbouring countries was, on average, less favourable than the preceding year in terms of the overall HICP. This deterioration resulted essentially from the price evolution of energy and tobacco. It is also noteworthy that, in terms of the evolution of the global HICP, Luxembourg finished last in the euro area in both March and April 2005, with increases of respectively 3.5% and 3.7% in annual terms. The next automatic salary indexation is expected for the fourth quarter of 2005. However, the evolution of the HICP, whose average rhythm of progression is expected to increase slightly to 3.5% in 2005, contrasts with the evolution of the national index of consumer prices.

The **unemployment rate** has risen from 2.6% in 2001 to 4.2% in 2004, notwithstanding the cyclical recovery observed since 2002. This paradoxical evolution seems to invalidate the existence of an inverse relationship between economic growth and that of unemployment ("Okun's law"). BCL calculations show that growth rates of 5.7% to 7.3% are required in order to stabilise the rate of unemployment in the strict sense in Luxembourg. The average economic growth in Luxembourg has been below this range during the period 1985 - 2004, suggesting that Okun's law only provides a partial explanation regarding the evolution of unemployment in Luxembourg. The atypical structure of Luxembourg's labour market could be at the base of this weak "reactivity" of the unemployment rate to economic growth. Indeed, the presence of commuters from neighbouring countries, who contribute to production and GDP but who, when losing their job, do not appear in the Luxembourg unemployment statistics, might well weaken the link between the evolution of unemployment and GDP.

Luxembourg's **public administrations** constantly registered budgetary surpluses from 1993 to 2003, and these reached a peak of more than 6% of GDP in 2000 and 2001. In this respect, the occurrence of a significant deficit in 2004, equivalent to 1.1% of GDP, represented a major shift. The deterioration of public finances observed in 2004 occurred as the increase in spending (+9%) was much more pronounced than the increase in income (+5.3%). The spring projections of the BCL predict a further budgetary deterioration for the period from 2005 to 2007. Without a reaction on their part, public administrations would incur deficits of about 1.8% of GDP in 2007. According to the ESCB methodology, the deficits, adjusted for cyclical factors, would reach 1.4% and 1.7% of GDP in 2006 and 2007, respectively. Such results would be difficult to reconcile with the reformed Stability Pact.

Under Luxembourg's presidency, the ECOFIN Council reached an agreement on the reform of the **Stability and Growth Pact (SGP)** on 20 March 2005. The impact of the new agreement on the budgetary situation will depend on the modalities of its implementation. Thus, the manner in which the medium-term objectives are formulated and put into practice at the national level will be decisive. While it is essential that these medium-term objectives be considered as a first anchor of budgetary policy, this should not exempt the national authorities from adopting more ambitious objectives. According to the agreement reached in March 2005, the middle-term objective (lower limit) would present a cyclically adjusted deficit of 1% of GDP for lowly indebted, high growth countries. In Luxembourg, however, a deficit of this size would imply a significant deterioration in the overall net asset situation of public administrations. Moreover, such deficits would not comply with the 3% reference value, notably because cyclical factors are more pronounced in Luxembourg than in other Member States. In order to assure compliance with the reference value and the maintenance of net assets at an adequate level, Luxembourg's authorities should, in their successive updates of the Stability Pact, propose more ambitious objectives than the middle-term objective resulting from the March agreement.

Yves Mersch

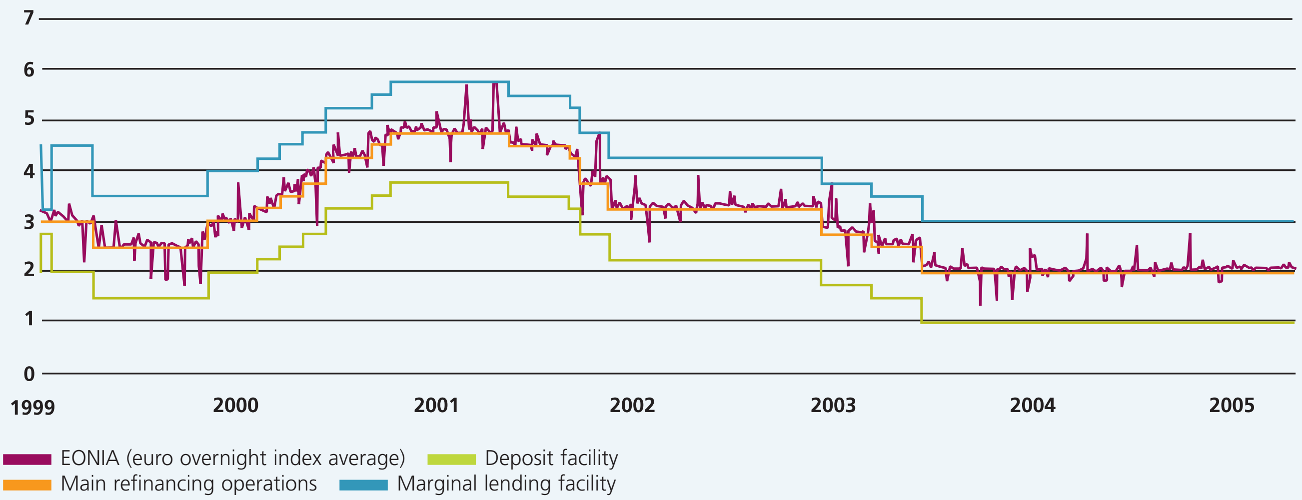
1. ECONOMIC AND FINANCIAL SITUATION

1.1 Economic situation at the international level

1.1.1 Short-term interest rates

After cutting interest rates twice in 2003, the Governing Council of the ECB decided to leave rates unchanged for the whole period under consideration, in line with its assessment that the monetary policy stance remains compatible with the maintenance of price stability over the medium term. Thus, the minimum bid rate on the main refinancing operations was maintained at 2%, while the interest rates on the deposit facility and the marginal lending facility were left unchanged at 1% and 3% respectively.

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



Source : ECB, Bloomberg

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

Nominal and real interest rates have been at exceptionally low levels since 2003, providing ongoing support for the economic recovery in the euro area. The recovery has however been modest in spite of robust global economic growth; this is in part attributable to the persistence of high oil prices which has also led to short-term inflationary pressures, although the medium-term outlook remained in line with price stability throughout the period under review.

Moreover, the impact of higher dollar-denominated commodity prices was somewhat mitigated by the euro's appreciation, while the absence of second-round and other (indirect) effects has prevented further inflationary pressures from building up. Additionally, the Governing Council stresses the importance of sustainable fiscal policies and structural reforms as a precondition to the maintenance of price stability at relatively low interest rate levels.

Overall, since the beginning of 2005, the Governing Council has not modified its assessment regarding the medium-term outlook for the maintenance of price stability and growth in the euro zone is expected to pick up towards the end of 2005.

Regarding the monetary analysis, the annual growth rate of M3 has remained above the reference rate since May 2001 and liquidity in the euro area thus continues to exceed the volume required for non-inflationary growth. Although M3 growth has been slowing down considerably since the second semester 2003, it picked up again in June 2004, reaching 6.5% on an annual basis in March 2005. The acceleration of monetary growth since the second half of 2004 is attributable to the upward impact from continued historically low interest rates - which has stimulated demand for the most liquid components of M3 by reducing the opportunity cost of holding such assets - outweighing the downward impact of the portfolio normalisation effect. The low level of interest rates has also stimulated growth of credit to the private sector, in particular credit extended to households; mortgage loans, which grew over 10% annually in the first quarter of 2005, have largely contributed to this development.

1.1.2 Long-term government bond yields

Throughout the review period, government bond yields were largely driven by commodity prices and by developments in the US labour market. High energy prices tended to reduce growth prospects and increase inflationary pressures, while labour market developments in the United States reflected market participants' concerns regarding the sustainability of the US recovery. Bond yields in the United States and in the euro area essentially moved in tandem throughout most of the year under review; by the end of the year, bond yields in the euro area had reached historic lows, while in the United States yields stood at roughly the same level as end-2003. More recently, bond yields fell until mid-February when they rebounded, only to fall again one month later.

GRAPH 2: LONG-TERM GOVERNMENT BOND YIELDS

Source: Bloomberg

Following several months of decline in 2003, government bond yields continued on a downward trend in the first quarter of 2004 owing to a string of disappointing macroeconomic data, in particular US non-farm payroll data. This trend was subsequently reversed by better than expected data from the US labour market, as well as by inflationary pressures stemming from a rise in energy prices. After a temporary interruption to the rising oil prices, bond yields embarked on a long downward trajectory in mid-2004 in the face of renewed growth concerns in the United States and the euro area. Bond yields continued to move in tandem after a brief decoupling at the end of October 2004 when euro area yields declined while US yields went up due to contrasting growth expectations in the two economies.

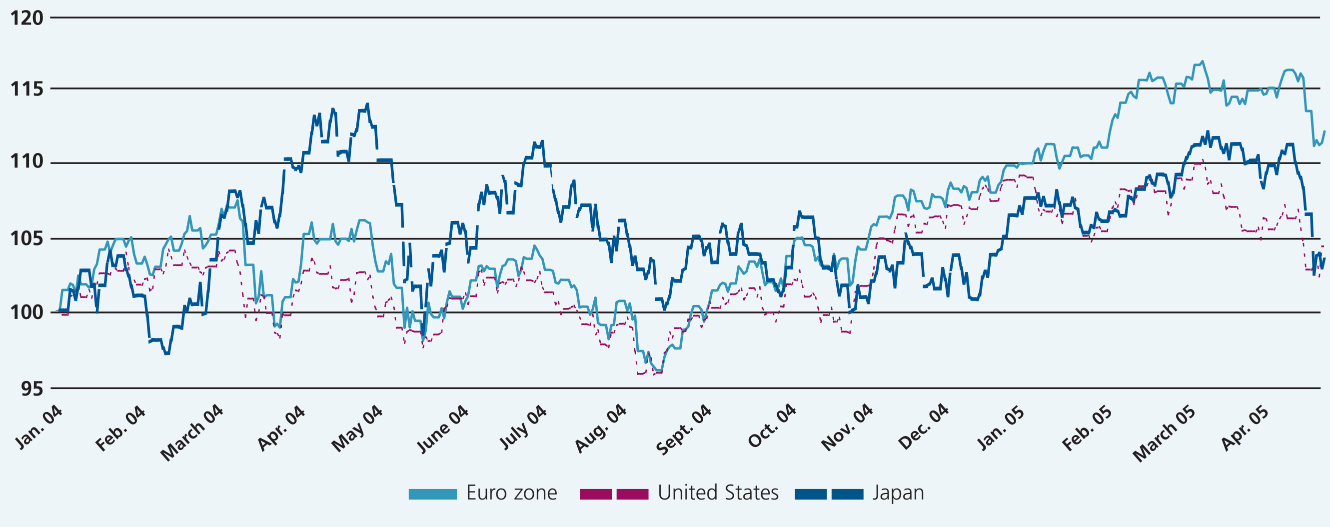
The downward trend then continued until mid-February 2005, with euro area government bond yields reaching new historic lows which may at least in part be attributable to increased demand for bonds from institutional investors seeking to comply with new prudential regulations and accounting rules. Although yields have rebounded since February 2005, in March developments in government bond yields were divergent across the two markets, most likely because of relative changes to the growth outlook in the two economies.

1.1.3 Equity markets

Following a mixed performance in the first eight months of the year under review, the major stock price indices resumed the upward trend observed from early 2003. Between end-2003 and end-2004, the Dow Jones EURO STOXX and the Standard and Poor's 500 gained 9.96% and 8.99% respectively, finishing the year at 267.41 and 1 211.92; this contrasts with a slightly more modest performance for the Nikkei 225, which gained 7.61% in the same period (finishing at 11 488.76). Although corporate earnings and low government bond yields have had a positive impact on equity markets throughout most of the period under review, continuously rising energy prices acted as a drag, especially in Japan where the recovery was essentially export-led.

More recently, the Dow Jones EURO STOXX outperformed the other two indices owing to the strong performance of euro area companies; soaring energy prices, however, have been depressing equity markets since March 2005.

GRAPH 3: MAJOR STOCK PRICE INDICES IN THE EURO AREA, THE UNITED STATES AND JAPAN (INDEX: 01/01/2004 = 100; DAILY DATA)



Source: Bloomberg

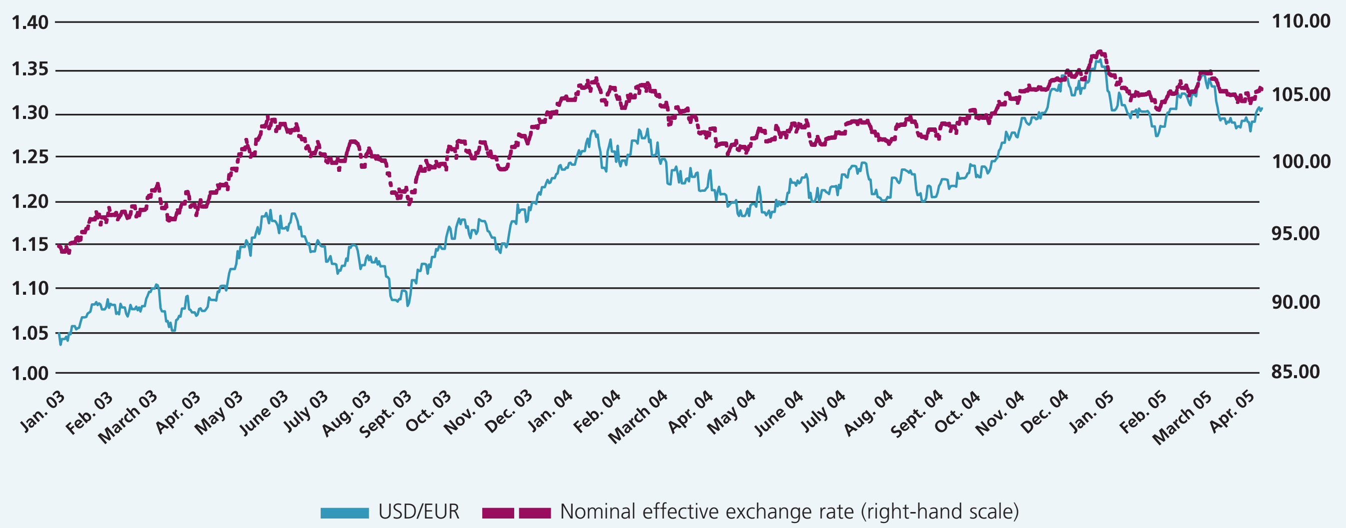
While in the first two months of the year under review the Dow Jones EURO STOXX and the Standard and Poor's 500 were supported by positive corporate earnings results and low government bond yields, the Nikkei 225 evolved in a rather volatile environment owing to fears about future exchange rate developments. In the aftermath of the terrorist attacks in Madrid, markets rebounded briefly although continuously rising energy prices implied that gains were modest and temporary at best. It was not until mid-August that stock price indices resumed on an upward trajectory; while oil prices were rising almost incessantly, equity markets increasingly benefited from a gradual improvement in the corporate outlook. Even the record energy prices in October 2004 did not fully interrupt the bullish mood that prevailed in equity markets, although the Nikkei 225 continued to remain somewhat more sensitive to oil price developments.

Throughout early 2005, the Dow Jones EURO STOXX outperformed the other two indices in the context of a continued upward movement in stock prices that gradually tapered off in the face of soaring oil prices; in the wake of peaking energy prices in March and April 2005, equity markets plummeted again.

1.1.4 Exchange rate developments

In the course of 2004, the euro appreciated by roughly 8% against the dollar, finishing the year at USD 1.36. Since the dollar's weight in the calculation of the euro's effective exchange rate is quite significant, this appreciation was largely transmitted to the nominal and real effective exchange rates of the euro; this was exacerbated by the fact that several Asian countries still peg their currencies to the dollar. In nominal terms, the effective exchange rate appreciated by 2.3% in 2004, while the real effective exchange rate strengthened by 1.83%.

GRAPH 4: BILATERAL EURO-DOLLAR AND NOMINAL EFFECTIVE EURO EXCHANGE RATES



Source: Bloomberg, ECB

For most of the year under review, the euro's nominal effective exchange rate moved in line with the bilateral euro-dollar exchange rate. The euro's appreciation against the dollar in early-2004 was only short-lived and in fact it was to a large extent reversed between mid-February and May. Following a period of substantial fluctuations, the upward trend in the euro-dollar exchange rate resumed and continued throughout most of 2004. The appreciation was especially sharp between October and December 2004, in the context of very high energy prices and renewed concern regarding the US trade deficit. The appreciation of the euro's effective exchange rate was less significant though, in part because the euro appreciated much less against the yen and the pound than it did against the dollar.

Since January 2005, the dollar has regained some of its earlier losses; on 28 April 2005, the euro stood at USD 1.31. The nominal effective exchange rate of the euro declined by 2.7% between January and April 2005.

It is also worth noting that six new Member States (Estonia, Lithuania, Slovenia, Malta, Cyprus and Latvia) have entered ERM II since the enlargement of the European Union on May 1, 2004.

1.1.5 Consumer prices

Euro area HICP inflation averaged 2.1% in 2004, unchanged compared to the previous year. Unexpected oil price hikes, further increases in indirect taxes (mainly on tobacco) and administered prices (mainly health-related services) had an inflationary impact on consumer prices. By contrast, the appreciation of the euro, subdued demand conditions and the decline in the annual growth rate of unprocessed food prices - due to the favourable meteorological conditions - offset these inflationary pressures in 2004.

The average inflation could be slightly above 2% in 2004. Its precise pattern will depend, to a large extent, on oil price developments. At the current juncture, there is no evidence suggesting that domestic inflationary pressures are building up in the euro area.

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

	2002	2003	2004	2004 Jan.	2004 Feb.	2004 March	2004 Apr.	2004 May	2004 June	2004 July	2004 Aug.	2004 Sept.	2004 Oct.	2004 Nov.	2004 Dec.	2005 Jan.	2005 Feb.	2005 March
Overall HICP of which:	2.3	2.1	2.1	1.9	1.6	1.7	2.0	2.5	2.4	2.3	2.3	2.1	2.4	2.2	2.4	1.9	2.1	2.1
Goods	1.7	1.8	1.8	1.3	1.0	1.1	1.8	2.4	2.2	2.1	2.1	1.8	2.2	2.0	2.0	1.6	1.8	1.9
Food	3.1	2.8	2.3	3.1	2.7	3.1	2.9	3.1	2.8	2.6	2.1	1.4	1.2	1.0	2.0	1.5	1.9	1.5
- Unprocessed food	3.1	2.1	0.6	2.9	1.9	1.7	1.6	1.7	1.2	0.7	-0.2	-1.5	-1.2	-1.0	0.0	-0.6	0.7	1.3
- Processed food	3.1	3.3	3.4	3.3	3.2	4.1	3.9	3.9	3.8	3.8	3.6	3.3	2.8	2.3	3.2	2.8	2.6	1.6
Industrial goods	1.0	1.2	1.6	0.4	0.2	0.1	1.2	2.1	2.0	1.8	2.1	2.0	2.7	2.5	2.0	1.7	1.8	2.1
- Non-energy industrial goods	1.5	0.8	0.8	0.6	0.8	0.7	1.0	0.9	0.9	0.7	0.9	0.8	0.8	0.8	0.8	0.5	0.2	0.4
- Energy	-0.6	3.0	4.5	-0.4	-2.2	-2.0	2.0	6.7	5.9	5.9	6.5	6.4	9.8	8.7	6.9	6.2	7.7	8.8
Services	3.1	2.5	2.6	2.5	2.6	2.5	2.5	2.6	2.6	2.7	2.7	2.6	2.6	2.7	2.7	2.4	2.4	2.5
HICP excluding unprocessed food and energy	2.5	2.0	2.1	1.9	2.0	2.1	2.1	2.1	2.2	2.1	2.2	2.0	2.0	1.9	2.1	1.7	1.6	1.6

Source: Eurostat

1.1.6 Output, demand and labour market developments

The recovery of economic activity in the euro area observable from the second half of 2003 continued in 2004. According to first estimates, real GDP as a whole increased by 1.8% in 2004, following a less significant increase of 0.5% in 2003. The recovery was largely driven by export growth, whereas the contribution of final domestic demand to GDP growth has been relatively modest. However, it should be noted that high oil prices and exchange rate developments weighed on growth during the second half of 2004.

Labour market conditions remained broadly unchanged in the euro area in 2004, although signs of a gradual improvement appeared. Employment growth was only moderate in 2004 (0.5%), after remaining relatively stable in 2003 (0.2%). The standardised unemployment rate in the euro area stabilised at 8.8% in 2004, reflecting the usual lags in cyclical developments in the labour market relative to economic activity.

1.1.7 External trade

Driven by strong international demand, the euro area exports increased to EUR 1 149 billion in 2004, i.e. an 8.5% rise compared with 2003 levels. Imports of goods also increased strongly (8.7%) reaching EUR 1 075 billion in 2004. As a result, the euro area trade surplus rose to EUR 73.7 billion in 2004 from 69.7 billion in 2003.

Developments in trade can be better explained by breaking down the values of exports and imports into price and volume indexes. The rise in the value of exports was entirely accounted for by the volume growth of exports as export prices fell slightly. Regarding the increase in the value of import goods, this reflected rises in both volume and price. The higher prices of oil and raw materials explained most of the rise in import prices. In 2004 as a whole, the geographical allocation of trade shows that the euro area registered the biggest surplus with the United Kingdom (EUR 62 billion), followed by the United States (EUR 60 billion) and Switzerland (EUR 13 billion). Trade deficits were recorded with China (EUR 52 billion), Japan (EUR 20.6 billion), Russia (EUR 20.5 billion), Norway (18.5 billion) and OPEC members (EUR 12.6 billion).

1.1.8 Balance of payments

In 2004, the euro area current account surplus amounted to EUR 42.3 billion compared with a surplus of EUR 21.8 billion in 2003. This almost twofold increase was the result of a drop in income and in the current transfers deficits. While services contributed slightly to the rise of the current account surplus, the goods surplus remained stable, as exports and imports of goods increased in the same proportions.

Developments in the financial account were characterised by net outflows amounting to EUR 4.5 billion in 2004 as a whole compared with EUR 18 billion in 2003. Driven by the stronger growth outlook for the rest of the world in 2004, net outflows in direct investments increased massively (EUR 38 billion). These net outflows were however offset by net inflows in portfolio investments as a result of net purchases of euro area equity securities and bonds by non-resident investors.

1.2 Economic situation in Luxembourg

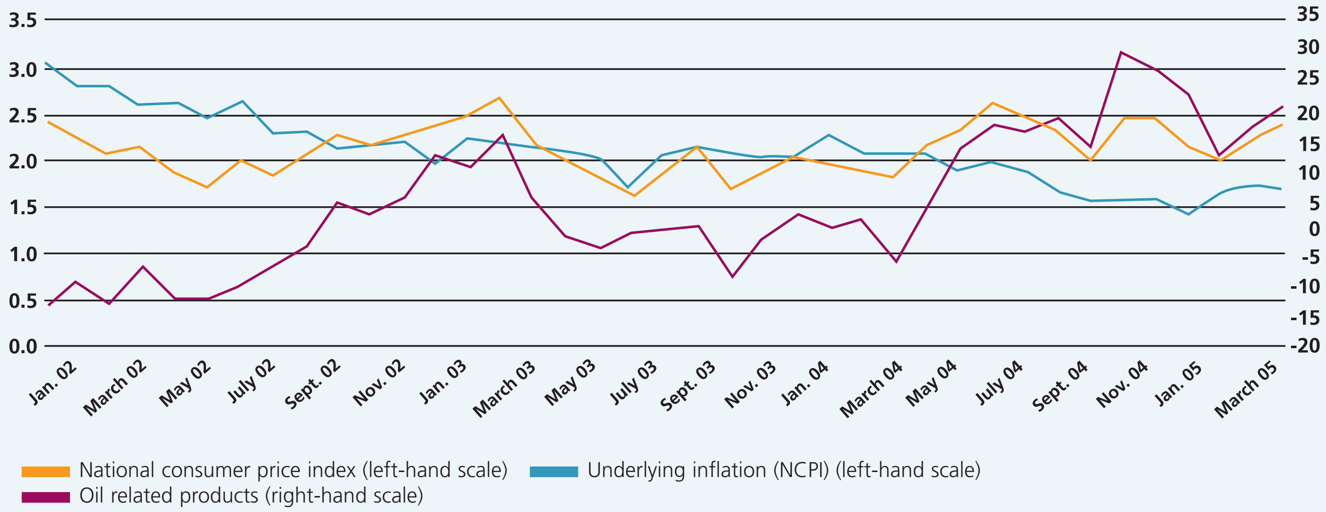
1.2.1 Prices and costs

1.2.1.1 Consumer prices

HICP inflation in Luxembourg averaged 3.2% in 2004, substantially up from 2.5% in 2003, while the national consumer price index was at 2.2%, which represents an increase of 0.2 percentage point compared to the previous year.

This rise in overall inflation reflected to a large extent the sharp oil price hike which was somewhat moderated by the appreciation of the euro. In contrast, the easing of underlying inflationary pressures, which started in 2002, continued in 2004.

GRAPH 5: INFLATION AND OIL RELATED PRODUCTS (ANNUAL PERCENTAGE CHANGE)



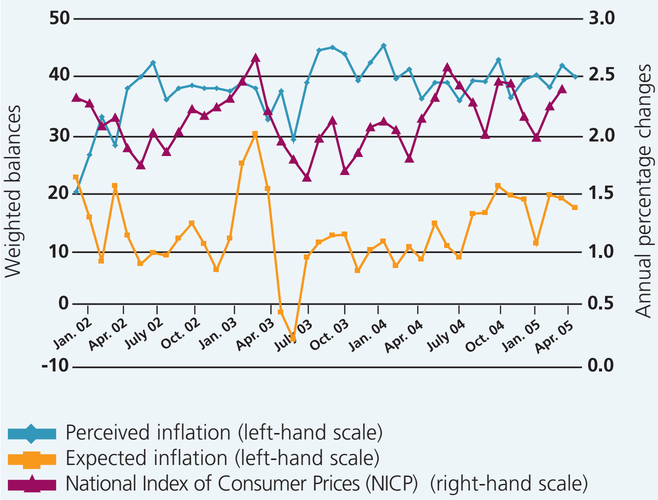
Source: STATEC

The annual growth rate of the services component moderated compared to 2003, while remaining high at 2.7% on average. The direct impact of the fiscal policy on the NICP was 0.5 percentage point in 2004.

The inflation differentials between Luxembourg and the euro area and between Luxembourg and its neighbouring countries worsened in 2004 as far as the overall HICP was concerned. By contrast, the differential for the HICP excluding energy and unprocessed food improved in the same year, while remaining unfavourable to Luxembourg.

On the one hand, expected inflation remained remarkably stable in the course of 2004, while measured inflation reflected the high volatility of oil product prices. At the same time, consumers' inflation expectations for the next 12 months increased sharply during the first half of 2004 before stabilising at a high level.

GRAPH 6: PERCEIVED, EXPECTED AND ACTUAL INFLATION



Source: BCL

Inflation projections

Projection Assumptions

The underlying assumptions for the HICP energy projections follow the traditional scheme, i.e. a constant euro/dollar exchange rate over the forecast horizon and a pattern of oil prices as observed on the futures markets. At the end of May 2005, the quote for one euro against the dollar stood at 1.29, which corresponds to an appreciation with respect to the average of 2004 and is unchanged compared to the assumptions of the previous exercise. The price of oil fluctuated around the 53$/bl level and the markets were only anticipating a marginal fall to a level close to 50$/bl in June 2006, a significant upward revision compared to the previous exercise. Detailed assumptions are given in the following table.

TABLE 2: ASSUMPTIONS UNDERLYING THE INFLATION PROJECTIONS

	2003	2004	2005	05-Q1	05-Q2	05-Q3	05-Q4	06-Q1	06-Q2
Price of oil in $/bl	28.9	38.3	50.6	47.7	51.7	51.4	51.7	51.3	50.9
Exchange rate $/€	1.13	1.24	1.29	1.31	1.29	1.29	1.29	1.29	1.29
Price of oil in euro (in annual percentage changes)	-2.8	20.7	26.9	42.1	36.3	17.4	16.9	9.9	-1.3

Source: BCL

The government has increased the level of excise duties on diesel by 12.5€/1 000l from 1st January 2005 onwards. Simultaneously, the VAT rate on fuel was adjusted from 12% to 15%. According to our estimates, the additional impact of the two fiscal measures on the HICP corresponds to 0.2pp in 2005.

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. Despite the expected gradual improvement in economic activity in the euro area, imported inflation should remain muted, reflecting a significantly negative output gap. In addition, the euro's recent stabilisation against the dollar should not yield strong upward price pressure.

Furthermore, despite the hike in oil prices, wage developments have so far remained contained at the euro area level, favouring thereby a gradual deceleration of the HICP excluding energy. Nevertheless, domestic inflation may decelerate only very slowly. The risk of second round effects from the persistently high oil prices are indeed higher because of the automatic wage indexation scheme.

The VAT rate on tobacco was adjusted from 12% to 15% from 1st May onwards.

Projection Results

On the basis of the euro oil price assumptions, the energy component would evolve rather unfavourably over the forecast horizon, and especially in the short term. The projections for the HICP excluding energy have become slightly more positive since the Autumn 2004 exercise but, overall, inflation rates remain relatively high compared to neighbouring countries. Headline inflation should decelerate over the projection horizon, and the NICP is expected to fall close to 2% by the end of the year 2005.

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

	2003	2004	2005	2005-1st half	2005-2nd half	2006-1st half
NICP	2.1	2.1	2.2 (+0.1)	2.3 (-)	2.2 (+0.3)	2.1
HICP	2.6	3.2	3.5 (+0.5)	3.6 (+0.1)	3.4 (+0.9)	2.6
HICP energy	1.2	11.8	9.5 (+5.4)	12.3 (+3.4)	6.8 (+7.1)	1.2
HICP ex energy	2.7	2.5	2.7 (-0.2)	2.6 (-0.4)	2.9 (+0.1)	2.7
Impact of government measures[1] on the NICP, in pp	0.4	0.5	0.5 (-)	-	-	-
Impact of government measures on the HICP, in pp	1.0	1.5	1.7 (+0.2)	-	-	-

[1] Impact of administered prices, indirect taxation and tobacco. For further details, please see BCL Bulletin 2004/3, pp.76-81.
Source: BCL

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

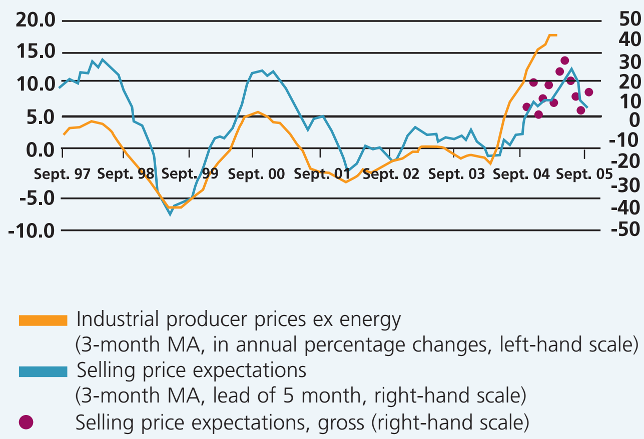
	Shares	2003	2004	04-Q1	04-Q2	04-Q3	04-Q4	05-Q1
Total	1000	1.2	9.0	0.7	7.5	3.8	3.0	1.1
Intermediate goods	675.9	0.8	12.8	1.1	10.4	4.9	4.2	0.9
Capital goods	109.9	0.7	5.6	1.4	2.1	1.4	3.0	1.8
Consumer goods	136.3	1.7	0.0	-0.8	1.2	0.3	-0.1	-0.1
Energy	77.9	4.6	5.6	4.0	2.1	3.1	2.6	2.1

Source: STATEC, BCL

1.2.1.2 Producer prices in industry

Spurred on by strong price dynamics in the steel sector, industrial producer prices increased at an exceptionally fast pace in 2004. The increase of 9% was the highest recorded over the last 15 years and was well above the rate observed at the euro area level. While the cyclical situation in the euro area hardly favoured such positive developments, the reasons for the increase are probably twofold. On the one hand the increase is probably partly cost-driven as the oil price increased on average by 33% in 2004 compared to 2003. Furthermore, it is likely that the global economic expansion has favoured a scenario where companies can pass the increase in costs on to their customers. So far, however, the overall price increase remains confined to intermediate and capital goods. Consumer goods are mostly sold in nearby markets. The fact that their prices stagnated in 2004 could therefore be due to the much more muted demand on these markets.

GRAPH 7: INDUSTRIAL PRODUCER PRICES, PAST AND EXPECTED DEVELOPMENTS



Source: Eurostat, BCL

The outlook for industrial producer prices has become slightly less favourable in recent months. While inflation is expected to decelerate in 2005, industrial producer prices should still increase by around 5% (in annual percentage changes) according to the results of the harmonised business surveys (see figure).

1.2.1.3 Construction prices

Prices of construction services increased by 2.9% in 2004, at an accelerated pace compared to 2003 and at a slightly higher level than the national index of consumer prices. While the contribution of the automatic wage indexation to the nominal wage increase remained unchanged in 2004 compared to 2003, the relatively strong house price dynamics probably reflected the still dynamic demand in the building branch.

1.2.2 Sectorial developments

1.2.2.1 Industry

In 2004, the world economy expanded at the fastest pace of the past 20 years. The euro area economy was characterised by an acceleration in economic activity compared to the previous year.

On the back of these very favourable external conditions, industrial production in Luxembourg increased by 7.8%, its highest growth rate in recent years. A higher level of production, combined with the strong rise in prices implied an exceptional increase in turnover in 2004 with respect to 2003. However, the adjustment process on the cost side continued as companies laid off staff and real wages barely changed.

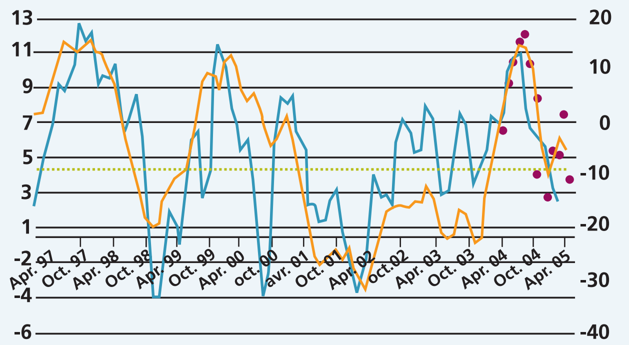
TABLE 5: INDICATORS FOR THE INDUSTRIAL SECTOR (IN ANNUAL PERCENTAGE CHANGES)

	2003	2004	T1-04	T2-04	T3-04	T4-04
Production - whole industry	5.0	7.8	7.3	10.2	7.9	5.9
Production - whole industry ex steel	6.5	8.5	7.6	10.7	8.9	7.0
Employees	-0.9	-0.6	-0.6	-0.4	-0.7	-0.7
Wage costs	1.8	1.9	2.9	3.2	1.4	0.1
Hours worked	-0.2	0.3	1.4	0.5	0.4	-1.2
Turnover	3.2	20.5	15.1	22.7	23.3	21.2
Order books	-0.1	14.2	4.3	17.0	21.1	16.2

Source: STATEC, BCL

Business confidence tracked relatively closely the industrial production cycle. It peaked in August 2004 and then embarked on a continuous downward trend until the end of the year. At the beginning of 2005, business confidence stabilised at a level consistent with trend growth.

GRAPH 8: CONFIDENCE INDICATORS AND INDUSTRIAL PRODUCTION



Industrial production per working day, 3-month MA annual percentage changes (left-hand scale)
Industrial confidence indicator, 3-month MA (right-hand scale)
Confidence indicator, gross (right-hand scale)
Industrial confidence indicator, average 96-03 (right-hand scale)

Source: STATEC, BCL

1.2.2.2 Construction

The construction sector saw a decline of its activities in 2004 compared to the previous year. Production and turnover decreased by 1% and 0.2%, respectively. However, the headline figures mask heterogeneous developments in the different branches. Demand for civil engineering slowed significantly as some large projects had been completed in 2003 and were not replaced by new work of a similar order of magnitude. The building branch benefited from the shortage of dwellings and the still buoyant housing demand. Building permits are up sharply and financing conditions remain very favourable precluding a continuation of the short-term dynamics into 2005.

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

	2003	2004	T1-04	T2-04	T3-04	T4-04	T1-05
Turnover - Total	6.7	-0.2	11.7	-2.7	-0.6	-5.8	Na
Production per working day - Total	0.8	-1.0	1.7	1.4	-1.0	-6	Na
Production per working day - Building	0.6	3.0	5.5	4.0	3.5	-0.5	Na
Production per working day - Civil engineering	2.6	-13.6	-3.2	-12.5	-15.1	-22	Na
Building permits[1]	11.5	18.2	9.8	-5.6	124.8	-17.6	Na
Loans for house purchases[2]	24.6	5.7	6.7	6.3	10.7	0.6	Na
Mortgage rates[3]	3.8	3.4	3.4	3.4	3.4	3.4	3.4

[1] *Number of dwellings.*
[2] *Total of mortgage loans to residents.*
[2] *Break in series since the beginning of 2003.*

Source: STATEC, BCL

TABLE 7: TURNOVER AND CAR REGISTRATIONS (IN ANNUAL PERCENTAGE CHANGES)

	2003	2004	T1-04	T2-04	T3-04	T4-04	T1-05
Car registrations	0.2	10.0	6.5	14.4	5.4	13.8	4.8
Wholesale trade	11.1	12.3	11.7	12.8	13.5	11.2	Na
Retail trade	5.5	3.1	2.8	3.1	3.5	3.1	Na
Hotels and restaurants	-4.6	-0.9	2.1	-1.5	-2.4	-1.3	Na

Source: STATEC, BCL

1.2.2.3 Commerce and other sectors

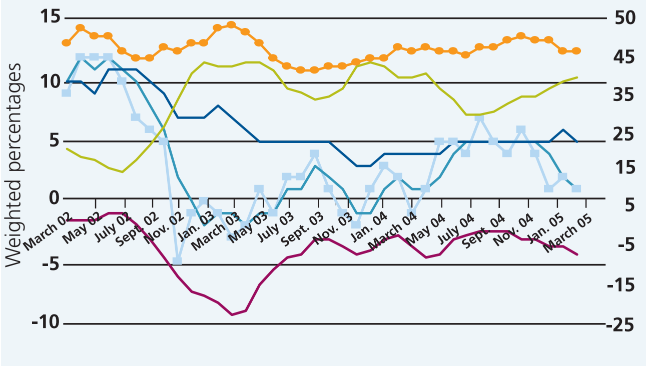
The overall acceleration in economic activity also had its repercussions on the trade sectors. Turnover in the retail sector might only have increased by 3.1%, but new car registrations saw a record year in 2004 with a 10% increase compared to 2003. However, turnover in the hotel and restaurant branch stabilised, probably reflecting some latent weakness in tourism activities.

1.2.3 Economic activity

Consumer survey on cyclical conditions

The three-month moving average of the consumer confidence indicator did not follow a clear trend in the first half of 2004, before stabilising at a higher level in the second half of the year. The rebound in the indicator toward mid-2004 was driven by more optimism with respect to the economic situation and unemployment. However, the indicator's value of 5 observed between August and December 2004 remains weak if compared to the levels recorded in the first half of 2002.

GRAPH 9: THE CONSUMER CONFIDENCE INDICATOR AND ITS COMPONENTS (THREE-MONTH MOVING AVERAGES UNLESS OTHERWISE INDICATED)



Confidence indicator original series (left-hand scale)
Confidence indicator (left-hand scale)
Financial situation (left-hand scale)
Economic situation (right-hand scale)
Unemployment (right-hand scale)
Ability to save (right-hand scale)

Source: BCL

Turning to developments in consumer confidence in the beginning of 2005, the three-month moving average of the confidence indicator progressively declined to 1 in April. This worsening reflected deteriorations in three of the confidence indicator's components, namely the expectations with respect to the general economic situation, unemployment and the ability to save.

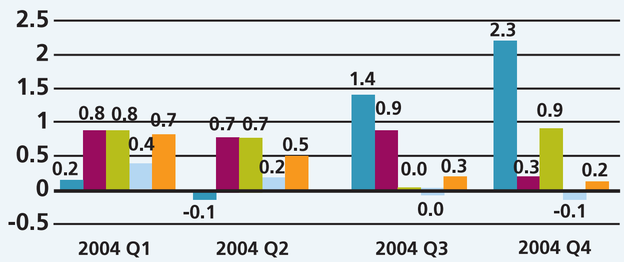
Economic activity in 2004

In 2004, the economic recovery of Luxembourg was confirmed. Real GDP growth amounted to 4.5% in 2004, following an increase of 2.9% in 2003. The recovery was essentially export-led; exports were up 6.4% compared to 2003, while domestic demand was less dynamic than the year before.

As regards the domestic side, year-on-year growth of private consumption remained relatively moderate in 2004 (1.4% after 1.6% in 2003), reflecting developments in unemployment and the impact of oil prices on purchasing power. Gross capital formation decreased significantly during 2004, reflecting its volatile nature (-1.8% after 3.6% in 2003).

Benefiting from the strong expansion of international economic activity, exports and imports increased by 8.2% and 6.8% respectively in 2004; growth was, respectively, around 6 and 5 percentage points higher than in 2003. Thus, the contribution from net exports to real GDP growth in 2004 was higher than 2003.

GRAPH 10: REAL GDP GROWTH IN LUXEMBOURG, IN THE EURO AREA AND IN THE BORDERING COUNTRIES



Luxembourg
Belgium
France
Germany
Euro area

Source: STATEC, Eurostat

TABLE 8: REAL GDP GROWTH, ITS COMPONENTS AND CONTRIBUTIONS TO REAL GDP GROWTH

	Annual growth rate at constant prices			Contributions (in p.p.) to real GDP growth		
	2002	2003	2004	2002	2003	2004
Households and NPISHs final consumption expenditure	3.2	1.6	1.4	1.3	0.7	0.6
Final consumption expenditure of general government	3.2	5.0	6.0	0.5	0.9	1.1
Gross capital formation	-8.4	3.6	-1.8	-2.0	0.8	-0.4
Domestic demand (excluding changes in inventories)	-0.2	2.9	1.6	-0.1	2.3	1.3
Exports of goods and services	-0.6	1.8	8.2	-0.9	2.6	11.3
Imports of goods and services	-2.6	1.6	6.8	3.5	-2.0	-8.1
Net exports	18.4	3.4	19.2	2.6	0.6	3.2
Gross domestic product	**2.5**	**2.9**	**4.5**			

Source: STATEC

Potential growth in Luxembourg

This box provides an update of the output gap estimates published in the 2003 BCL annual report. Combining the output gap with the observed level of GDP, one may estimate the level of potential output each year and thus potential growth. Several alternative methods are applied to estimate the output gap[1], thus evaluating the degree of divergence across results, which provides an initial estimate of the level of uncertainty that affects them. The sample includes annual observations from 1980 to 2004 and is extended to 2007 using the latest BCL projections. To take account of the important role of cross-border employment in Luxembourg, the unemployment measure used by the Apel-Jansson and production function methods is the regional unemployment rate.

The following table presents the different output gap estimates (expressed as a percentage of GDP) in the upper panel. In this part, the first column indicates the observed (or projected) level of GDP in 1995 prices. In the middle panel, the table reports the revisions to the output gap estimates published in the 2003 BCL annual report. In the middle panel, the first column indicates the revisions to observed or projected GDP compared with data available in 2004. Finally, the lower panel of the table presents the estimated rate of potential growth each year according to the different methods of estimating the output gap. In this lower panel, the first column reports the real growth GDP rate. The last two lines in the table indicate average potential growth since 1981 and since 2001 for each method.

[1] See BCL working paper n°4 for a description of the different methods.

TABLE 9: ESTIMATED OUTPUT GAPS AND POTENTIAL GROWTH

	Real GDP (mia EUR)	Linear trend	Hodrick-Prescott	Harvey-Jaeger	Kuttner	Apel-Jansson	Production/Function
		Output gap estimates					
2001	18.87	3.7%	2.7%	3.9%	3.1%	3.0%	1.7%
2002	19.34	1.1%	0.7%	2.4%	2.4%	1.8%	-0.3%
2003	19.90	-1.1%	-0.7%	0.5%	1.0%	0.1%	-1.2%
2004	20.72	-1.7%	-0.5%	-0.7%	-0.6%	-1.1%	-0.4%
2005	21.53	-3.1%	-0.9%	-2.5%	-1.9%	-2.4%	-0.5%
2006	22.37	-4.2%	-1.1%	-3.8%	-2.6%	-2.9%	-0.5%
2007	23.24	-5.3%	-1.2%	-4.4%	-2.6%	-2.8%	-0.5%
	Revisions	**Revisions from output gap estimates published in 2004**					
2001	0.3%	-0.3%	-1.3%	0.6%	0.1%	-0.8%	-1.1%
2002	1.2%	0.8%	-0.6%	0.4%	0.5%	-0.1%	-2.3%
2003	1.7%	2.4%	0.6%	0.0%	0.8%	1.1%	0.5%
2004	2.5%	4.8%	2.3%	-0.2%	0.8%	2.7%	1.9%
2005	0.7%	5.6%	2.7%	-1.2%	0.5%	2.9%	1.3%
	Real GDP growth	**Potential growth estimates**					
2001	1.5%	5.2%	5.0%	3.1%	1.3%	3.0%	5.7%
2002	2.5%	5.2%	4.6%	4.1%	3.2%	3.7%	4.5%
2003	2.9%	5.2%	4.4%	4.9%	4.4%	4.7%	3.8%
2004	4.5%	5.2%	4.3%	5.8%	6.3%	5.8%	3.7%
2005	3.5%	5.2%	4.2%	5.5%	5.1%	5.1%	3.8%
2006	3.9%	5.2%	4.1%	5.3%	4.6%	4.4%	4.0%
2007	3.9%	5.2%	4.1%	4.6%	4.0%	3.9%	3.9%
	Average real growth	**Potential growth: average**					
Since 1981	4.8%	5.2%	4.8%	5.1%	4.9%	5.1%	5.0%
Since 2001	3.2%	5.2%	4.4%	4.8%	4.1%	4.4%	4.2%

Source: STATEC, BCL calculations

Comparing actual growth in the first column to the potential growth estimates, two methods (Hodrick-Prescott filter and production function approach) find that actual growth in 2004 already exceeded potential growth. However, in 2005 actual growth projected will fall below potential growth according to both these methods. It is only in 2006 and 2007, when actual growth nears 4% that it returns to potential growth. In fact, at the end of the sample, projected growth converges with potential growth according to all the methods except two (linear trend and Harvey-Jaeger).

Estimates of the output gap and potential output are subject to significant uncertainty, as illustrated by the size of revisions. However, these estimates can help position the national economy in its business cycle, along with an analysis of other economic indicators. The results presented here confirm that the level of GDP is currently below potential output and that growth in 2005 will probably remain below potential growth.

1.2.4 Financial sector

1.2.4.1 Profit and loss accounts of credit institutions

Despite the slight recovery of global financial markets and the world-wide economic up-swing, aggregated gross revenue before taxes and provisions for Luxembourg's credit institutions fell to 3 909 million euro in 2004. This represents a decrease of 6.8% or 284 million euro, compared with 2003. Global expenses (staff costs and other costs) rose by 3.3% during 2004. This increase in staff costs is due to a rise in wages and, in contrast to previous years, to new job creations.

First quarter 2005 total gross income increased by 3.5% compared to the corresponding period of 2004 and reached 1 985 million euro. This, combined with strict cost controls of, raised aggregated gross revenue before taxes and provisions to 1 085 million euro, resulting in an increase of 5.3% compared to the first quarter of 2004.

Net interest income in the first quarter of 2005 (934 million euro) declined by 2.8% compared with the first quarter of 2004 due to low interest rates. However, during the same period net income earned on commissions increased by 4.9% to 771 million euro relative to the first quarter of 2004.

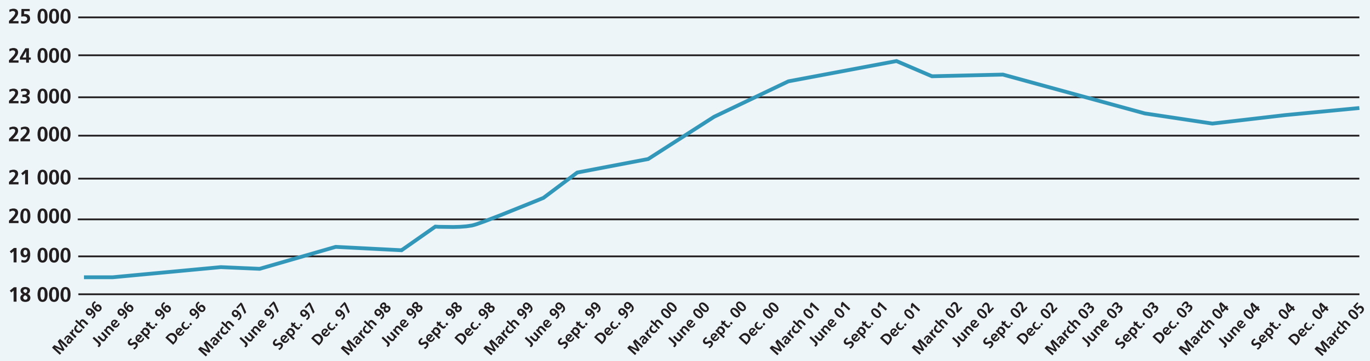
Global expenses (staff costs and other costs) rose by 2.5% during the first quarter of 2005 in comparison with the first quarter of 2004. This is due to the creation of new jobs and a rise in wages resulting from an index tranche which became effective from October 2004.

1.2.4.2 Employment in the financial sector

The collapse of stock markets during early 2001 and the subsequent economic slowdown strongly affected the activity of credit institutions in Luxembourg, which traditionally focuses on private banking. Confronted with a decrease in revenues due to lower demand for their services, credit institutions implemented payroll and operating cost reduction programs. As a result, employment in the financial sector decreased by 2.5% (594 positions) in 2002. A stronger contraction was observed in 2003 with employment reduction of 3.4% (787 positions).

The improving economic outlook and rising stock markets brought customers back to financial investments in early 2004. This allowed for the creation of new positions during early 2004 and this trend became even more pronounced in 2005. The number of positions at credit institutions grew by a quarterly average of 52 during 2004, and by 162 during the first three months of 2005. Between March 31, 2004 and 2005, the number of positions at credit institutions increased by 319 (+1.4%) to 22 711. Nonetheless, a turnaround of economic conditions cannot be ruled out and one should bear in mind that 1 183 positions were lost between end 2001 and March 2005 (-4,9%) in the financial sector.

GRAPH 11: EMPLOYMENT EVOLUTION, MARCH 1996 TILL MARCH 2003



Source: BCL

1.2.5 Labour market

Employment growth accelerated throughout 2004, in line with the lagged response of employment to economic activity, rising by 2.6% in 2004 after an increase of 1.8% in 2003.

The inflow of non-resident labour has continued to account for the largest part of employment growth. Cross-border commuters represent nearly 67.7% of newly created jobs. This share is smaller than the previous year's figure. In 2004, the share of cross-border commuters in total domestic employment reached more than one third (37.1% of the annual average); 51.9% of all cross-border workers come from France, 27.2% from Belgium and 20.9% from Germany.

Despite the recovery in employment growth, the unemployment rate continued to increase further throughout 2004 (4.2% after 3.7% in 2003). This evolution shows that annual GDP growth has been insufficient to stabilise the unemployment rate.

Wages and social benefits increased automatically by 2.5% in October 2004 due to their peg to consumer prices. This raised labour costs in the last quarter 2004.

Okun's law revisited: What output growth is required in order to stabilise unemployment?

Although the recovery observable in Luxembourg from 2002 was confirmed in 2004, the unemployment rate has increased throughout this period (from 2.9% in 2002 to 4.2% in 2004). This evolution seems to reveal a period of economic contradiction. Theory usually suggests that there is a negative relation between output and unemployment rates. Okun's law describes this link between unemployment rates and output and is usually readily accepted as an obvious empirical regularity that does not require formal hypothesis testing. The purpose of this box is to investigate the nature of this relation and to derive the output growth that is necessary to stabilize the unemployment rate in Luxembourg.

To estimate this relationship over the period 1985-2004 using annual data, we consider the following variant of Okun's law describing the relation in first differences between the unemployment rate (annual growth) and output (logarithm). The econometric estimation of this relationship does indeed suggest including up to one lag of GDP growth in the explanation of the current annual change in unemployment rate.

$$\Delta U_t = a_1 + a_2 \Delta Y_t + a_3 \Delta Y_{t-1} + \varepsilon_t$$

Where $\Delta U_t = U_t - U_{t-1}$ denotes the first difference of the annual growth of unemployment

and $\Delta Y_t = log(Y_t) - log(Y_{t-1})$ is a measure of the first difference of output

a_1, a_2 and a_3 : are the estimated coefficients of the regression.

And ε_t : is the error term.

The following table describes the estimation results of Okun's law for Luxembourg[2], the European Union, the Euro Area and the neighbouring countries.

TABLE 10: THE LAGGED REACTION OF UNEMPLOYMENT TO OUTPUT GROWTH

	Luxembourg	European Union (UE15)	Euro Area (12 countries)	France	Germany	Belgium
a_1	0.771** (5.870)	1.060** (8.200)	1.108** (6.634)	1.042** (5.426)	1.206** (5.845)	1.611** (8.269)
a_2	-0.059** (3.896)	-0.332** (7.138)	-0.347** (6.234)	-0.318** (4.746)	-0.512** (6.629)	-0.415** (7.996)
a_3	-0.059** (3.240)	-0.265** (10.564)	-0.290** (8.515)	-0.175** (3.164)	-0.271** (3.579)	-0.365** (5.802)
R-squared	0.629	0.950	0.942	0.725	0.845	0.850
Adjusted R-squared	0.579	0.937	0.927	0.688	0.810	0.831
F-statistic	12.703**	76.237**	64.457**	19.726**	24.489**	42.753**
Durbin-Watson-statistic	1.9	1.6	1.2	1.3	1.6	1.6
$-a_1/(a_2+a_3)$	6.5	1.8	1.7	2.1	1.5	2.1
Confidence interval of $-a_1/(a_2+a_3)$	[5.7; 7.3]	[1.6; 1.9]	[1.5; 1.9]	[1.6; 2.6]	[1.3; 1.8]	[1.8; 2.3]

(·): t-statistic with Newey-West correction

*: the estimated coefficient is different from zero at (approximately) the 5% significance level

**: the estimated coefficient is different from zero at (approximately) the 1% significance level

Source: ADEM, STATEC, Eurostat and BCL's estimations

[2] The unemployment rate corresponds to the "strict" domestic definition.

a_1 represents the autonomous growth in unemployment independent from output fluctuations.

a_2 and a_3 characterize the transmission of cyclical fluctuations in output to cyclical variations in the unemployment rate.

The results suggest that the estimated coefficients are significant (t-statistic with Newey-West correction) for all geo-political entities.

When proceeding with the hypothesis: $0 = \Delta(U_t) = a_1 + a_2\,\Delta(Y_t) + a_3\,\Delta(Y_{t-1})$, it is possible to calculate the output growth required in order to stabilise the unemployment rate: $\Delta(Y_t) = \Delta(Y_{t-1}) = -a_1/(a_2 + a_3)$ assuming that the actual and past output growth accrued. As a result, the output growth required to stabilise the unemployment rate in Luxembourg is 6.5%. The confidence interval calculated with the Delta method shows that the average output growth observed from 1985 to 2004 is outside the calculated interval [5.7; 7.3]. Hence, the unemployment rate in Luxembourg can only be partially explained by Okun's law.

Moreover, it is worth noting that the regression adjustment as measured by the R-squared is lower for Luxembourg than for other geo-political entities. In addition, the confidence intervals for the other geo-political entities are narrower than in Luxembourg. One explanation for this could be the atypical labour market structure in Luxembourg. The fact that a large number of cross-border workers contribute to output without appearing in the unemployment statistics might weaken the relation between output and unemployment in Luxembourg.

TABLE 11: DISTRIBUTION OF OBSERVATIONS

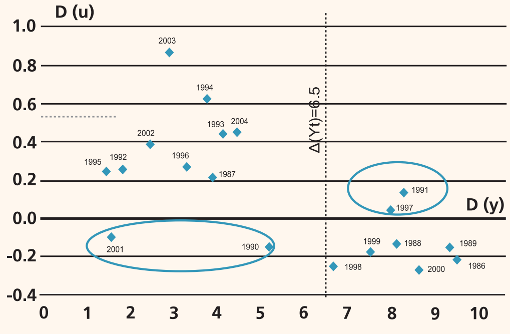
	$\Delta Y > \frac{-a_1}{a_2 + a_3}$	$\Delta Y < \frac{-a_1}{a_2 + a_3}$
$\Delta U > 0$	2	9
$\Delta U < 0$	6	2

Source: ADEM, STATEC and BCL

Observations are in most cases (78.9%) located on the diagonal, which means that they are compliant with Okun's law. But it should be noted that output growth above the value estimated by the ratio $-a_1/(a_2+a_3)$ is neither necessary nor sufficient to reduce the unemployment rate. It is indeed not necessary because in 1990 and 2001, the unemployment rate decreased even though output growth was below the estimated ratio. And it is not sufficient because in 1991 and 1997, the unemployment rate increased even though output growth exceeded the estimated ratio.

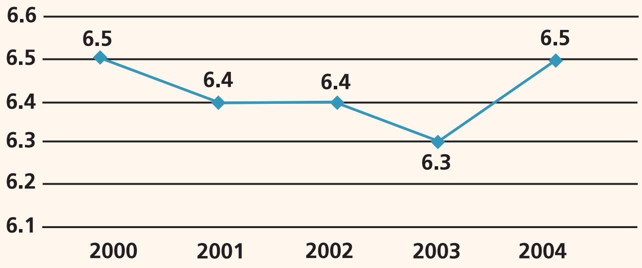
In order to explain the potentially growing impact of cross-border workers on the link between unemployment and growth, it would be appropriate to re-estimate the relation using a rolling regression. This approach consists in re-estimating the equation with a given number of observations while shifting the sample period by one year for each estimation. Results are presented on a chart describing the growth rate of annual GDP necessary to stabilise unemployment for each subperiod of 16 years ending at the indicated date on abscissa. The number of observations contained in the sample period is, of course, relatively small; this is due to data availability constraints with the SEC 95 version of the Luxembourg national accounts.

GRAPH 12: UNEMPLOYMENT AND GDP GROWTH N LUXEMBOURG



Source: ADEM, STATEC and BCL

GRAPH 13: ROLLING REGRESSION RESULTS FOR OKUN'S LAW IN LUXEMBOURG



Source: ADEM, STATEC and BCL

The estimates show a relative constancy of the GDP growth rate necessary to stabilise the unemployment rate. Considering the confidence intervals, differences between the results are not statistically significant. As a consequence, it is not possible to confirm the growing impact of cross-border workers on Okun's law in Luxembourg. The equation needs to be re-estimated using the newly published quarterly national accounts for Luxembourg.

1.2.6 External trade

After two consecutive years of decline, Luxembourg's external trade strongly recovered in 2004. The exports of goods rose by 10.4% reaching 9.7 billion euro. However, as the import of goods also increased strongly (10.8%), the trade deficit stood at 3.6 billion euro in 2004, i.e. a 11.7% rise if compared with 2003. The rise in imports of goods was driven by higher prices of oil and raw material as well as by the purchase of some aircraft. The growth of exports in 2004 resulted largely from the steel sector that benefited from higher international demand and prices.

1.2.7 Balance of payments

The Luxembourg current account surplus rose to 2.26 billion euro in 2004, from 1.96 billion euro in 2003. This improvement of 15% was the result of a strong rise (18%) in the services surplus while the goods, the income and the current transfer balances continued to deteriorate. The rise in net services receipts was for the most part driven by favourable developments in the financial sector. The performance of total services also benefited from computer and information services, from freight transport by air as well as from insurance services.

In the financial account, portfolio investments registered higher net inflows that were largely offset by net outflows in other investments and in direct investments to a lesser extent.

1.2.8 Macro-economic projections

In 2004, real GDP growth at 4.5% turned out slightly above our expectations as expressed last autumn. Real wage growth was contained and the profit margin expanded for the second consecutive year after the sharp deterioration in 2002 and 2003. Short-term indicators for the beginning of 2005 provide a mixed picture. Business confidence in the industrial sector dampened in the wake of uncertainty about domestic demand in Europe, itself probably the consequence of the rise in oil prices to around 50$/bl.

Overall, the outlook for the international environment has largely remained unchanged compared to the previous exercise. Only the oil price assumptions have been significantly revised upwards. A deceleration in economic activity would still be expected in 2005 and 2006, hardly a surprise since, in 2004, the world economy expanded at the fastest rate seen in the last 20 years.

However, the dynamism of the world economy has not yet spilled over into more favourable cyclical developments at the euro area level. In June 2005, the Eurosystem revised downwards its real GDP growth projections for 2005, from a range of 1.4% and 2.4% that prevailed in Autumn 2004 to a range of 1.1% and 1.7%. The downward revision stems mostly from the weaker than expected second half of 2004 that entailed a less favourable carry-over effect for 2005. The central scenario of a cyclical rebound in the second half of 2005 remains however intact. As regards the components of GDP, it is mainly the domestic demand, and in particular weak private consumption and private investment that remain below levels that might commonly be expected in the current economic environment.

TABLE 12: PROJECTIONS OF INTERNATIONAL INSTITUTIONS (IN ANNUAL PERCENTAGE CHANGES, RESPECTIVELY IN PERCENTAGE POINTS)

	2004	2005	2006
World trade (EE)	10.7 (+0.6 pp)	8.2 (+0.1 pp)	7.4 (-0.3 pp)
World GDP (EC)	5.0	4.2 (-)	4.1 (-0.1 pp)
Euro area GDP (EC)	2.0	1.6 (-0.4 pp)	2.1 (-0.1 pp)
Euro area GDP (Eurosystem)	1.8	1.1 - 1.7	1.5 - 2.5
World demand for Luxembourg	6.7 (+0.1 pp)	5.1 (-1.7 pp)	6.2 (-0.2 pp)
Oil in $/bl[1]	38.3 (-0.7)	50.6 (+6.2)	50.7 (+9.9)
Exchange rate $/€	1.24 (-)	1.29 (-)	1.29 (-)

[1] Revisions in $/bl

Source: European Central Bank, European Commission

On the back of the euro area weakness, growth in world demand for Luxembourg in 2005 has been sharply revised downwards since Autumn 2004. But an acceleration is still expected for 2006, favouring thereby export-led growth dynamics. Financing conditions in the euro area remain favourable and do not impede the expected rebound.

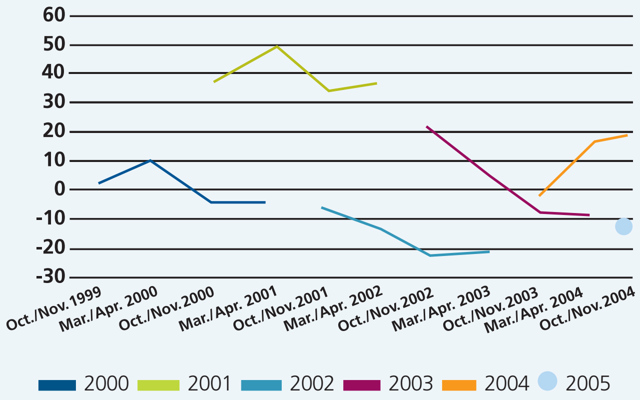
As regards the profile of economic growth in Luxembourg, it is likely that economic growth has decelerated in the first half of 2005. Indeed, the exceptionally strong dynamics in the fourth quarter of 2004, the weak growth performance of several euro area economies, except Germany, and the relatively weaker results of the opinion surveys in the industrial sector in the beginning of 2005 favour this scenario. The technical assumptions favour a rebound in the second half of 2005.

As regards the expenditure components of GDP, growth is mainly driven by the trade components and the impulse from the exports has not yet spilled over into a more vigorous growth of the domestic demand. Indeed, although the fundamentals such as real net wage income for households and balance sheets for companies remain quite solid in Luxembourg, past developments for private consumption and private non-residential investment suggest a relatively cautious consumption and investment behaviour of economic agents.

In light of the traditional determinants, projections for these two components remain also relatively low and our projections do not embody a catch-up effect for foregone consumption and investment. Indeed, the European Commission's bi-annual investment surveys in the industrial sector suggest that companies might have lowered their investment plans in 2005 compared to last year (see chart).

On the basis of this analysis and in the euro area context, it seems appropriate to revise downwards the real GDP growth projections for 2005 to between 3.2% and 3.8%. At the end of 2004, the carry-over effect on annual real GDP growth in 2005 amounts already to 2.2%, highlighting the relatively muted growth profile in the course of 2005. Economic growth is however expected to rebound to around 3.9% in 2006, a scenario in line with the profile of the foreign demand assumptions.

GRAPH 14: 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

TABLE 13: MACRO-ECONOMIC PROJECTIONS AND REVISIONS COMPARED TO AUTUMN 2004 (IN ANNUAL PERCENTAGE CHANGES, RESP. IN PERCENTAGE POINTS)

	Spring 2005				Revisions		
	2003	2004	2005	2006	2004	2005	2006
Real GDP	2.9	4.5	3.2 - 3.8	3.5 - 4.3	0.4	-0.4	-
HICP	2.6	3.2	3.5	2.2	-	0.5	0.5
HICP energy	1.2	11.8	9.5	0.6	-	5.4	3.2
HICP excluding energy	2.7	2.5	2.7	2.4	-	-0.2	0.3
NICP	2.0	2.2	2.2	1.6	-0.1	0.1	-0.3
Compensation per employee	2.1	2.5	3.1	3.3	-0.5	0.3	-0.3
Employees	1.9	2.7	2.5	2.4	0.2	0.1	-
Unemployment rate	3.7	4.2	4.5	4.5	-	0.2	0.3

Source: BCL

As regards wage costs, real wage increases have remained very low in 2004. Most wages are still being negotiated in light of the sharp deterioration of the profit margin that was observed in 2001 and 2002; they are thereby based on relatively cautious behaviour by the involved parties. The minimum wage was adapted by 2.1% in January 2005 and it is assumed that wages in the public sector will not be adjusted in 2005 and 2006. Automatic wage indexation in the context of an oil shock, the rise in unemployment and wage moderation in the neighbouring countries would indeed plead for relatively moderate real wage developments. The profit margin would thereby stabilise in 2005 and increase marginally in 2006 in the wake of the revival in economic growth.

In light of the upward revisions to the oil price, inflation in 2005 should exceed our previous expectations. The NICP is expected at slightly above 2% in 2005 and the timing of the automatic wage indexation has been brought forward to the end of 2005. The more optimistic scenario for 2006 is largely based on the absence of additional fiscal measures, moderate imported inflation and a decreasing profile of the oil price.

The strong employment growth seen in 2004 is unlikely to continue as economic growth decelerates and as the one-off factors related to public sector employment fade away in 2005. Despite the cyclical rebound in 2003 and 2004, there is hardly an impact detectable in the employment measures. In this respect, it is also likely that the narrow unemployment rate will at best stabilise at its current level.

1.2.9 Public finance

1.2.9.1 Central government budgetary policy

The Luxembourg Parliament approved the 2005 central government budget on 9 December 2004. Total expenditure and revenue would both increase by 8% compared to the 2004 budget. As a result, the budget would be in deficit by 0.3% of GDP in both 2004 and 2005. However, the Treasury and Budget Minister announced on 10 May 2005 that the 2004 accounts posted a EUR 71 million surplus due, *inter alia*, to buoyant indirect taxes.

TABLE 14: KEY FIGURES OF THE 2005 CENTRAL GOVERNMENT BUDGET (IN EUR MILLION, UNLESS STATED OTHERWISE)

	2004 budget	2005 budget	Increase in nominal terms
Revenue	**6 392.6**	**6 902.5**	**+8.0%**
Expenditure	**6 476.7**	**6 991.5**	**+7.9%**
Balance	**-84.2**	**-89.0**	**--**
of which current balance	433.0	543.3	--
of which capital balance	-517.2	-632.3	--

Source: 2004 and 2005 budget laws

By contrast, the ESA 95 central government accounts were in deficit by 2.4% of GDP in 2004 according to data released by the national statistical institute STATEC in March (EDP notification) and May ("Note de conjoncture"). This discrepancy is attributable to the fact that Table 14 is confined to the central government *sensu stricto*, irrespective of the expenditures of extra-budgetary funds. Only the much lower transfers from the central government *sensu stricto* to the funds are taken on board in the official presentation synthesised in the table. Below we focus on the more encompassing ESA 95 presentation. In Moreover, all the subsectors of general government (i.e. central government, local governments and social security) are treated as a single consolidated entity in the text below.

1.2.9.2 General government revenue

In spite of dynamic indirect taxes, the revenue-to-GDP ratio declined by nearly 1% of GDP in 2004. This development reflects an even more pronounced decline in business taxes due to a marked deceleration in the collection of tax balances related to previous exercises. Social contributions also decreased as a percentage of GDP due to the underlying developments of the wage bill, whereas lower interest rates and government assets pushed down interest receivables (they are included in the "other revenue" item).

These negative evolutions were counterbalanced to a certain extent by buoyant indirect taxes, owing inter alia to higher prices for oil products, the impact on VAT of the strong activity of electronic commerce companies and tax hikes on tobacco and oil products by 0.3% of GDP in 2004.

TABLE 15: GENERAL GOVERNMENT REVENUE (% OF GDP, UNLESS STATED OTHERWISE)

	STATEC data March 2005						BCL projections spring 2005		
	1999	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Direct taxes	15.7	15.4	15.5	16.0	15.7	13.9	14.0	14.1	14.0
Indirect taxes	14.2	14.6	14.0	13.7	13.8	15.2	15.4	15.2	15.0
Social contributions	11.4	11.2	12.0	12.2	12.4	12.2	12.3	12.3	12.2
Other revenue	4.2	4.1	4.2	4.3	3.9	3.7	3.7	3.6	3.6
Total revenue	**45.5**	**45.3**	**45.7**	**46.2**	**45.8**	**45.0**	**45.4**	**45.2**	**44.8**
Nominal increase in total revenue (%)	***9.3***	***12.9***	***4.5***	***4.8***	***4.0***	***5.3***	***6.3***	***5.6***	***5.2***

Source: IGF, IGSS, STATEC, UCM, 6th update of the Luxembourg stability programme 2003-2007, BCL calculations.

According to the BCL spring 2005 projections, which are based on unchanged policy assumptions, the revenue ratio and its structure will be fairly stable over the 2005-2007 horizon. The ratio would increase in 2005 owing to new discretionary measures, namely higher indirect taxes on oil products and an upward adjustment in healthcare social contributions. However, the ratio would resume its decline in 2006 and 2007. Indirect taxes would be less dynamic than GDP due to the underlying evolution of the tax base (i.e. essentially private consumption) and interest receivable would further decline as a result of eroding general government assets.

Direct taxes would be remarkably steady throughout the projection horizon. The introduction of a withholding tax on the interest income of non-resident households in the aftermath of the EU Savings Directive and the non-indexation of personal income tax brackets will induce additional direct revenue. However, a new deceleration in the collection of business taxes related to previous tax exercises would outweigh these two favourable factors.

1.2.9.3 General government expenditure

The expenditure ratio was once again on the increase in 2004, when it amounted to about 46% of GDP in spite of more sustained GDP growth. Public investments reached a high level despite the negative incidence of a real estate sale, resulting from a methodological change brought about by a decision taken by Eurostat in February 2005 with respect to the statistical treatment of public-private partnerships. Due to this decision, some investment expenditure carried out by private real estate developers are now considered as government investment. The investment expenditure involved reached 0.6% of GDP in 2004.

TABLE 16: GENERAL GOVERNMENT EXPENDITURE (% OF GDP, UNLESS STATED OTHERWISE)

	STATEC data March 2005						BCL projections spring 2005		
	1999	2000	2001	2002	2003	2004	2005	2006	2007
Social transfers	20.1	18.8	20.1	21.4	22.4	22.5	22.7	22.7	22.7
Government investments	4.6	4.0	4.4	5.1	4.9	5.0	5.5	5.6	5.6
Consumption expenditure[1]	11.4	10.8	11.4	11.9	12.2	12.2	12.4	12.3	12.2
Subsidies[2]	1.6	1.7	1.7	1.8	1.8	1.8	1.9	1.9	1.9
Other expenditure[3]	4.4	3.8	1.9	3.8	4.0	4.6	4.3	4.3	4.2
Total expenditure	**42.1**	**39.1**	**39.5**	**44.0**	**45.3**	**46.1**	**46.8**	**46.8**	**46.6**
Nominal increase in total expenditure (%)	***8.7***	***5.4***	***9.8***	***9.8***	***8.3***	***9.0***	***7.0***	***6.1***	***5.7***

[1] Compensation of employees and intermediate consumption.
[2] Disregarding capital transfers.
[3] The expenditure ratio recorded in 2001 was negatively affected by a one-off transaction, namely the sale of a license to the satellite company SES Global. This explains the marked decrease in the "other expenditure" item in 2001. The nominal growth rates displayed in the antepenultimate row of the table have been adjusted by the impact of this transaction, which amounted to 1.9% of 2001 GDP.

Source: IGF, IGSS, STATEC, UCM, 6th update of the Luxembourg stability programme 2003-2007, BCL calculations.

All the expenditure categories displayed in the attached table increased in line with GDP in 2004, except the "Other expenditure" item due to much higher capital transfers (2.0% of GDP compared to 1.5% in 2003). However, capital transfers are usually overestimated in the spring public finance accounts. In order to remedy this bias, it is assumed in the projections that capital transfers expressed as a percentage of GDP will decrease over the 2005-2007 period (from 2.0% in 2004 to 1.7% in 2007). In spite of this assumption and of the dilution effect brought about by a sustained rate of economic growth, the expenditure ratio would exceed 46% of GDP throughout the projection horizon. A high level of public investment and the indexation of private sector pensions to real wages in 2005 and 2007 will indeed outweigh the new measures aimed at curbing health expenditure adopted at the end of 2004. The more expansionary stance of the 2005 central government budget would further magnify the rise in the expenditure ratio compared to its 2004 level.

1.2.9.4 General government net lending or borrowing and asset position

The general government balance moved into deficit in 2004 (1.1% of GDP) for the first time since 1992. This deterioration reflects a significant increase in expenditure (+9%) not matched by revenue growth (+5.3%). All general government subsectors contributed to this evolution. The central government deficit amounted to 2.4% of GDP in 2004, due a substantial gap between the revenue and expenditure of extra-budgetary funds. Local governments also recorded a deficit in 2004 because of a deceleration in the collection of local corporate taxes related to previous tax exercises. However, this adverse development was cushioned to a large extent by lower local investments. Finally, social security surpluses decreased for the third year in a row under the conjunction of social contributions which were less dynamic than GDP and a sustained increase in healthcare expenditure.

According to ESCB projections, the general government deficit will continue to deteriorate over the projection period. In 2005, the central government net borrowing requirement would rise to 3% of GDP due to the expansionary stance of the 2005 budget and high public investments. By contrast, the social security surplus would improve by 0.3% of GDP owing to new restrictive expenditure measures in healthcare and to an upward adjustment in social contributions. Overall, the general government deficit would increase to 1.4% of GDP in 2005. In spite of quite favourable macro-economic conditions, the general government deficit would amount to 1.6% of GDP in 2006 and 1.8% in 2007.

TABLE 17: GENERAL GOVERNMENT NET LENDING (+) OR NET BORROWING (-) (% OF GDP)

	1999	2000	2001	2002	2003	2004	2005	2006	2007
				Actual balances					
	STATEC data March 2005						BCL projections spring 2005		
General government	**3.4**	**6.2**	**6.2**	**2.3**	**0.5**	**-1.1**	**-1.4**	**-1.6**	**-1.8**
of which central government	1.7	3.1	3.1	-0.2	-1.4	-2.4	-3.0	-3.2	-3.3
of which local governments	0.2	0.5	0.2	0.1	0.0	-0.1	-0.1	-0.1	-0.1
of which social security	1.5	2.6	2.9	2.4	1.9	1.4	1.7	1.7	1.6
Stability programme					**0.8**	**-1.4**	**-1.0**	**-0.9**	**-1.0**
				Cyclically adjusted balances					
Spring 2005 BCL estimate[1]	3.4	5.2	5.2	1.7	0.6	-0.8	-1.0	-1.4	-1.7
Stability programme estimate	--	--	--	--	0.8	-1.4	-0.9	-0.5	-0.6

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

Source: STATEC, 6th update of the Luxembourg stability programme 2003-2007, BCL calculations.

The cyclically adjusted deficits would also increase over the projection period according to BCL estimates based on a common ESCB method. The corresponding calculations in the 6th update of the Luxembourg stability programme also point to a negative adjusted balance over the 2004-2007 horizon. As indicated in the chart below, continued compliance with the 3% reference value of the Treaty establishing the European Community would not be guaranteed with an adjusted deficit of about 1% of GDP, because of the pronounced volatility of cyclical developments in Luxembourg and of the influence of additional erratic budgetary components (e.g. a decline in the elasticity of revenue items to their respective tax bases, or a tax base less dynamic than GDP). According to the European Commission, the erratic component of the fiscal balance would reach 0.6% of GDP on average in Luxembourg (see "Public Finances in EMU - 2000"). The safety margin needed in order to withstand cyclical developments without infringing the reference value would be even higher, as it would amount to about 3% of GDP (see "Public Finances in EMU - 2002").

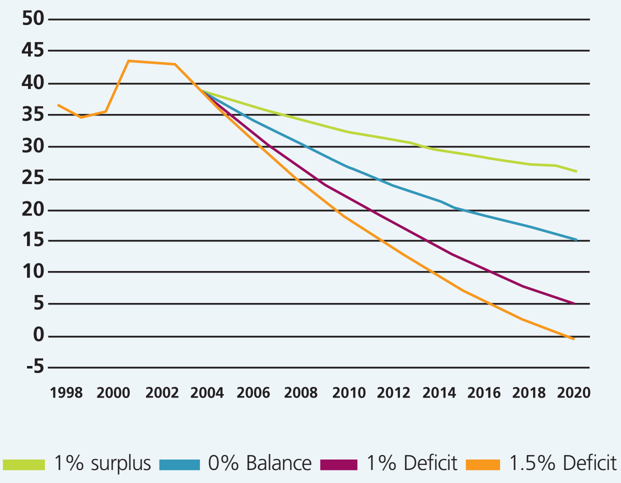
Continued compliance with the 3% deficit limit would therefore require a cyclically adjusted balance in equilibrium or even in surplus. These results underscore that Luxembourg should target a much more rigorous budgetary objective than the 1% deficit limit embedded in the March agreement on the reform of the Stability and Growth Pact for countries with a high potential GDP growth rate and a low public debt ratio.

The evolution of the general government net asset position - including the reserves of the private sector pension system - further illustrates the paramount importance of more ambitious medium-term objectives. As indicated in the following chart, general government accounts in balance or even in surplus should also be pursued in order to ensure an appropriate level of net assets in the medium-term. By contrast, net financial assets would quickly melt down in case less rigorous objectives are targeted. The Luxembourg economy would then loose a powerful buffer against adverse shocks.

A prudent medium-term fiscal strategy is all the more necessary because Luxembourg will have to address long-term sustainability issues, in particular as regards the pension system and healthcare. Moreover, some precautionary room for manoeuvre needs to be restored in order to ensure that discretionary initiatives related, for instance, to research and development, transport, housing and development aid could be financed.

Finally, indirect taxes are extremely buoyant owing to the conjunction of several favourable factors. These circumstances may come to an end, for instance in case the VAT regime of cross-border electronic transactions is amended.

GRAPH 15: GENERAL GOVERNMENT NET FINANCIAL ASSETS RESULTING FROM ALTERNATIVE MEDIUM-TERM BUDGETARY OBJECTIVES (% OF GDP)



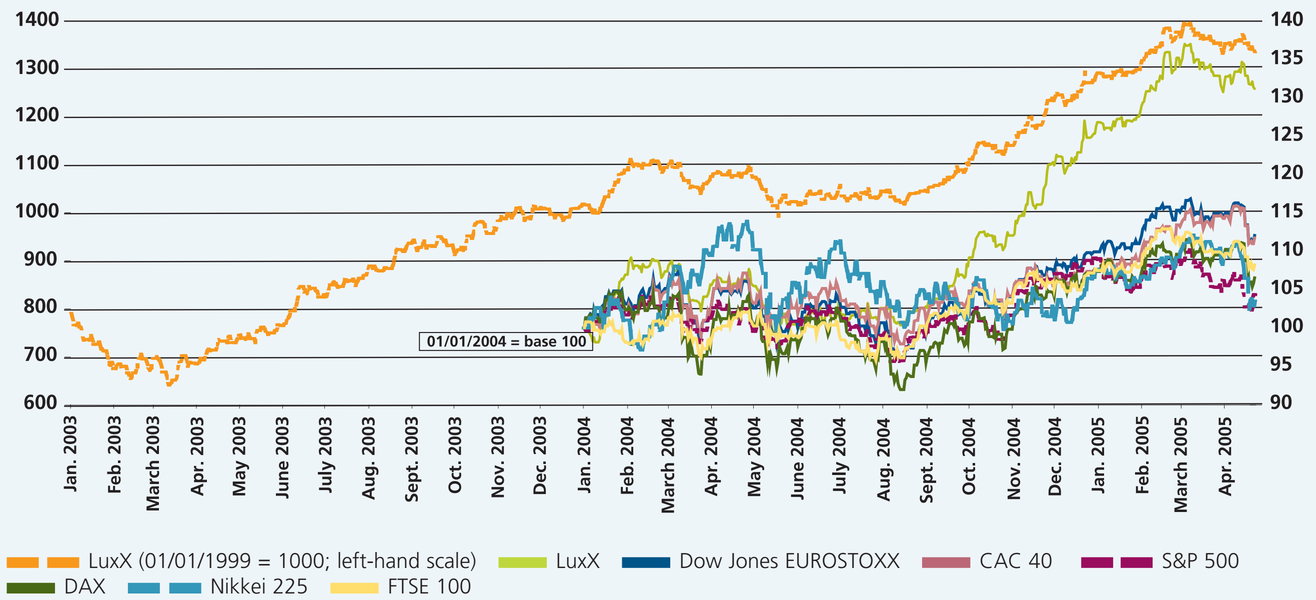
Note: The net financial assets are equal to total general government financial assets (including the equity portfolio at acquisition value) minus gross non-consolidated general government debt. Local government assets over the 1998-2004 period are estimated on the basis of interest receivables. From 2005 onwards, the net financial assets are inferred on the basis of the respective medium-term budgetary objectives. By assumption, the impact on assets of exchange rates and other financial market prices is nonexistent over the 2005-2020 period. Nominal GDP growth is set at 6% per year over the 2008-2020 period (the BCL spring projections are considered from 2005 to 2007).

Source: STATEC, Finance and budget commission of the Luxembourg Parliament, Finance Ministry, 6th update of the stability programme, Treasury, IGSS, UCM, BCL calculations.

1.2.10 Luxembourg Stock Exchange

In 2004, the Luxembourg stock price index continued the recovery observed from 2003. Although the LuxX moved in tandem with other major equity markets for most of the year under review, it has been outperforming other stock price indices since mid-September 2004; between January and December 2004, the LuxX was up 26,83%, finishing the year at 1 292.22.

GRAPH 16: THE LUXX COMPARED TO MAJOR FOREIGN STOCK PRICE INDICES (INDEX: 01/01/2004 = 100 UNLESS OTHERWISE INDICATED; DAILY DATA)



Source: Bloomberg

Regarding the major index constituents of the LuxX, Arcelor shares (with a weighting of 22.5%)[3] performed exceptionally well, gaining 26.76% between end-2003 and end-2004. SES Global and RTL Group (with respective weighting coefficients of 20% and 17.5%) gained 19.38% and 17.3% respectively. KBL shares also recorded significant gains, in large part due to the merger between KBC and its holding Almanij.

Trade volume increased by 50.80% in 2004, while the number of listed securities rose to 33 022 (9 143 new listings versus 5 222 delistings).

In addition, it is worth noting that the Luxembourg Stock Exchange will launch an alternative market called LuxAlter; this alternative market will be defined by the Luxembourg Stock Exchange's internal regulations rather than by European directives. Moreover, a new project called "e-file" was launched; this project will enable all the steps and procedures required for launching an undertaking for collective investment or listing a security to perform in a virtual environment.

[3] The weightings date from December 31, 2004.

2. OTHER BCL FINANCIAL ACTIVITIES

2.1 Monetary policy

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

Open market operations are divided into:

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

In 2004, several operational features of the monetary policy framework were modified. These changes were intended to minimise speculation on rate changes occurring during the reserve maintenance period.

- The calendar of reserve maintenance periods was modified in order to always start the new period on the settlement day of the MRO following the Governing Council meeting at which the monthly assessment of the monetary policy stance is scheduled.
- Since 10 March 2004, the maturity of MROs has been shortened from two weeks to one week.
- Since 26 February 2004, the LTROs are normally allotted on the last Wednesday of each month.
- Rate modifications for standing facilities now occur in principle on the first day of a new reserve maintenance period.

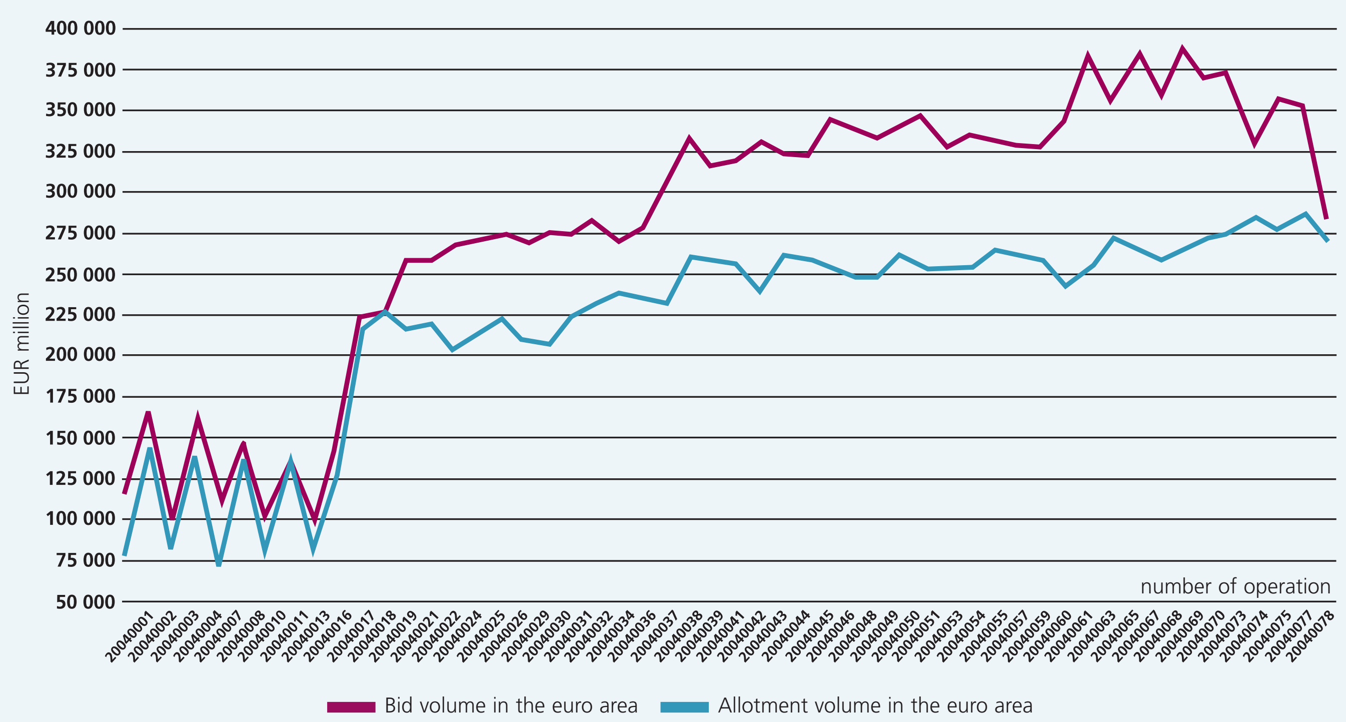
The ECB also improved its communication policy with counterparties. On announcement days of MROs the ECB continues to publish its autonomous liquidity factors forecast and, in addition, it has started to publish an updated version on the allotment day. Furthermore, on both the announcement and the allotment day, the ECB now communicates a neutral allotment amount forecast, i.e. the allotted amount enabling the banking system to respect its reserve requirements.

Since the shortening of the maturity of MROs to one week, fluctuations of allotted amounts decreased considerably. The weekly average variation dropped to 7 billion euro since the implementation of the changes in the operational framework, compared to an amount of 33 billion euro for the period between June 2000 and March 2004.

- The main refinancing operations (MROs)

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

GRAPH 1: MROs IN 2004 - BID AND ALLOTMENT VOLUME IN THE EURO AREA



Following the implementation of changes as of 10 March 2004, the bid and allotment volumes of MROs increased more than twice.

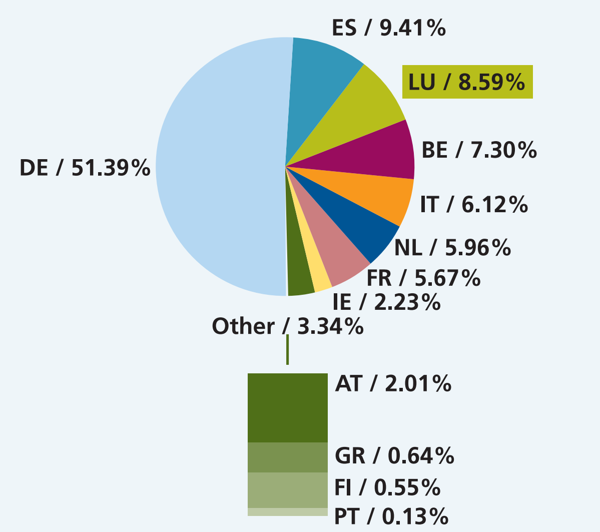
In 2004, Luxembourg ranked third in the allotment volume behind Germany and Spain with, on average, 8.59% of the total euro area volume. This ranking was confirmed during the first quarter of 2005, when Luxembourg's allotment volume amounted to 8.00%.

Compared to 2003, the average percentage allotted in Luxembourg decreased from 9.97% to 8.59%.

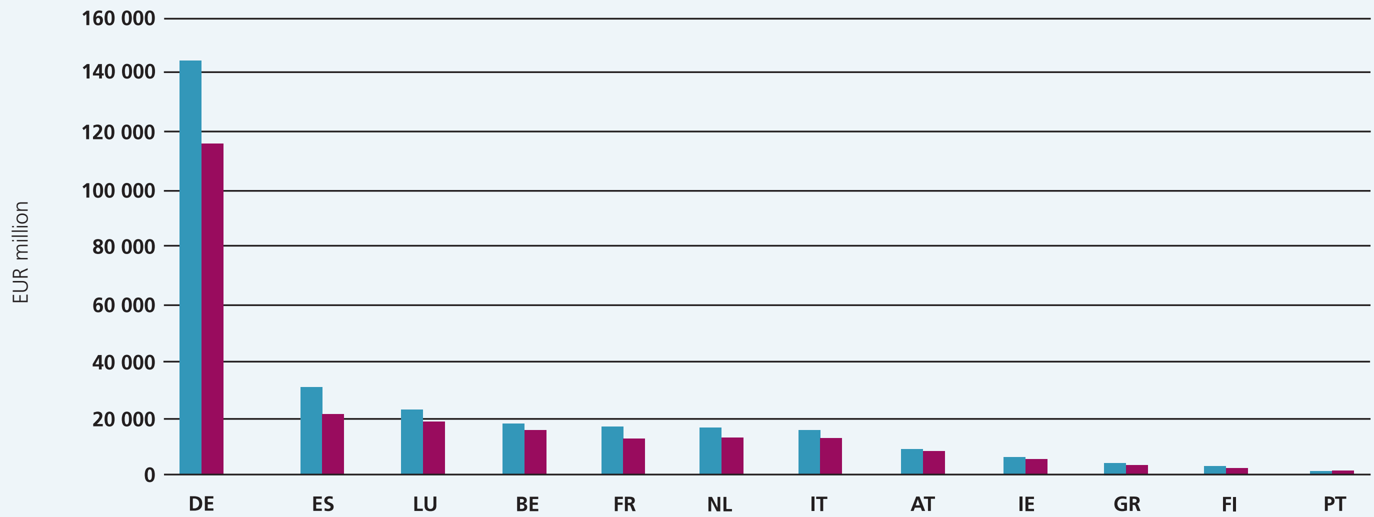
In 2004, the number of counterparties participating in MROs remained broadly stable in Luxembourg with an average of 20 banks in comparison with 19 in 2003 and 18 in 2002. In the euro area, the number of participating counterparties rose, on average, from 266 in 2003 to 339 in 2004, reversing the declining trend observed since 1999. The reason of this increase in the euro area could well be explained by the reduction of the maturity from two weeks to one week and by the simplification of the new framework.

During the first quarter of 2005, the average number of participating counterparties in MROs remained stable with 19 banks in Luxembourg and 340 banks in the euro area.

GRAPH 2: MROs IN 2004 - AVERAGE ALLOTMENT VOLUME IN THE EURO AREA



GRAPH 3: MROs IN 2004 - AVERAGE BID AND ALLOTMENT VOLUME IN THE EURO AREA

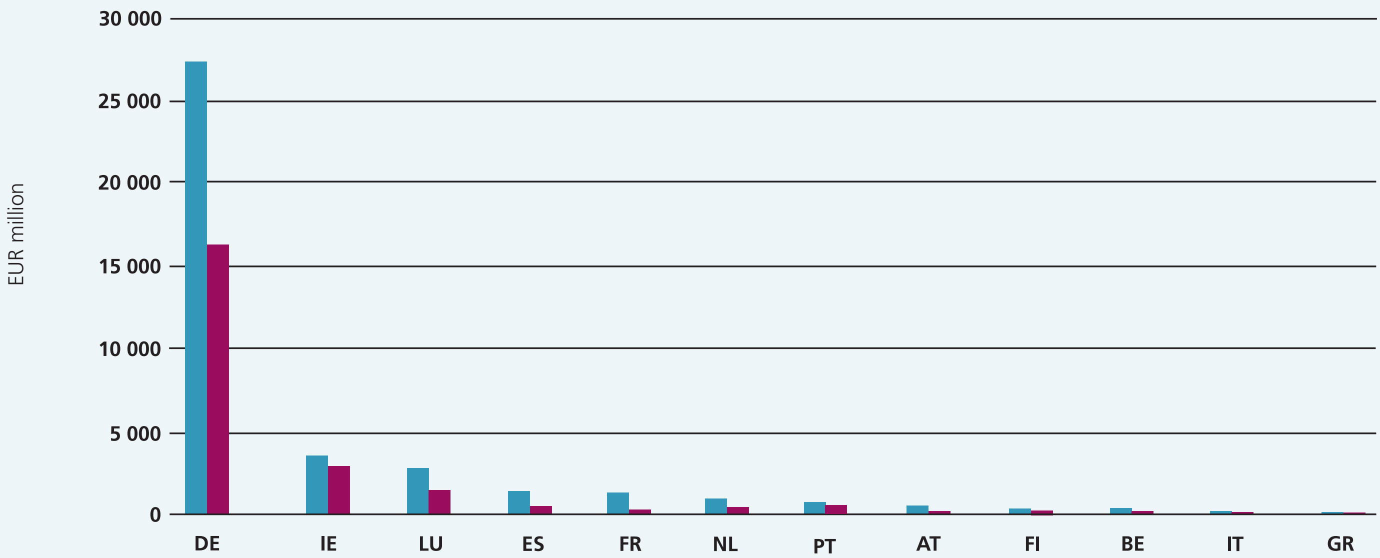


	DE	ES	LU	BE	FR	NL	IT	AT	IE	GR	FI	PT
Bid	143 160.0	27 693.7	22 660.9	18 235.8	17 783.0	17 073.3	16 574.9	7 053.5	5 211.5	2 189.1	1 432.0	583.3
Allotment	113 262.0	20 734.2	18 926.3	16 084.1	12 498.7	13 138.9	13 481.0	4 432.6	4 908.9	1 403.5	1 222.1	296.0

- The Longer Term Refinancing Operations (LTROs)

With regard to the allotment volume in the whole euro area, Luxembourg ranked, on average, third in 2004 and in the first quarter of 2005. The average number of participating counterparties remained broadly unchanged with 7 banks in 2004 and 8 in the first quarter of 2005 in comparison to 7 in 2003.

GRAPH 4: LTROs IN 2004 - AVERAGE BID AND ALLOTMENT VOLUME IN THE EURO AREA



	DE	IE	LU	ES	FR	NL	PT	AT	FI	BE	IT	GR
Bid	27 343.4	4 039.5	2 998.0	1 904.1	1 605.9	1 208.8	988.6	739.4	700.0	550.8	504.6	28.0
Allotment	16 342.3	3 547.9	1 857.5	854.4	207.1	352.2	746.0	307.7	527.6	75.4	186.5	22.6

In January 2005, the ECB Governing Council decided to raise the allotment amount from 25 to 30 EUR billion euro for each LTRO.

- Fine-tuning operations

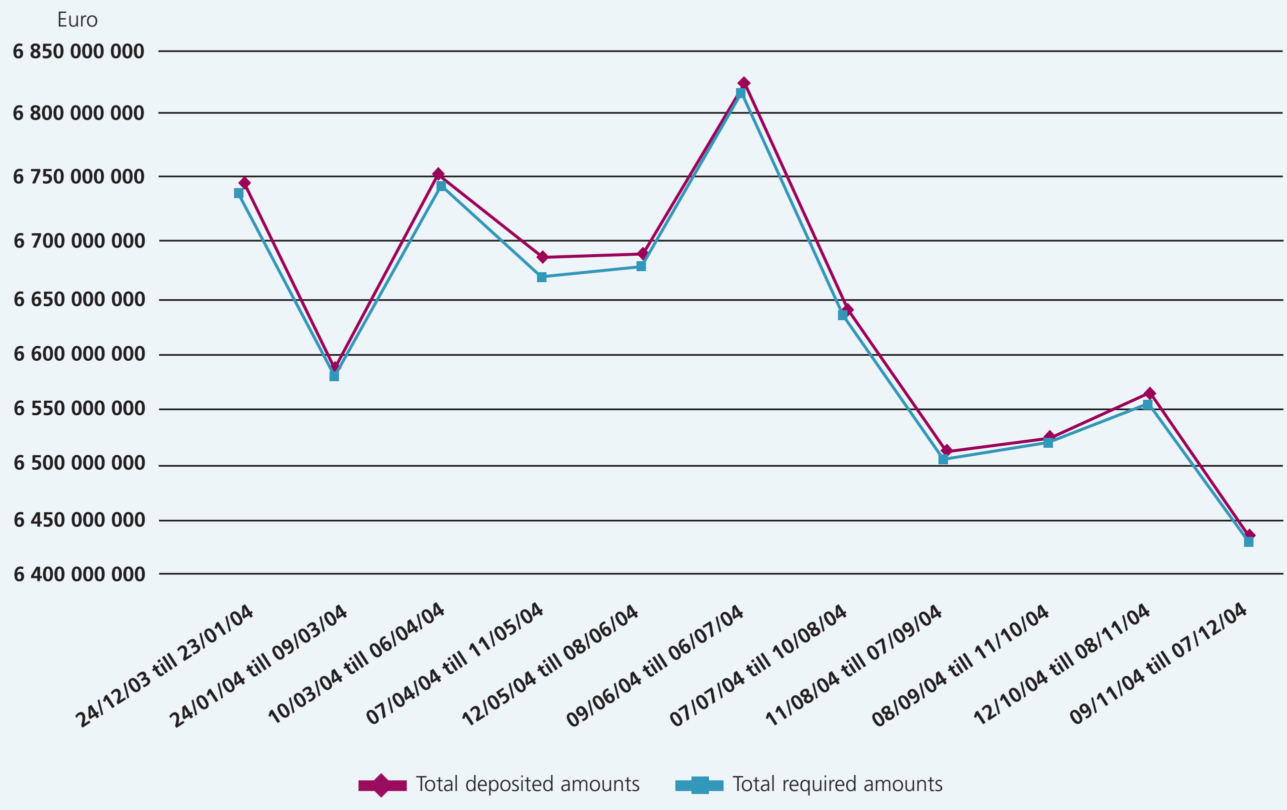
While the volatility of EONIA rate decreased during 2004, short-term rate fluctuations increased during the last days of reserve maintenance periods. This reflects the fact that, as the allotment of the last MRO during a reserve maintenance period now occurs eight days before its end, the risk of a liquidity imbalance is thereby increased. In order to restore neutral liquidity conditions, the ECB carried out several fine-tuning operations during the last day of minimum reserve periods. Three fine-tuning operations were conducted in 2004 (May, November and December) and 3 in the first quarter of 2005 (January, February and March).

The minimum reserves system

From 24 December 2003 until 7 December 2004, the average amount of minimum reserves held by credit institutions in Luxembourg was estimated at 6.6 billion euro.

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

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



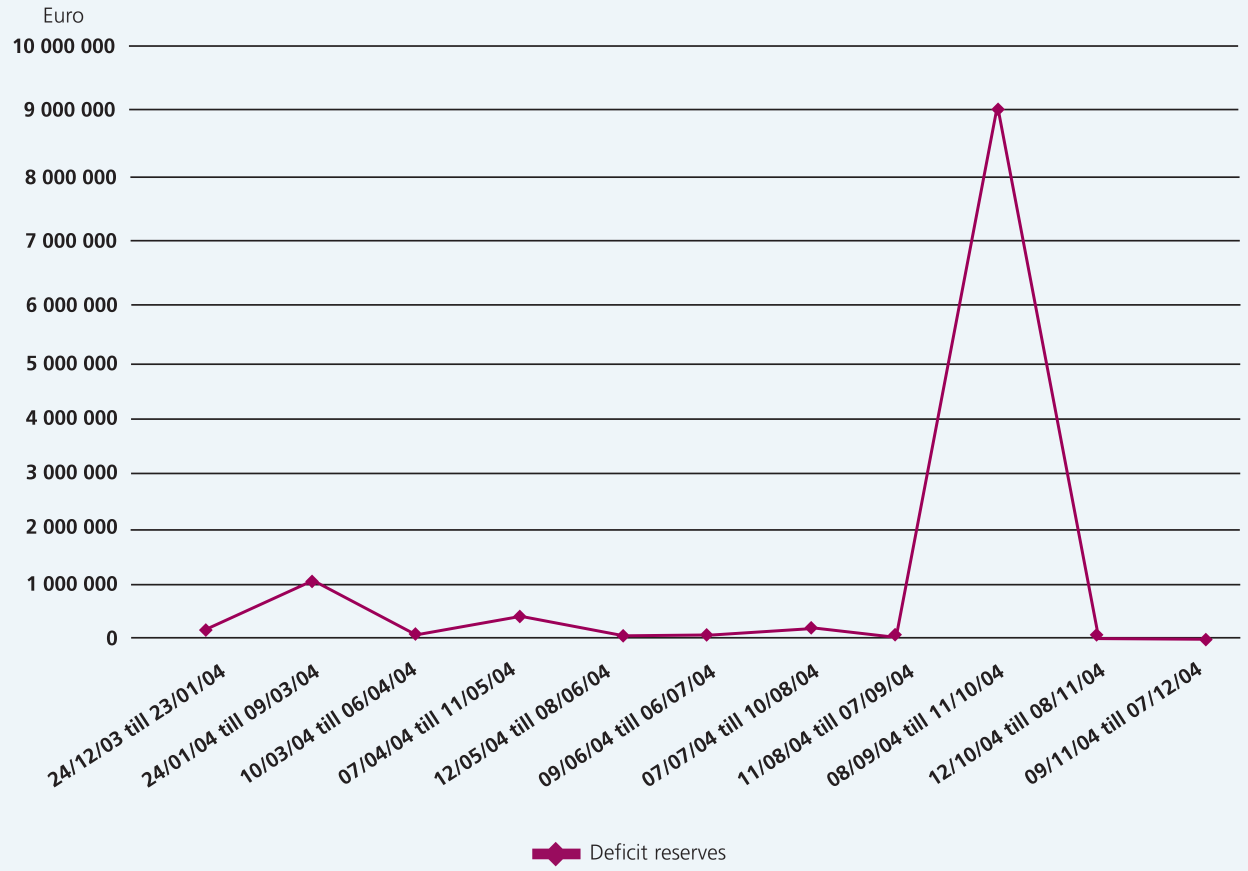
Evolution of the remuneration rate in 2004

The rate at which minimum reserves were remunerated increased from 2.02% at end-2003 to 2.05% at end-2004.

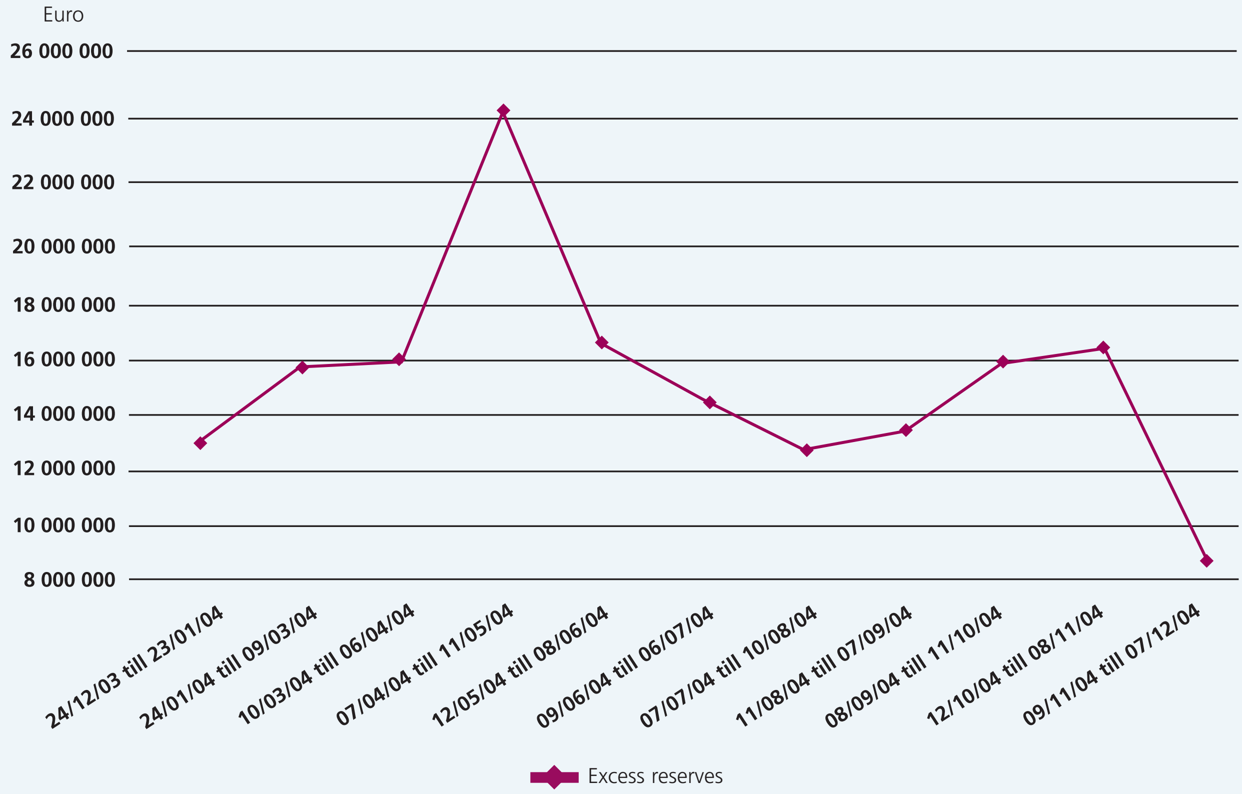
Period	24/12/03 23/01/04	24/01/04 09/03/04	10/03/04 06/04/04	07/04/04 11/05/04	12/05/04 08/06/04	09/06/04 06/07/04	07/07/04 10/08/04	11/08/04 07/09/04	08/09/04 11/10/04	12/10/04 08/11/04	09/11/04 07/12/04
Rate (%)	2.02	2.00	2.00	2.00	2.00	2.00	2.01	2.02	2.02	2.03	2.05

Counterparties paid seven sanctions for not respecting minimum reserves requirements in 2004, compared to 6 in 2003.

GRAPH 6: DEVELOPMENT OF AVERAGE DEFICIT RESERVES



GRAPH 7: DEVELOPMENT OF AVERAGE EXCESS RESERVES



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

2.2 Foreign exchange reserves management by the BCL

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

The ECB's foreign exchange reserves have been managed in a decentralised way by NCBs since January 1999. As a result of the EU's enlargement on 1 May 2004, the BCL's share of the ECB's capital rose to 0.1568%; an additional amount of 12.6 million euro was transferred to the ECB. As of 31 December 2004, the total market value (accrued interest included) owned by the BCL corresponded to 76.2 million euro.

One goal of the foreign exchange reserves management of the ECB is to make sure that, if required, the ECB has a sufficient amount of liquidity available to intervene in the foreign exchange markets. Security and liquidity are therefore basic requirements for the management of these reserves.

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

In the management of this portfolio, the 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 an objective of return maximisation. The amount of assets in gold that are managed actively is fixed by the ECB by taking account of strategic considerations as well as market conditions.

2.3 Management of BCL's assets

2.3.1 Institutional structure

Asset management is based on a structure implying 5 intervention levels:

- The Council (level 1),
- The Executive Board (level 2),
- The Asset and Liability Management committee (ALCO) (level 3),
- The tactical committees (level 4),
- The portfolio manager (level 5).

- **Level 1**: The Council

The Council approves the guidelines of the asset management framework. Thus, the Council enabled the BCL to provide asset management services to third parties, to hold own funds asset portfolios in order to diversify the Bank's income and to establish a pension fund. The mitigation of the risk framework applied to asset management is also part of the guidelines. This framework includes two kinds of risk mitigation: institutional mitigation and operational mitigation.

- **Level 2**: The Executive Board

The Executive Board defines the risk management framework and sets corresponding parameters. Thus, the Executive Board determines the maximal 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 Executive Board also determines warning thresholds, which can trigger emergency meetings for assessment and arbitrage purposes.

As such the Executive Board sets the limits of the framework annually.

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

The ALCO determines the **strategic benchmark** in accordance with the annually fixed framework decided by the Executive Board by examining the impact of each risk profile (market, credit and liquidity risk) resulting from the proposed investment policies, with respect to the overall balance sheet and with respect to the profit and loss accounts of the BCL. During the year, the 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** complying with the limits imposed by the strategic benchmark.

The tactical committees are 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 tactical benchmark committee for the pension fund of the BCL.

- **Level 5**: The portfolio managers

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

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

The OR unit[1] monitors all positions of the portfolios in order to assess risks and to control compliance with the predefined limits. This monitoring, carried out by an independent Unit of the Front Office is done on a daily basis. The AI unit completes the control structure with specific missions at different levels of the organisation. In addition, the middle and back-offices also take part in the control process.

2.3.2 Conceptual framework

The investment policy objectives:

The investment policy aims to generate a high income on a regular basis and to enhance the total return in the long term by taking into account considerations such as capital safety, stability of securities and liquidity. In order to achieve its goals and with respect to the principle of risk diversification, the BCL applies 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 definition 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 investment decisions is measured by comparing the performances to the external benchmarks of leading investment banks. This permits the assignment of relative performances to all decision levels (strategical, tactical) as well as to daily management.

[1] At present the risk manager is a staff member of the OR unit.

2.3.3 Structure of portfolios

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

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

"Investment Portfolio" (Portfolio 1)

This portfolio is composed of assets representative of own funds (with a longer term investment profile). The main goal of this investment portfolio is to maximise yield by taking into account the risk constraints as quoted above (cf. point 2.3.2). On 31 December 2004, the total market value (accrued interest included) amounted to 533.4 million euro.

In 2004, a significant proportion of the funds was invested in long-term bonds, as market conditions for that kind of investment were very favourable. However, around the end of the year the underlying duration of the portfolio was reduced.

It is worth noting that the securities included in this portfolio are largely diversified according to the issuer's geographic location and activity.

"Liquidity Portfolio" (Portfolio 2)

This portfolio represents the other assets that can, in large part, be attributed to a Eurosystem arrangement (Agreement on Net Financial Assets) in compensation of 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 (ECP), provided that they comply with strict and predefined rating criteria. As of 31 December 2004, the total market value (accrued interests included) amounted to 2.091 million euro.

"Domestic reserve portfolio"

The domestic reserve portfolio aims at maintaining 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. On 31 December 2004, the total market value (accrued interests included) of this not yet fully constituted portfolio in foreign currencies amounted to 105.4 million euro.

"Pension Fund Portfolio"

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

"Institutional portfolios"

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

Since 1 January 2005, the Bank has acted as an ESP (Eurosystem service provider). Within the Eurosystem, a group of six Eurosystem central banks, including the BCL, provides a comprehensive range of reverse management services in euro. These standardised services are offered to institutional clients (central banks, public authorities, international organisations) in a new harmonised Eurosystem framework.

TABLE 1: ASSET ALLOCATION AS OF 31 DECEMBER 2004

MATURITY	Portfolio 1	Portfolio 2
0-1 year	43%	71%
1-3 years	21%	27%
3-5 years	26%	1%
5-10 years	10%	1%

2.4 Banknotes and circulation of fiduciary money

Euro banknotes are produced according to the needs of all the participating NCBs which have been aggregated by the ECB. The production of one denomination is assigned to no more than two NCBs. In 2004, the BCL was thus responsible for the production of 1.9 million 500-euro banknotes, for its own needs. The production of these banknotes has been entrusted to the specialised printing works *Bundesdruckerei* in Berlin.

In accordance with its organic law of 23 December 1998, the BCL has the task of putting euro coins into circulation. As of 1 May 2003, as a result of the new agreement between the Luxembourg Government and the BCL, the BCL has been entrusted with the production of Luxembourg euro coins. In 2004, the BCL put the Royal Dutch Mint (*Koninklijke Nederlandse Munt)* in charge of the production of 112.5 million coins, for the BCL's own needs. At the end of September 2004, the BCL signed an agreement with the Mint of Finland (*Rahapaja Oy*) for the production of 45.2 million Luxembourg euro coins dated 2005 in order to satisfy the demand for coins during that year.

2.4.1 Evolution of currency circulation

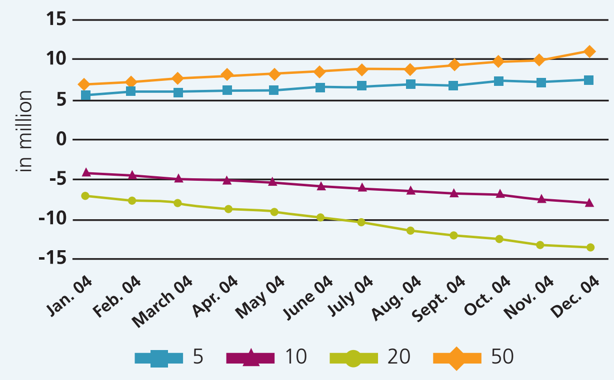
2.4.1.1 Euro coins and banknotes

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

The total net volume of euro banknotes put into circulation by the BCL during 2004 amounts to 23.22 million notes, compared to 27.80 million banknotes in 2003; a decrease of 16.5%. The volume of 10-euro and 20-euro banknotes lodged at the BCL itself exceeds the total volume ever issued by the BCL and for the 20-euro denomination this development was accentuated as of mid-2004. This occurred as tourists and cross-border workers brought in these two denominations in massive quantities to pay for their everyday transactions in Luxembourg. In turn, credit institutions, which are BCL clients, deposited more 10- and 20-euro banknotes at the BCL than they withdrew.

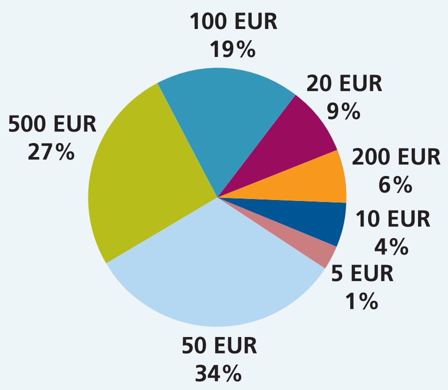
The graph below illustrates the divergent evolution in the volume of the denominations mainly used in everyday transactions:

GRAPH 8: EVOLUTION OF THE NUMBER OF EURO BANKNOTES USED FOR EVERYDAY TRANSACTIONS PUT INTO CIRCULATION BY THE BCL



In comparison with the whole euro area, the BCL has increased its contribution to the total volume of banknotes put into circulation by the Eurosystem, passing from 0.74% at end 2003 to 0.93% at end 2004. In Luxembourg and in the euro area, the year 2004 has been characterised by a steady demand for higher denominations, which are used mainly for hoarding purposes. This development can be seen as a sign of increased trust in the new currency. The total value of euro banknotes put into circulation by the Eurosystem increased by 14.93%, reaching 501.26 billion euro at the end of 2004 and with the following total value breakdown by denomination:

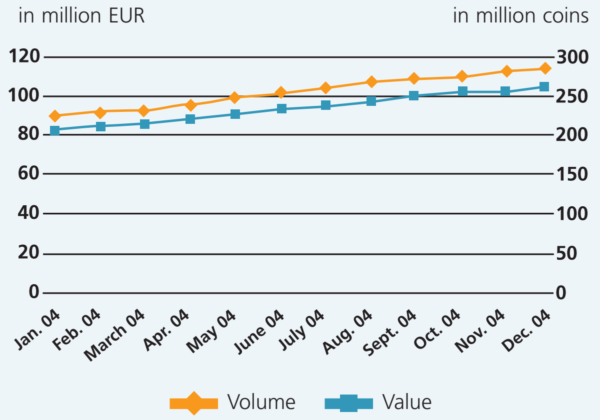
GRAPH 9: BREAKDOWN OF THE VALUE OF EURO BANKNOTES PUT INTO CIRCULATION BY THE EUROSYSTEM



Luxembourg euro coins have also been subject to important demand by the public. The total value of Luxembourg euro coins in circulation increased by 27.5% in 2004 passing from 81.30 million euro to 103.65 million euro. The volume of Luxembourg euro coins in circulation increased by 64.06 million coins (more than 300 tons of metal), or 29.2%, and amounted to 283.57 million coins at the end of 2004. This volume represents a total weight of 1 376 tons of coins, which statistically represents 3.06 kg or some 630 coins at a value of 230 euro per Luxembourg resident. As in 2003, Luxembourg euro coins have been subject to large demand from collectors.

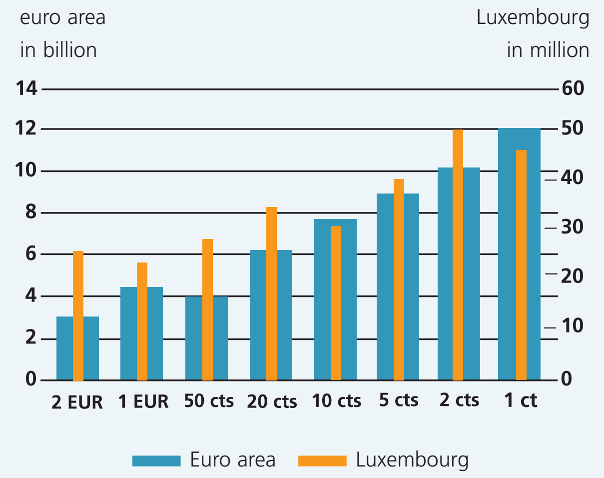
The average monthly volume of coins in circulation amounts to 254.42 million. The following graph shows the evolution of the volume and value of Luxembourg euro coins in circulation in 2004. The demand for Luxembourg coins has kept increasing, notably since July 2004, when the BCL put into circulation a 2-euro commemorative coin.

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



Within the euro area, Luxembourg's contribution to the total number of coins put into circulation increased from 0.45% in 2003 to 0.50% in 2004, whilst Luxembourg contributes 0.68% of the total value issued by all the issuing authorities of the euro area. The average value of Luxembourg euro coins in circulation amounts to 36.6 cent in comparison to an average of 27.3 cent for the euro area coins. The following graph compares the volume of the different coin denominations put into circulation by Luxembourg to the corresponding volume in the euro area.

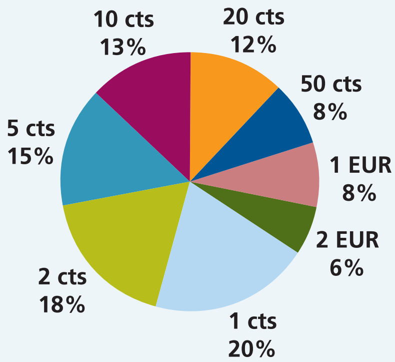
GRAPH 11: COMPARISON OF THE CIRCULATION VOLUME OF THE DIFFERENT EURO COIN DENOMINATIONS IN LUXEMBOURG TO THAT OF THE EURO AREA



As regards Luxembourg coins, the 2-cent denomination remained the most widespread in 2004. Compared to 2003, the ranking according to volume remained unchanged in 2004, confirming a public preference for the denominations with a face value starting with 2. The classification in descending order was as follows: 2 cent, 1 cent, 5 cent, 20 cent, 10 cent, 50 cent, 2 euro and 1 euro. The same classification for the euro area gave the following result: 1 cent, 2 cent, 5 cent, 10 cent, 20 cent, 1 euro, 50 cent and 2 euro.

The total value of euro coins put into circulation by the Eurosystem grew from 14.07 billion euro at the end of 2003 to 15.35 billion euro at the end 2004, whereas the total volume of coins reached 56.24 billion. The following graph shows the breakdown per denomination of this volume for the euro area:

GRAPH 12: BREAKDOWN PER DENOMINATION OF THE VOLUME OF EURO AREA COINS IN CIRCULATION



In 2004, the use of small denominations (1- and 2-cent coins) was subject to a debate in some euro area countries. The BCL is not the institution responsible for taking any decision in this matter. EC Council Regulation (EC) No 975/98 stipulates that the coins denominated in euro shall include eight denominations in the range 1 cent to 2 euro.

Thus, a decision on a possible withdrawal of the 1- and 2-cent coins falls within the competence of the Council of the European Union, namely the "ECOFIN" Council whose members are the Ministers of Finance.

The BCL notices a very sustained demand for the 1- and 2-cent coins in Luxembourg, and indeed they are the most widespread denominations. In the event that a decision to withdraw the legal tender status of these coins were taken, the BCL would stop their production and, in coordination with all the central banks of the Eurosystem, would organise the physical withdrawal and the reimbursement of the 1 and 2 cent coins in circulation within the country.

2.4.1.2 Luxembourg francs coins and banknotes

In 2004, the total value of Luxembourg currency[1] still in circulation and not yet exchanged decreased from 470 million to 452 million Luxembourg francs, or by 3.8%. The average monthly value for last year amounted to 462.8 million Luxembourg francs, against 479.2 million in 2003. The circulation of the 5 000-francs banknote decreased most strongly, that is to say by 6.3%, while that of the 1 000- and 100-francs banknotes decreased by 3.0% and by 0.5%, respectively. These figures show that collectors prefer lower denominations. The following table shows the evolution of the outstanding Luxembourg francs banknotes for the five last years:

TABLE 2: TOTAL VALUE OF LUXEMBOURG FRANCS BANKNOTES IN CIRCULATION BETWEEN 2000 AND 2004

in LUF

End of period	5 000 LUF	1 000 LUF	100 LUF	Withdrawn LUF banknotes abroad	Total
2000	3 054 750 000	676 114 000	153 731 500	-168 910 000	**3 715 685 500**
variation*	-4.3%	-20.8%	-9%		**-8.3%**
2001	2 398 720 000	435 327 000	141 357 900	-198 966 000	**2 776 438 900**
variation*	-21.5%	-35.6%	-8.1%		**-25.3%**
2002	93 855 000	83 749 000	83 781 100	0	**261 385 100**
variation*	-96.1%	-80.8%	-40.7%		**-90.6%**
2003	80 720 000	79 038 000	82 003 000	0	**241 761 000**
variation*	-14.0%	-5.6%	-2.1%		**-7.5%**
2004	75 625 000	76 702 000	81 592 200	0	**233 919 200**
variation*	-6.3%	-3.0%	-0.5%		**-3.3%**

* Relative to the previous year

[1] Coins and banknotes altogether, numismatic and commemorative coins included.

It is worth noting that the global circulation volume of Luxembourg notes has decreased by 93.7% between the end of 2000 and the end of 2004. The flow back of the notes in 2004 took the form of a nearly linear curve, showing a stronger fall in July and December 2004.

The final deadline for the exchange of francs coins was 31 December 2004, and at the end of the year many people rushed to the BCL's counters. The value of francs coins that can no longer be exchanged amounted to 218.1 million francs at the end of 2004, including numismatic productions as well as collector coins. This profit is assigned to the Treasury and not to the BCL.

At the end of 2004, a total volume of 907 749 Luxembourg notes and 63.1 million coins were still in circulation and represented a global value of 418.5 million francs. The numismatic productions and the collector coins not yet exchanged amounted to 33.5 million francs.

The number of Luxembourg francs notes returned to the BCL by financial institutions came close to 2 100 notes, whereas the return of Belgian notes slightly exceeded 29 000.

Luxembourg and Belgian francs notes continue to be exchangeable at the counters of the BCL.

2.4.2 Management of fiduciary money

The number of euro notes returned by the financial institutions to the BCL reached 56.18 million. Expressed in the number of lodgement operations this required, the volume of returned notes represented more than 1 780 different operations managed and registered by the cash department. Furthermore, the number of withdrawals of euro notes by the financial institutions exceeded 4 430 operations managed and registered by the cash department in 2004.

The public also took advantage of the services offered by the BCL through its public counter for the exchange of notes and coins that had become unsuitable for circulation, and in order to buy numismatic products. More than 14 300 operations were handled at the public counter during 2004, averaging some 55.1 operations per workday. All in all, the total number of operations managed and registered by the cash department was more than 20 500.

The number of processed euro notes by sorting machines saw a substantial increase of some 10%, moving from 49.34 million notes in 2003 to 54.23 million processed notes in 2004. The sorting machines not only operate authenticity tests, but also soiling tests. Considering all denominations taken together, nearly 17.9 million notes were destroyed because of their unfitness for circulation. The reject/destruction rate progressed, rising from 29% in 2003 to 33% of the total number of euro notes sorted. Moreover, this rate showed important variations depending on the denomination, varying from 6% for the highest denomination to 58% for the 10-euro banknote.

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

2.4.3 Numismatic issues

The opportunity for the issuing authorities to issue, as of 2004, a 2-euro commemorative coin showing a distinctive national side renewed the interest of collectors for all numismatic issues. The BCL took this opportunity to issue a 2-euro commemorative coin where the national side shows, beside the effigy of the Grand Duke Henri, his monogram (special letter "H" topped with a crown) in order to revive an 80-year-old tradition of issuing coins depicting the monogram of the sovereign.

In Luxembourg, the BCL put the following numismatic products into circulation during the course of 2004:

- The "2004 BU-set" displays the Luxembourg euro coins (1 cent to 2 euro, including the 2-euro commemorative coin with a distinctive national side), struck in "Brilliant Uncirculated" quality with the date 2004. The mintage is limited to 40 000 sets.
- The "2004 Benelux-set" contains the 2004 series of 8 euro coins of the three Benelux countries struck in "Brilliant Uncirculated" quality. This set also includes a silver medal specially conceived for the 60th anniversary of the Benelux.
- The "2004 Proof set" displays the nine Luxembourg euro coins (ranging from 1 cent to 2 euro, including the 2-euro commemorative coin), struck in Proof quality and dated 2004. This set is sold simultaneously with the Proof sets 2002 and 2003 which only contain the 8 usual coins. The mintage is fixed at 1 500 sets per issue year.
- The gold coin "the mask of Hellange", issued in November 2004 within the series "Cultural history of the Grand-Duchy of Luxembourg" (mintage: 5 000 coins) is the second Luxembourg collector coin in gold. Its theme is the visor of an iron helmet belonging to a Roman horseman. This coin has a face value of 10 euro and is minted in Proof quality with a gold fineness of Au999. Its diameter is 16 mm and its weight 3.11g.
- The silver coin " European Parliament ", issued in July 2004 with a mintage of 10 000 coins, is the second Luxembourg collector coin in silver and commemorates the 25th anniversary of direct elections to the European Parliament. This coin has a face value of 25 euro and is minted with a silver fineness of Ag925. Its diameter is 37 mm and its weight 22.85g.

The euro collector coins in precious metal are only legal tender within the territory of the issuing Member State.

2.5 Developments in the area of Statistics

2.5.1 Monetary and financial statistics

The introduction of ECB Regulations ECB/2001/13 and ECB/2001/18 in January 2003 allowed for a considerable improvement of the statistical framework in the monetary and financial sector.

Since January 2003, the BCL collects monetary financial institution (MFI) balance sheet data established according to the modified classification introduced by Regulation ECB/2001/13 on the consolidated balance sheet of the MFI sector. Detailed monthly information on loans and deposits as well as revaluation adjustments of balance sheet positions are collected via enlarged reporting forms. Monthly information is broken down by type of instrument for agreed loans to private household and non-profit institutions serving households (NPISH) and also by economic sector of the counterparty. Furthermore, revaluation adjustments allow for a considerable improvement in the statistical quality of derived flows calculated by the Eurosystem at a monthly frequency.

In parallel with the improved statistical reporting on consolidated MFI balance sheet data, the BCL has started collecting data on interest rates applied by credit institutions on loans and deposits for households and non-financial corporations in Luxembourg and the euro area.

Both statistics are the basis for regular publication of MFI aggregate balance sheet data and interest rates on loans and deposits applied by credit institutions, available on the BCL's website and in its periodic bulletin. Moreover, press releases informing on balance sheet totals, employment in the financial sector as well as minimum reserves requirements are regularly disseminated.

During 2004, the BCL continued its efforts to achieve better data quality by means of more detailed reporting instructions and by enhanced quality controls of statistical data.

2.5.2 Balance of payments and international investment position

Through its website and periodical publications, the BCL publishes quarterly statistics on the Luxembourg balance of payments, the international investment position (IIP) and reserve assets. Furthermore, the BCL and the STATEC communicate the most recent balance of payments data for Luxembourg by means of press releases.

During 2004, the BCL published for the second time Luxembourg's annual IIP data, and these were also analysed in great detail in the Bank's bulletin 2004/3. Additionally, the BCL started with a compilation of quarterly IIP data as well as with quarterly balance of payments statistics providing a detailed geographical breakdown. These substantial efforts made it possible for national compilers to respect the deadline fixed at 2 May 2003 by Recommendation ECB/2003/7 of the European Central Bank.

2.5.3 Financial accounts

Discussions were held with the Luxembourg government in order to set up the financial accounts of Luxembourg by the BCL. However, these discussions did not succeed, and consequently Luxembourg is likely to miss the deadline imposed by Council Regulation EC no. 2223/96 of 25 June 1996, supplemented by Guideline ECB/2002/7 of 21 November 2002 addressed to the BCL.

2.5.4 The IMF special dissemination standard

In 1996, the IMF introduced the Special Dissemination Standard (SDDS), which aims at improving the production and the publication of a large set of macroeconomic statistics. The objective is to improve economic analysis by enriching the scope and quality of published statistics at the disposal of policy-makers and financial markets.

In 2004, Luxembourg institutions have continued their efforts to adapt their statistical framework to this standard. Thus the BCL finalised statistics on the analytical accounts of the central bank, the monetary financial institutions (MFI) sector, the balance of payments (jointly with STATEC), the international investment position, and foreign reserve assets.

2.6 Payments and securities settlements systems

2.6.1 LIPS-Gross

2.6.1.1 Activity in 2004

Domestic payments

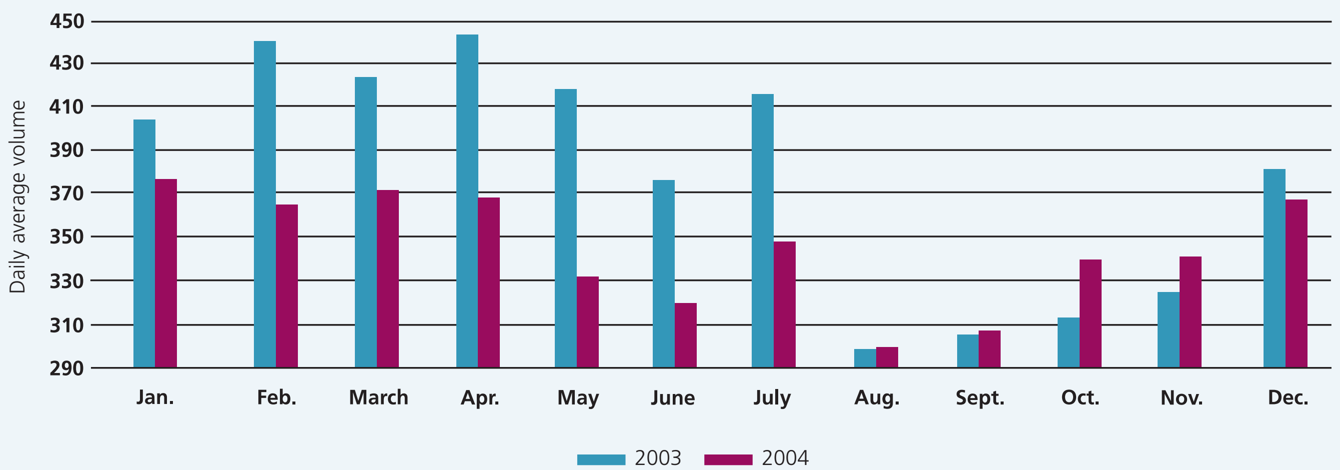
In 2004, LIPS-Gross participants exchanged a total of 89 128 payments (96 525 in 2003) for a total value of 2 258 billion euro (1 513 billion euro in 2003). In comparison to 2003, the volume decreased by 8% whereas the value exchanged increased by 49%. The average value per payment amounted to 25.3 million euro.

The following graphs show the evolution of the average daily volume and value of domestic payments.

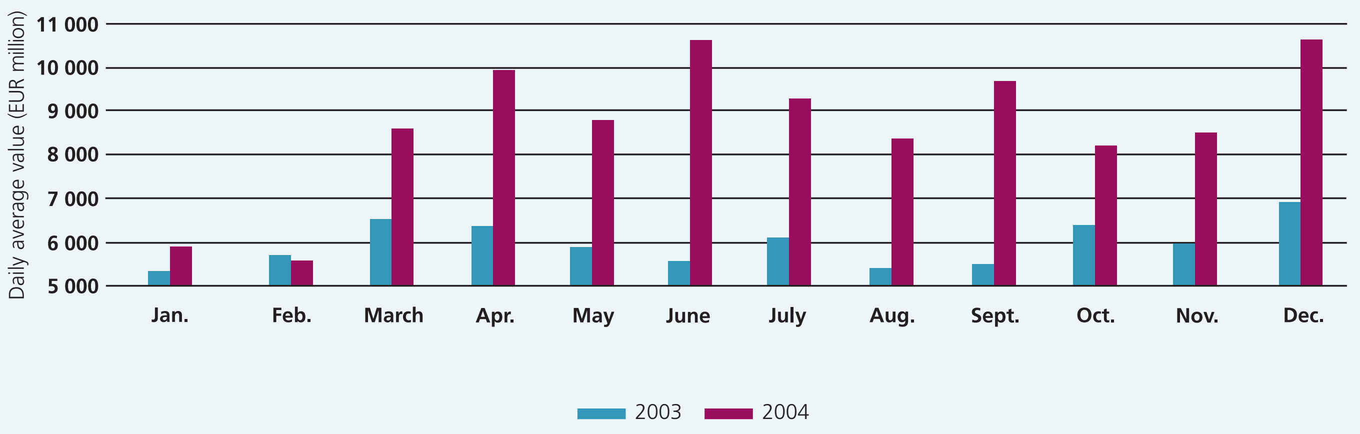
In comparison to 2003, and independently of seasonal factors, domestic traffic decreased between 1 January 2004 and 1 August 2004. This decrease was mainly due to the reduction of the domestic activity of one participant since August 2003.

By contrast, values exchanged in 2004 were markedly higher than in 2003. The main explanation for this is to be found in a change in the Eurosystem's procedures regarding MROs, where the duration was reduced from two weeks to one. This modification, effective since February-March 2004, caused payments of the MROs to double as Banks that previously borrowed a given amount for 2 weeks now have to borrow twice the same amount for 1 week. Whereas the impact on the volume of payments is insignificant, the impact on the values exchanged in LIPS-Gross is substantial.

GRAPH 13: DOMESTIC PAYMENTS: EVOLUTION OF THE DAILY AVERAGE VOLUME



GRAPH 14: DOMESTIC PAYMENTS: EVOLUTION OF THE DAILY AVERAGE VALUE (EUR MILLION)

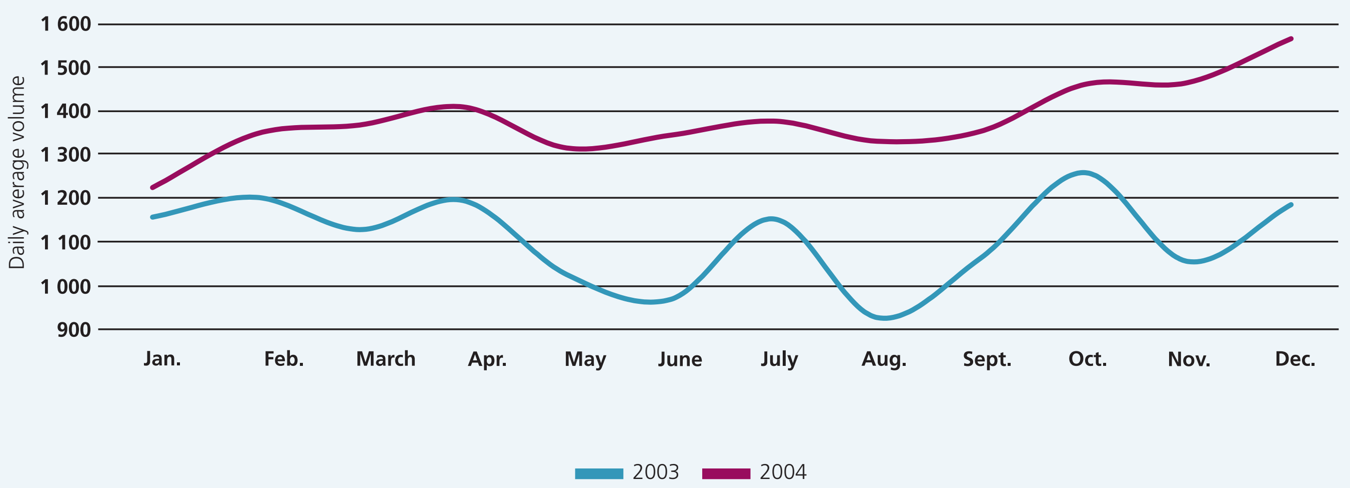


Cross-border payments

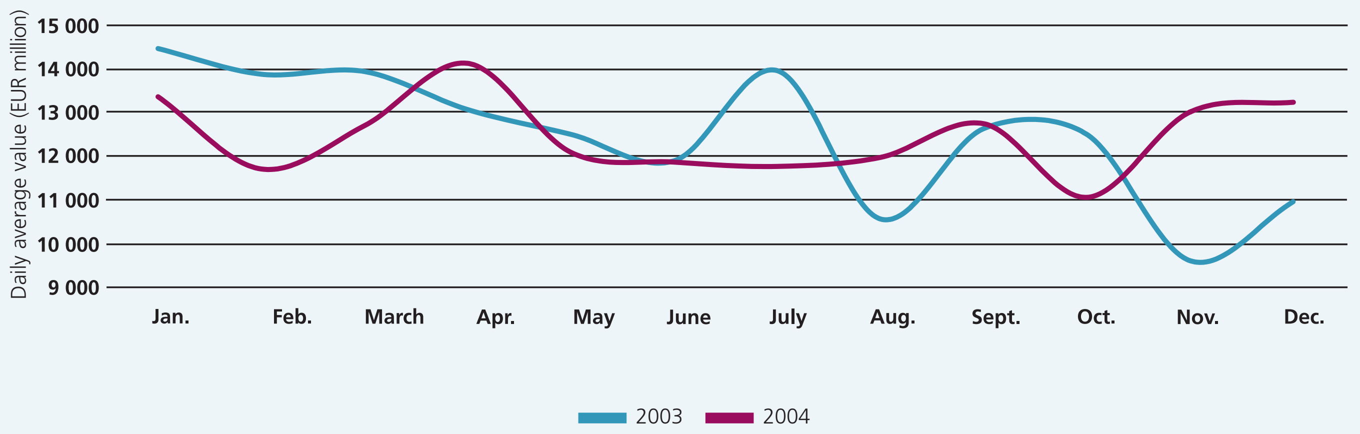
In 2004, LIPS-Gross participants sent 357 317 payments to other RTGS systems linked to TARGET (286 798 payments in 2003) for a total value of 3 241 billion euro (3 242 billion euro in 2003). They received 321 711 cross-border payments (307 246 payments in 2003) for a total of 3 242 billion euro (3 254 billion euro in 2003). The average value per payment was 9.1 million euro.

The following graphs show the evolution of average daily volumes and values of cross-border payments sent by Luxembourg participants.

GRAPH 15: CROSS-BORDER PAYMENTS: EVOLUTION OF THE DAILY AVERAGE VOLUME

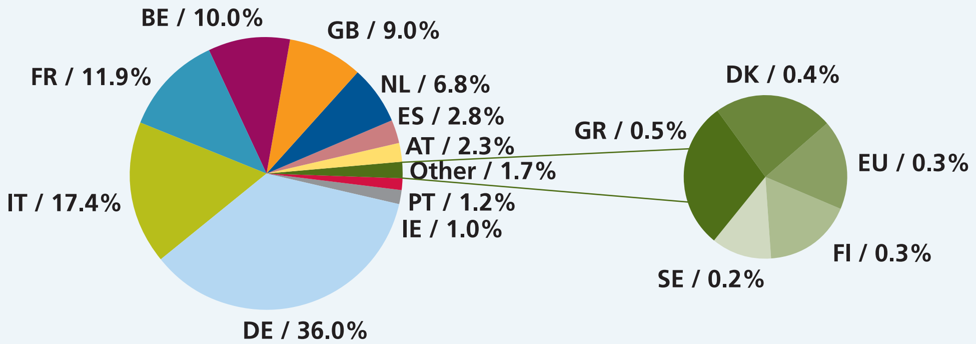


GRAPH 16: CROSS-BORDER PAYMENTS: EVOLUTION OF THE DAILY AVERAGE VALUE (EUR MILLION)

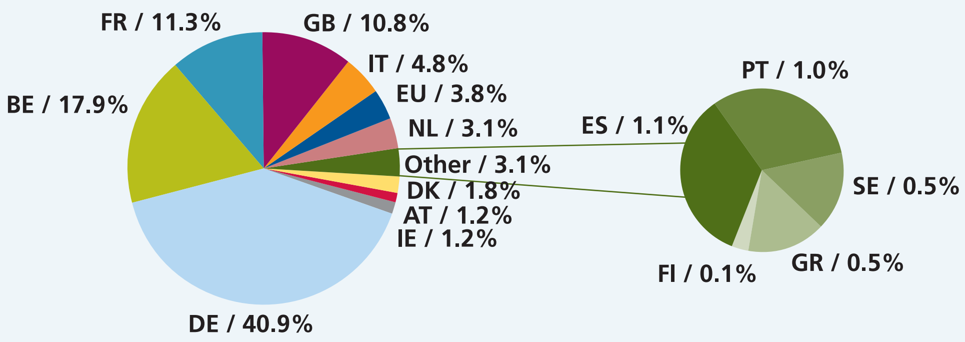


In 2004, the volume of cross-border payments sent increased by 24.6% whereas their value remained unchanged (-0.03%). Five participants increased their volume while two participants decreased payments in 2003. The increase in value generated by the 5 participants offset the decrease of value stemming from the 2 other participants.

GRAPH 17: NUMBER OF CROSS-BORDER PAYMENTS SENT BREAKDOWN BY COUNTRY



GRAPH 18: VALUE OF CROSS-BORDER PAYMENTS SENT BREAKDOWN BY COUNTRY



In volume and in value, about 85% of cross-border payments are sent to 5 countries, among which are Luxembourg's 3 neighbouring countries.

Aggregated figures of domestic and cross-border payments

The following tables provide a global view of the average daily volume and value of payments in different years. The volumes and the values exchanged globally continued to increase.

In 2004, the tendency that members of the RTGS-L GIE received more payments than they sent was reversed.

TABLE 3: DAILY AVERAGE VOLUME OF PAYMENTS

	Domestic	Cross-border sent	Cross-border received	**Total**
2002	321	1 042	1 168	**2 531**
2003	379	1 125	1 205	**2 708**
2004	344	1 380	1 242	**2 966**

TABLE 4: DAILY AVERAGE VALUE OF PAYMENTS (EUR MILLION)

	Domestic	Cross-border sent	Cross-border received	**Total**
2002	4 826	12 539	12 544	**29 908**
2003	5 932	12 715	12 760	**31 407**
2004	8 717	12 515	12 519	**33 752**

LIPS-Gross compared to other systems connected to TARGET

In 2004, all national RTGS systems together executed a total of 52.4 million national payments (51.4 million in 2003) for a value of 297 857 billion euro (283 871 billion euro in 2003). With 89 128 national payments for a total of 2 258 billion euro, Luxembourg represented 0.17% of this volume and 0.76% of this value.

In addition, TARGET handled 16.8 million cross-border payments (15.2 million in 2003) for a total value of 146 137 billion euro (136 878 billion euro in 2003). Luxembourg contributed 2.03% to the volume and 2.24% to the value exchanged.

Availability of TARGET

The global availability of TARGET passed from 99.79% in 2003 to 99.80% in 2004. During the 6 years of TARGET's existence, availability averaged 99.67%.

After 99.74% in 2003, the availability of LIPS-Gross increased to 99.97% in 2004. The availability of LIPS-Gross was 100% for 11 months out of 12 in 2004. For the 6 years of the existence of LIPS-Gross, the average availability has been 99.65%. Since its creation 6 years ago, LIPS-GROSS' availability averaged is 99.65%.

Membership of the RTGS-L GIE

In 2004, the number of participants in LIPS-Gross remained unchanged at 31.

2.6.1.2 TARGET2

LIPS-Gross, the Luxembourg RTGS system, is connected to the other RTGS systems of member countries of the Eurosystem. Together they constitute the cross-border payment system TARGET. On 24 October 2002, the Governing Council of the ECB took a strategic decision with respect to the new generation of TARGET. TARGET2 will offer a single shared platform, to which all national central banks of the Eurosystem can move their respective RTGS systems. It is foreseen that TARGET2 will be operational as from 2 January 2007.

In close cooperation with the other central banks of the ESCB and taking into account the recommendations that the market issued during different consultation rounds three central banks, Deutsche Bundesbank, Banca d'Italia and Banque de France, elaborated a common concept for the construction of the TARGET2 platform. In 2004, the Governing Council of the ECB accepted the joint offer of the 3 central banks for the construction and the exploitation of the TARGET2 platform.

2.6.2 Evolution of the Interbank netting system LIPS-Net

The number of participants in LIPS-Net remained stable and amounted to 13 on 31 December 2004. The volume remained globally stable for the whole year.

Regarding the future of the interbank netting system, LIPS-Net participants launched in 2004 an analysis considering the evolution of the national clearing system in the framework of the "*Single European Payments Area (SEPA)*".

Concerning the volumes exchanged in 2004, the total number of transactions decreased by 1.36% to 13.24 billion. On the other hand, values exchanged in LIPS-Net showed an increase of 5% in comparison with 2003, the total value exchanged for 2004 being 56.78 billion euro. The daily average number of transactions exchanged amounts to 51 983. The highest volume was recorded on 2 March with 118 469 operations.

TABLE 5:

	2003	2004	Variation
Numer of **credit transfers**	13 131 658	13 043 626	-0.67%
Value of credit transfers (EUR million)	45 079	45 846	1.70%
Average value per credit transfers (EUR)	3 433	3 515	2.39%
Number of **cheques**	275 563	174 396	-36.71%
Value of cheques (EUR million)	3 182	2 567	-19.32%
Average value per cheques (EUR)	11 545	14 719	27.49%
Number of transactions related to the settlement of balances of **debit and credit cards**	21 841	28 951	32.55%
Value of transactions related to the settlement of balances of debit and credit cards (EUR million)	5 800	8 363	44.20%
Average value per transactions related to the settlement of balances of debit and credit cards (EUR)	194 893	267 775	37.40%
Total number of operations	**13 429 062**	**13 246 973**	**-1.36%**
Total value of operations (EUR million)	**54 060**	**56 776**	**5.02%**
Average value per operation (EUR)	**4 026**	**4 286**	**6.47%**

Credit transfers

The year 2004 can be split in two: the first half of the year showed a 4.8% decrease in the number of credit transfers in comparison with the first half of 2003, whereas during the second half of 2004 volume increased by 3.7% in comparison with the corresponding period in 2003. This change of trend can be explained by the European Regulation on the pricing of credit transfers which came into effect on 1 July 2003 and led to a traffic decrease until 30 June 2004. The daily average number of credit transfers exchanged amounted to 51 183, whereas the daily average value amounts to approximately 180 million euro.

The value of credit transfers exchanged records a 1.7% increase.

Cheques

With regard to cheques, the significant decrease in volume since the withdrawal of the Eurocheque guarantee at the end of 2001 continued (-37% in comparison with 2003). At the end of 2004, the daily average number of cheques exchanged amounted to approximately 600, whereas the daily average value amounted to about 10 million euro.

The value of cheques diminished also, but to a lesser extent (-19%). The average value of cheques exchanged in LIPS-Net increased from 11 545 euro in 2003 to 14 719 euro in 2004.

Debit and credit card operations

In May 2003, the clearing of credit card balances was integrated in LIPS-Net, which already processed debit cards. As a result, settlement operations of balances between card issuers have considerably increased since this date. Unlike clients' payment transactions (credit transfers and cheques), this type of interbank settlement transaction is limited in volume (less than 1% of the volume), but represents a considerable share of the values exchanged in LIPS-Net (15%).

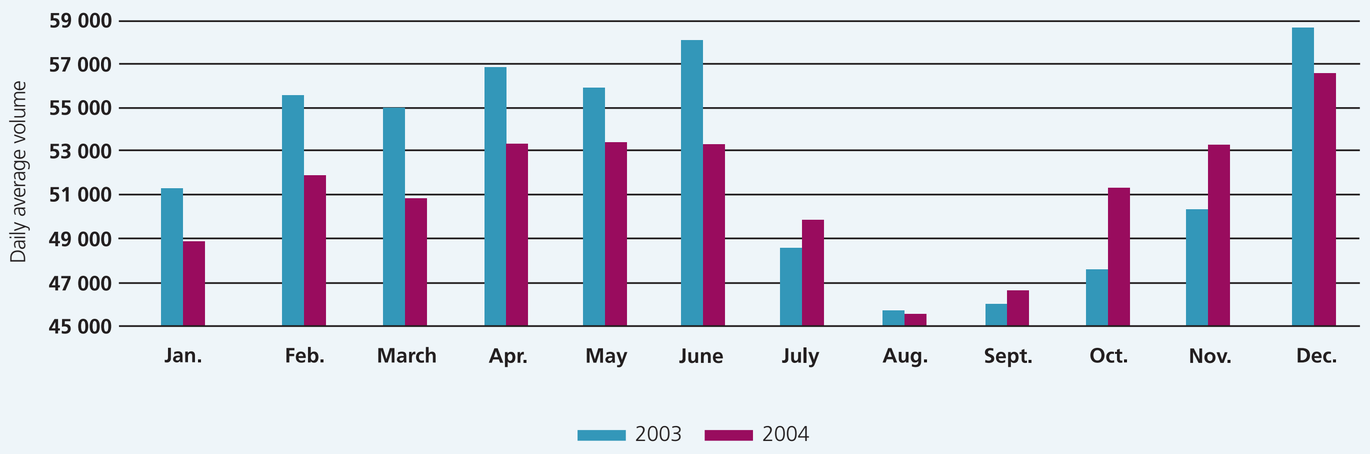
2.6.3 The general framework of eligible collateral in Eurosystem credit operations

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"[2]. Consequently, each counterparty guarantees the credit received from a Eurosystem central bank by providing securities as collateral. These securities have to fulfill specific eligibility criteria defined by the Eurosystem.

The Eurosystem has established a distinction between two categories of assets eligible for credit operations. The first consists of debt instruments fulfilling uniform euro area wide eligibility criteria specified by the Eurosystem. The second consists of additional assets that are of particular importance to national financial markets and banking systems.

GRAPH 19: CREDIT TRANSFERS: EVOLUTION OF THE DAILY AVERAGE VOLUME



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

In order to further improve its collateral framework, the Eurosystem is preparing for the gradual implementation of a single list of collateral eligible throughout the euro area. In a public consultation launched by the Eurosystem a majority of banks has expressed overall support for this project. This was also the position taken by Luxembourg counterparties. A first measure taken in the context of the single list has been the exclusion of "out collateral" from the list of securities eligible for intraday credit operations in TARGET. The term "out collateral" refers to eligible securities deposited in a EU Member State, but issued in a country not part of the eurozone. As a second measure, it has been decided that bank loans will be included in the single list as of January 2007. The detailed procedures for the acceptance of bank loans - which include a minimum rating - and those required for the transfer of bank loans to the respective NCB are currently being worked out.

2.6.3.2 The Eurosystem as a user of securities settlement systems

Selection of depositories[3] at the domestic level

In order to meet the requirement of "adequate collateral"[4] the Eurosystem also assesses against specific safety criteria depositories that are safekeeping securities used in the framework of central bank credit operations. In 2004 the Eurosystem reviewed its assessment criteria (the User Standards) in order to adapt them to the changing landscape of depositories.

Cross-border use of collateral

Besides using eligible domestic securities settled via the national depository (Clearstream Banking Luxembourg - CBL - for Luxembourg counterparties), all Eurosystem counterparties may receive credit from their local NCB by using collateral issued in a depository located in another Member State of the European Union. The ESCB recognises two ways for such cross-border use of collateral. Counterparties may use

- the CCBM[5]; and
- links established between securities settlement systems.

In a given securities settlement system located in an EU country, these links make available securities issued in the system of another EU country, thanks to bilateral accounts that the two systems maintain between each other. In order to be used in the framework of Eurosystem credit operations these links have to be approved by the Governing Council of the ECB. Therefore, the links, just like national depositories, are assessed against safety standards set forth by the Eurosystem. On the basis of these links, a Luxembourg counterparty can pledge to the BCL on its account at CBL eligible securities issued into Clearstream Banking Frankfurt A.G., Euroclear, the National Bank of Belgium, Monte Titoli (Italy), OeKB (Austria), and Euroclear Netherlands.

2.6.4 The Correspondent Central Banking Model (CCBM)

In the framework of the CCBM each NCB acts on behalf of the other central banks as a custodian for securities held at the national depository. This procedure involves a central bank called a correspondent central bank (CCB) that is different 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) then grants the credit to its counterparty on the basis of confirmations received from the CCB.

In the beginning the CCBM was conceived as an interim solution to respond to the segmentation of European capital markets. As the model has been successful with 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. Moreover, the efficiency of the model has been further increased by the decision to limit the maximum processing time to one hour for each operation (this decision has taken effect as of 2004).

Across the eurozone the usage of the CCBM has remained extremely disparate. The most active correspondent central banks have been those from Italy (19%), Luxembourg (19%), Belgium (19%) and Germany (12%).

The most active home central banks have been those from Germany (61%), the Netherlands (10%), Ireland (7%), Luxembourg (5%) and from France (5%).

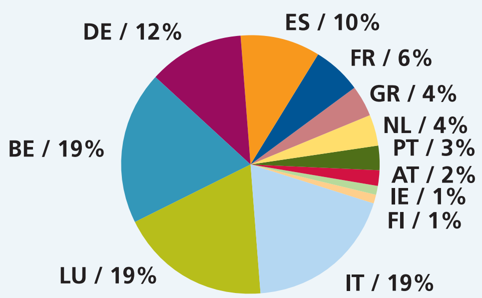
As in previous years the cross-border use of tier 2 assets has remained marginal.

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

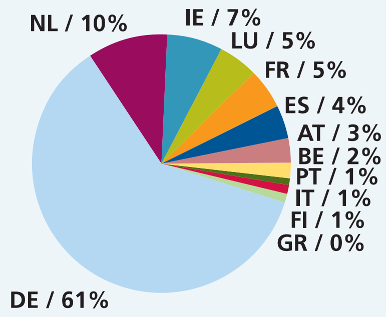
[4] Article 18 of the Statute of the ESCB and the ECB, article 22 of the founding law of the BCL.

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

GRAPH 18: CORRESPONDENT CENTRAL BANK 2004



GRAPH 19: HOME CENTRAL BANK 2004



2.6.5 Night-time Link with Clearstream Banking Luxembourg

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

The NTL procedure is subdivided into 2 parts:

1. A customer of CBL can use its cash and collateral available at BCL to guarantee credit granted by CBL for the clearing process taking place at night. The guarantee is issued by 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 effected by BCL on behalf of the customer.

BCL considers that NTL, 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.

2.7 Financial stability

2.7.1 Macro-prudential surveillance

2.7.1.1 Regular monitoring activities

Throughout 2004 the BCL has continued its ongoing analysis of major developments in the Luxembourg banking sector. This analysis is based in particular on a system of macro-prudential indicators, completed by a specific monitoring of systemically important institutions.

In 2004, the indicators measuring the return on assets and on equity of banks under Luxembourg law are globally at higher levels than in 2003. The share of the interest margin in total revenues of banks under Luxembourg law is decreasing while the share of commission revenues is rising. Banks under Luxembourg law remain well capitalised and their liquidity ratio remains stable, considerably above the prudential threshold. Net value adjustments in the banks' books have been reduced. Assets towards high-risk countries decreased against own funds, while exposures towards related entities have intensified, in particular at the level of interbank debt. The volume of credit outstanding towards non-financial corporations continued the decrease initiated in 2002, though at a slower pace.

Credit towards resident households is increasing, pushed in particular by the growth of mortgage loans. Overall the good quality of the sector's assets has been maintained; the share of non-performing loans in total large exposures has stabilised at a very modest level. The continuing reduction in the number of banks is mainly attributable to the mergers and acquisition processes that are going on in the banking sector. Nonetheless, the concentration of banking activities, measured by the total sum of balance sheets, remains stable.

Banks under Luxembourg law seem to be, globally, well positioned to face potential instability risks given the strengthening of profitability, the comfortable level of capital, the control of asset and market risks and the availability of liquidity. Certain signs of optimism are perceivable at the international and the national level. However, potential financial, economic or political turbulences remain possible. Moreover, the evolution of financial markets and of the regulatory framework, the outsourcing of certain activities as well as the consolidation or internationalisation of the banking sector imply challenges which need particular monitoring from a financial stability point of view. Market participants as well as authorities should remain vigilant. Crises risks are not obvious but their potential consequences could be very significant.

The macro-prudential indicators are published on a regular basis. A more detailed analysis has been published in April 2005 in the BCL's financial stability bulletin, and other detailed analyses have been published in 2002 and 2004.

The availability of qualitative information on the individual institutions, especially on those of systemic importance, would contribute to an enhancement of the quality of the analysis.

At an international level, the macro-prudential indicators become more and more of a prominent tool. The International Monetary Fund (IMF) has strengthened its efforts in this context and has developed a compilation guide on Financial Soundness Indicators (FSI). In addition, IMF staff have coordinated since 2004 the setting up of FSIs for about sixty countries. The BCL is the national coordinator in this context.

2.7.1.2 International cooperation

At the level of the European System of Central Banks (ESCB), the BCL contributes to the work of the Banking Supervision Committee that is, amongst others, analysing and monitoring the cyclical and structural developments in the European banking sector from a financial stability point of view.

Moreover, since 2004 the BCL participates in the work of the Committee of European Banking Supervisors (CEBS) set up by the European Commission as a level 3 committee within the framework of the Lamfalussy structure for banking supervision[6].

2.7.2 Oversight of payment and securities settlement systems

2.7.2.1 Regular oversight activities

During 2004, the BCL continued its mission in the field of oversight of operators and technical agents of those payment and securities settlement systems notified by the BCL to the European Commission on 12 February 2001.

The following operators: RTGS-L Gie (Lips-Gross), SYPAL Gie (Lips-Net) and Clearstream Banking Luxembourg and the technical agents: BCL for Lips-Gross, Cetrel for Lips-Net and Clearstream Services for Clearstream Banking Luxembourg, are subject to BCL's oversight.

To avoid any conflict of interests between its operation and oversight functions in the field of payment systems and, in accordance with IMF principles, the BCL operates a strict internal separation between these two activities.

[6] The Lamfalussy framework distinguishes 3 levels. Level 1, legislative, level 2, the 3 regulation committees in the different financial sectors assisting the European Commission, and finally level 3, the supervisory committees.

2.7.2.2 International cooperation

Regarding the work undertaken at the ESCB level by the "*Payment and Settlement Systems Committee*" (PSSC), the BCL contributed on issues relating to financial stability and to systemic risks, notably in the oversight of retail and large value payment systems.

The BCL was also invited to participate in the work of the "*Committee on Payment and Settlement Systems*" (CPSS) of the Bank of International Settlements (BIS) in Basel with a particular focus on the comparison between different oversight practices in payment and securities settlement systems as implemented by central banks.

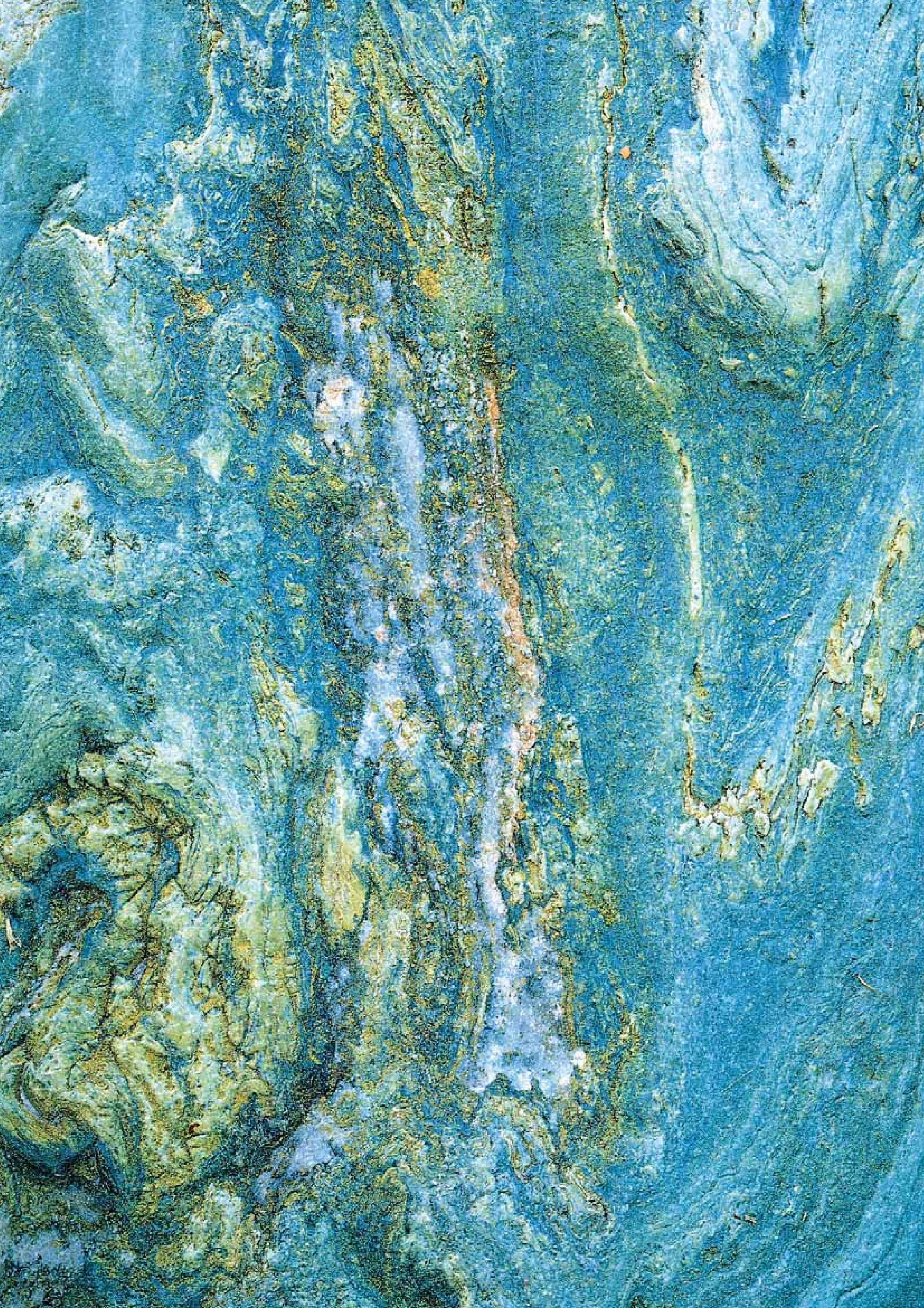
2.7.2.3 Standards for securities settlement systems

The BCL has actively contributed to the work of the joint working group ESCB-CESR (*European System of central banks - Committee of European Securities Regulators*) for the development of standards on clearing and securities settlement activities. These standards, approved by the ECB Governing Council and published in October 2004, will take effect after the development of an assessment methodology in this context. Work in this field is currently in progress.

2.7.3 Other activities

Besides its participation in the work of the ESCB relating to crises management, the BCL participates in the ESCB-CEBS joint task force whose major objective is the study of guiding principles for handling financial crises as well as of co-operation and information-sharing mechanisms between authorities at national and at European level.

At a national level, the BCL has proposed to the government the implementation of a co-operation scheme comprising of institutional, legal and contractual aspects linked to the prevention as well as to the management of financial crises.



3. EXTERNAL ACTIVITIES

3.1 European Activities

3.1.1 Enlargement of the European Union

Since 1 May 2004, the European Union counts ten new Member States, namely the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovakia and Slovenia. From May 2004 onwards, the national central banks of the new Member States have been integrated into the ESCB and their respective Governors became full members of the General Council of the ECB. Moreover, these central banks have become parties to the agreement of 1 September 1998 between the European Central Bank (ECB) and the national central banks (NCBs) of the Member States outside the euro area, on the exchange rate mechanism in Stage Three of Economic and Monetary Union (ERM II). Like its predecessor, ERM II includes central rates, maximal fluctuation bands, intervention points and financing facilities. With effect from 28 June 2004, the Estonian kroon, the Lithuanian litas and the Slovenian tolar were included in ERM II.

The BCL participated in preparatory work, notably in the fifth central bank seminar on the EU accession process, jointly organised by the Banque de France and the European Central Bank (ECB) in March 2004.

The enlargement led to a new equilibrium in the ESBC. Moreover, it led to a clarification of the concept of the Eurosystem, which has been utilised since the introduction of the euro by 11 Member States on 1 January 1999. The Eurosystem was formally defined in the new Rules of Procedure of the ECB as approved by the Governing Council on 19 February 2004.

The enlargement is also the source of the modification of Article 10.2 of the Statutes of the ESCB and the ECB which became effective on 1 June 2004 upon approval by the 15 Member States. The purpose of this amendment is to maintain the Governing Council's capacity for efficient and timely decision-making in an enlarged euro area. When the number of countries having adopted the euro reaches 16, voting among the NCB governors who are members of the Governing Council will be subject to a rotation system. This system will respect five fundamental principles: (1) one member, one vote, (2) *ad personam* participation, (3) representativeness, (4) robustness and automaticity and finally (5) transparency. Governors will then be divided into two groups, until their number reaches 22, when they will be allocated between three groups.

The allocation of Governors among the different groups will be based on an indicator made up of two components:

- The relative weight of the economy, measured by GDP at market prices, of their country within the euro area;
- The relative weight of the aggregate balance sheet of monetary financial institutions of their country within the euro area.

This second component, particularly important for Luxembourg, reflects the necessity to allow for the relative importance of Member States' financial sectors when taking monetary policy decisions. Thus, a weighting of 5/6 is given to GDP at market prices and of 1/6 to the aggregate balance sheet of monetary financial institutions.

The first report on the convergence of the new Member States was adopted by the General Council of the ECB in October 2004.

Pursuant to Article 29 of the Statute of the European System of Central Banks (ESCB) and of the European Central Bank (ECB), the proportions of the national central banks (NCBs) in the ECB's capital key are weighted according to the shares of the NCBs' Member States in the total population and gross domestic product of the EU, in equal measure, as notified to the ECB by the European Commission. These weightings are adjusted every five years and were last changed on 1 January 2004.

In accordance with Article 49.3 of the Statute of the ESCB, which was added to the Statute by the Treaty of Accession, the ECB's subscribed capital is automatically increased when a new Member State joins the EU and its NCB joins the ESCB. Therefore, on 1 May 2004 the subscribed capital of the ECB was increased to EUR 5 564 669 247.19.

Eurosystem NCBs are required to pay their subscribed capital in full. On 1 May 2004 the subscribed share of the BCL in the ECB's capital amounted to 8 725 401.38 euro. In percentage terms the share of the BCL was raised from 0.1492% on 1 January 2004 to 0.1708% but fell back to 0.1568% on 1 May 2004.

The total value of euro banknotes in circulation is allocated among the members of the Eurosystem by means of a banknote allocation key. In the case of the BCL, this key amounts, since 1 May 2004, to 0.2020%. The banknote allocation key means the percentage that results from taking into account the ECB's 8% share in the total euro banknote issue in circulation and applying the subscribed capital key to the Eurosystem's NCBs share in such total.

3.1.2 The Stability and Growth Pact

The debate concerning the Stability and Growth Pact, which was concluded in 1997 with regard to transition to the third stage of Economic and Monetary Union, has been at the centre of discussion in the context of economic governance of the European Union in 2004 until March 2005.

On 13 July 2004, the Court of Justice of the European Communities gave a judgement concerning the decisions adopted by the Council of the European Union on 25 November 2003 in respect to the excessive deficit procedures against Germany and France.

The European Commission published on 3 September 2004 a communication on the strengthening of economic governance and clarifying the implementation of the Stability and Growth Pact.

The Governing Council of the ECB insists on the importance of the Stability and Growth Pact; it considers the propositions of the European Commission useful as far as the improvement of the implementation of its preventive arm is concerned. It is opposed to formal changes to the Stability and Growth Pact, insisting notably on the respect of the excessive deficit procedure.

The debate led to a reform of the Stability and Growth Pact in March 2004. More particularly, the European Council meeting of 22 and 23 March 2005 endorsed the report of the Council of the European Union on the improvement of the implementation of the Stability and Growth Pact, approving the conclusions and propositions figuring therein. Council regulations (EC) No 1466/97 and 1467/97 need to be amended.

The Governing Council of the ECB is seriously concerned about the proposed changes to the Stability and Growth Pact.

Sound fiscal policies and a monetary policy geared to price stability are fundamental for the success of Economic and Monetary Union, constituting prerequisites for macroeconomic stability. It is imperative that all parties concerned fulfil their respective responsibilities and that the revised rules of the Stability and Growth Pact are implemented in a rigorous and consistent manner conducive to the conduct of prudent fiscal policies.

3.1.3 Consultative Committees

3.1.3.1 The Economic and Financial Committee (EFC)

A BCL representative participates in EFC meetings. The EFC is composed of representatives from the Finance Ministries and central banks of EU Member States, the European Commission and the ECB. According to the Treaty on European Union, 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. Moreover, the EFC was consulted concerning the central rates of the Estonian kroon, the Lithuanian litas and the Slovenian tolar vis-à-vis the euro in ERM II and concerning the compulsory intervention rates as of 28 June 2004. The EFC also contributed to streamlining the annual economic and employment policy coordination procedures. Finally, the EFC worked on economic policy issues discussed at informal ECOFIN meetings, which are attended by the BCL's Governor.

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

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

Regarding European statistics and within the context of EUROSTAT's mission, the Committee on monetary, financial and balance of payments statistics (CMFB) has notably the task of taking a position as to the development and coordination of the different types of statistics required by the Council, the Commission and the different committees which assist them. Within the CMFB, the central banks, the national statistical offices as well as the Commission and the ECB are represented. Under the aegis of the CMFB, work groups and task forces carry out specific missions. The BCL contributed actively to the activities of the CMFB in 2004. Progress was made with regard to the statistics on financial accounts, balance of payments, financial services, public finances as well as national accounts.

3.2 National Activity

3.2.1 Legal Activities

3.2.1.1 Securitisation

The previous annual report (see section 3.3.1.1) presented the draft law on securitisation, submitted by the Minister of Treasury and Budget, as well as the opinion rendered by the ECB in this respect. This draft was adopted as securitisation law on 22 March 2004.

3.2.1.2 Prevention of money laundering and terrorist financing

The Luxembourg legal framework has been supplemented by the law of 12 November 2004 aimed at combating money laundering and the financing of terrorism, transposing Directive 2001/97/EC of the European Parliament and of the Council of 4 December 2001, amending Council Directive 91/308/EEC on the use of the financial system for the purpose of money laundering, and amending: 1. the Criminal Code; 2. the Code of Criminal Procedure; 3. the law of 7 March 1980 on the organisation of the judicial system, as amended; 4. the law of 23 December 1909 setting up a Commission for Supervision of the Financial Sector, as amended; 5. the law of 5 April 1993 on the financial sector, as amended (…);

The "second money laundering Directive" (2001/97) of the European Parliament and Council of 4 December 2001 extends the scope of the money laundering predicate offences and widens the scope of persons targeted by the prevention of money laundering and the financing of terrorism. The Luxembourg legislator anticipated this development by means of the law of 11 August 1998 creating and introducing into the Criminal Code the offence of membership of a criminal organisation as well as the offence of money laundering. Since the national law was already in line with this Directive, the new law of 11 November 2004 on combating money laundering and the financing of terrorism merely provided some additional adaptations.

The BCL has a duty to report any indications of money laundering or terrorist financing to the Public Prosecutor of the Luxembourg District Court according to Article 33 (3) of its organic law of 23 December 1998.

Following a decision by the BCL's Executive Board in September 2004, the Bank has reinforced the supervision of the issuance of monetary signs to the public and to professionals and updated its internal procedure relating to public counter transactions. As a member of the Eurosystem and as a public institution, the BCL has established an internal verification procedure similar to the procedures in place in credit institutions and investment firms. Thus, transactions exceeding 15 000 euro require prior approval by the compliance officer after a detailed identification of the client.

This reinforcement of supervision is without prejudice to the powers of the Bank in the supervision of payment systems and securities settlement systems according to the official statement of the ECB of 1 October 2001 (see also BCL Circular 2002/172).

At the request of the Council of the European Union, the ECB provided an opinion on the proposal for the "third money laundering Directive" in February 2005. The ECB welcomed the draft and requested central banks to be covered in their specific capacity rather than by way of assimilation to other professionals. For payment systems, the ECB requested - based on the Luxembourg experience and the Bank's Circular in this matter - that operators ensure the traceability of ingoing and outgoing payment orders within their systems.

The new Directive defines its scope of application broadly, combining, for the qualification of serious offences, a detailed list of offences and a general definition of offences, including those offences punishable by imprisonment for a minimum of six months.

For the application of this provision, Member States need to adopt the principle of double incrimination, in both the requesting Member State and in the requested Member State where an infringement occurs.

3.2.1.3 The mobilisation of bank loans in favour of the Banque centrale du Luxembourg

A study published in the 2004/3 bulletin of the BCL deals with the mobilisation of bank loans in favour of the BCL in the light of the Luxembourg banking secrecy rules.

This study follows approval by the Governing Council of the principle of the integration into the single list of securities provided as collateral, of bank loans of the whole euro zone. The lawyers committee of the BCL discussed the said study.

Information to be received by the BCL upon the mobilisation of bank loans will be linked to the customer (identity, localisation, possibly its rating by the bank, etc.) and its estate, in particular its debt vis-à-vis the bank, which is represented by the bank loan. This kind of information is covered by the banking secrecy rules.

3.2.1.4 Modifications to the Institutional Framework

Within its field of competence, the Bank lends assistance to any amendment to the institutional framework relevant to Luxembourg's financial centre.

At a European level, regulation and coordination will be enhanced in the financial field, particularly in areas of financial stability as well as in crisis prevention and management. Such enhancements call for measures at a national level with a reinforcement of the cooperation between the central bank and the public authorities.

The 2004 modification of the Luxembourg constitution, which includes an article allowing the bestowing of regulatory power to public authorities, opens useful prospects.

In July 2004, the President of the ECB wrote to the Luxembourg Government in order that the legal framework be put in place for the due implementation of new measures decided by the ECB imposing data gathering upon a large number of economic actors such as investment funds, insurance companies or issuers of securities which, until then, had not been subject to reporting requirements from the central bank.

Another object may be modified in the organic setting law of the central bank. In a recommendation dated 21 October 2004, the ECB invites each Member State of the euro area to adopt specific legislation granting immunity of execution, on its territory, to assets including at least foreign exchange reserves belonging to or held by foreign central banks.

3.2.2 BCL Committees

The consultative committees of the BCL regroup experts with the view of assisting the Bank in specific areas of activity.

These are:

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

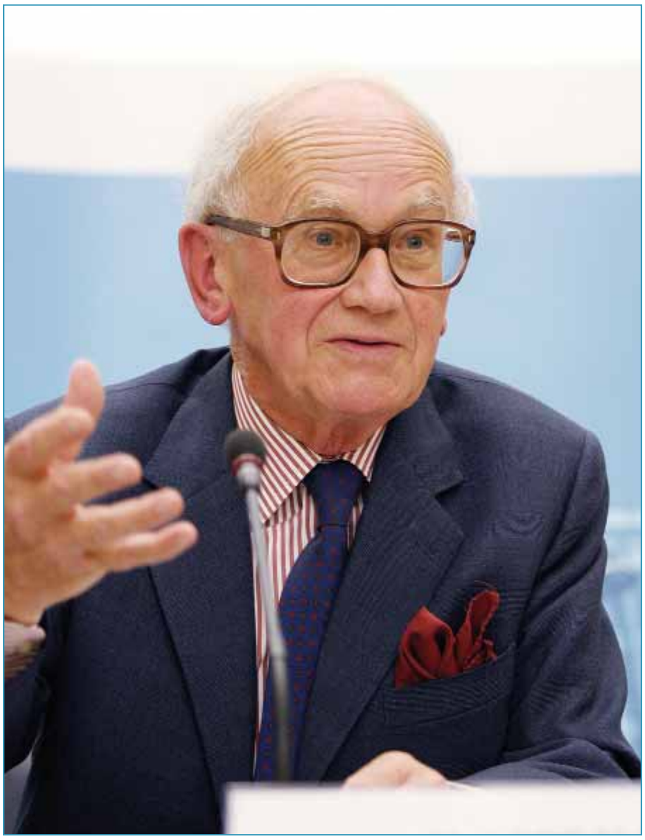
The Monetary and Financial Statistics Consultative Commission

3.2.3 The BCL's training initiatives

The BCL organised a series of internal courses on subjects falling directly within its competence, such as "EMU and the BCL", "Monetary Policy: Strategy and Instruments" and "Payment and Settlement Systems". Under certain conditions these courses can also be given outside the BCL.

The BCL is a shareholder of the Agency for the Transfer of Financial Technology (Agence de Transfert de Technologie Financière or ATTF), which celebrated its fifth birthday in 2004. The ATTF organises training courses, relying, *inter alia*, on the network of central bank cooperation. Members of the BCL staff made presentations during ATTF seminars to bankers and executives coming from Bosnia-Herzegovina, Egypt, Mongolia, Serbia and Uzbekistan.

During 2004, about ten staff members from the Bank of Mongolia completed brief internships at the BCL. In the context of exchange programmes, the BCL welcomed Japanese and Polish students.



Baron Alexandre Lamfalussy

On 26 October 2004, Baron Alexandre Lamfalussy was the speaker at the second Pierre Werner Lecture, organised on the premises of the BCL, on the theme of *Central Banks and Financial Stability* and which covered the contribution of central banks to the supervision of financial intermediaries and the financial system. For the speaker, central banks have an essential role to play in the area of crisis management. It is up to them to supply the financial system or individual institutions with liquidity. They play an essential role in the area of payments and they contribute to boosting the system's resilience. The specific role of central banks in banking regulation and supervision is very topical. New arrangements at the national levels and progress at the European level are being contemplated. These could also be boosted by the strengthening of the Eurogroup. Mr. Lamfalussy suggests making use of the possibilities of the Treaty of Madrid to widen the functions currently fulfilled by the Eurosystem.

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

The BCL handles Luxembourg's financial transactions with the IMF. For this purpose, it manages Luxembourg's assets and liabilities vis-à-vis the IMF in both the general account and the Special Drawing Rights (SDR) account. On 31 December 2004, Luxembourg's quota, entirely recorded in the BCL balance sheet, amounted to SDR 279.1 million, whereas the reserve position (the difference between Luxembourg's total quota at the IMF and the euro-denominated assets held by the IMF at the BCL) represented 32.13% of the Luxembourg 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 2004, the BCL was instrumental in making advances for 52.7 million euro related to IMF operations and was reimbursed 11.5 million euro.

At the end of 2004, Luxembourg held 58% of its SDR allocation (48.9% in 2003) following the accumulation of net interests received on the SDR account and on the reserve position. On 31 December 2004, the amount recorded on the SDR account was SDR 9.8 million.

The BCL also participated in several working groups of the Organisation for Economic Cooperation and Development (OECD) and the Bank for International Settlements (BIS). Besides its contributions to the area of financial stability, it concentrated on the work of the OECD Financial Markets Committee (FMC) and the BIS Committee on the Global Financial System (CGFS).

3.2.5 External events

3.2.5.1 Extra-European relations

The Governor of the BCL participated in the 11th annual meeting of the governors of the central banks of the French-speaking countries that was organised in June 2004 by the Banque de France. Some 30 governors discussed, *inter alia*, the impact of new international standards on financial stability and international cooperation in the fight against money laundering. The BCL's Governor delivered a speech "Financial stability - From the challenge of new international standards to the role of central banks".

In July 2004 the Governor of the BCL went to Asia on mission. In Hong Kong the Governor met representatives of the financial institutions. He also visited Mongolia in order to strengthen bilateral relations with the Bank of Mongolia, notably in the area of technical assistance. On 16 July 2004, Mr. Mersch participated in an EMEAP-Eurosystem high-level seminar in Singapore with eleven central bank governors from the Executives' Meetings of East Asia-Pacific (EMEAP), the President of the ECB and 11 other governors from the ESCB. The governors exchanged views on issues relevant to both Europe and the East-Asia region. They reviewed, *inter alia*, the emergence of East Asia in the global economy as well as the role of international currencies, including the use of such currencies in trade and investment flows in Asia.

In Latin America, the BCL's President took part in the second high-level seminar of the Eurosystem and Latin American central banks that was held on 26 November 2004 in Rio de Janeiro. This seminar was hosted by the Banco Central do Brasil and jointly organised together with the ECB and the Banco de España. It aimed at continuing the policy dialogue between central bankers of Europe and Latin America that was initiated at the first seminar in Madrid in 2002. The discussions focused on the fiscal, external and financial environment in which central banks operate.

The BCL participated in autumn 2004 in official missions to the People's Republic of China and the Gulf states. During the year, cooperation with other central banks, in particular with the *Banco de Cabo Verde* and the *National Bank of Cambodia*, was strengthened.

3.2.5.2 Meetings in Luxembourg of Committees and Working Groups

The Committee on Payment and Settlement Systems (CPSS) of the BIS held the fifth meeting of its working group, *Oversight of Payment and Settlement Systems*, on 8-9 June 2004 at the BCL. This working group was set up in order to analyse and compare the oversight activity concerning payment and securities settlement systems carried out by central banks. Central banks contribute directly to financial stability by providing accounts for the settlement of payments and for the settlement of the cash leg of securities transactions as well as by exercising oversight concerning those systems. A significant number of central banks have specific responsibilities in the field of financial stability.

The Banknote Committee (BANCO) of the ECB met on 17 and 18 June 2004 at the BCL. The current tasks of BANCO consist of coordinating the production of euro banknotes, including questions related to research and development issues, as well as the management and surveillance of circulation, including the management of stocks, the quality of the notes in circulation and counterfeiting.

The BCL maintained contacts with the European institutions and organisations based in Luxembourg. In December 2004, the bank's Executive Board received the six Luxembourg members of the European Parliament, who were elected on 13 June 2004.

3.2.5.3 Miscellaneous

The bust, sculpted by the artist Amar Nath Sehgal and offered by the Werner family to the BCL, is exhibited in the entrance hall of the building that is named after Mr. Werner.

In early January 2005, the BCL's Executive Board and staff decided to make a donation to help the victims of the tsunami that hit Asia. The BCL's gift goes to a special fund created by the Honorary Consul of Sri Lanka in Luxembourg that will finance the reconstruction of the village of Kosgoda in Sri Lanka.

3.3 The BCL's communication

3.3.1 Mission Statement of the Eurosystem and positioning of the BCL

In January 2005, in order to give specific and tangible indications as to how it executes its missions and fulfils the aims that the Treaty and the ESCB's statutes assigned to it, the Eurosystem published its mission statement, its strategic intents and its organisational principles as approved by the Governing Council.

The BCL harmonised its mission statement, which it had already formulated in October 2002, with the Eurosystem's statement. The BCL, which contributes fully to the missions assigned to together with the ECB and the other NCBs having adopted the euro, shares the objectives, the values and the principles of the Eurosystem. The BCL intends to be a centre of competence and of excellence, whose performance merits the public's confidence. Its corporate values are professionalism, quality, stability, objectivity and integrity.

3.3.2 Periodical bulletins

In 2004 the BCL published four bulletins, one of which covered financial stability. Besides topical messages and economic and financial reports on the European and Luxembourg economies, the BCL's bulletins included the following analyses:

Bulletin No 2004/1

- *Le secteur financier luxembourgeois en 2003 ;*
- *Risque de contagion du marché interbancaire luxembourgeois ;*
- *Crises management.*

Bulletin No 2004/2

- *Les finances publiques luxembourgeoises : état des lieux et perspectives ;*
- *La courbe de Phillips néo-keynésienne : résultats empiriques pour le Luxembourg.*

Bulletin No 2004/3

- *La mise en garantie de prêts bancaires auprès de la Banque centrale du Luxembourg au regard du secret bancaire luxembourgeois ;*
- *Impact des mesures prises par les autorités publiques sur les prix à la consommation ;*
- *Die Eurobargeldeinführung und regionale Preisunterschiede: Ist seitdem etwas passiert?;*
- *La persistance de l'inflation au Luxembourg : Une analyse au niveau désagrégé.*

Bulletin No 2004/4

- *Utilisation des instruments de paiement au Luxembourg ;*
- *Evolution de l'impact des fusions bancaires sur l'emploi dans les banques ;*
- *La position extérieure globale du Luxembourg ;*
- *Rigidités nominales et persistance de l'inflation.*

3.3.3 Working Papers

The BCL's working papers present the research of BCL staff. In 2004, two working papers were published on the following subjects:

Nr. 11: The new Keynesian Philips curve: empirical results for Luxembourg, by Leva Rubene and Paolo Guarda, June 2004

New Keynesian Phillips curve estimates for Luxembourg using the Galí and Gertler (1999) hybrid form suggest that firms change prices often but tend to use backward looking rules-of-thumb instead of resetting prices optimally using forward-looking expectations. In terms of policy implications, although the results suggest that prices in Luxembourg are relatively flexible, the prevalence of backward-looking price setting implies greater inflation persistence and a higher sacrifice ratio attached to disinflationary monetary policy. From the perspective of individual firms, backward-looking price setting may be a rational response in a very small open economy because of its vulnerability to external shocks. Small size and openness plausibly imply higher costs for collecting information and lower benefits from optimal price setting.

Nr. 12: Inflation persistence in Luxembourg a comparison with EU 15 countries at the disaggregate level, by Thomas Y. Mathä and Patrick Lünnemann, November 2004.

For monetary authorities and central banks, it is important to know how sluggishly inflation returns to its long-run equilibrium level after a disturbance, in order to assess the short-term impact of monetary policy decisions. A vast literature has emerged analysing the degree of inflation persistence. Working paper 12 analyses the degree of inflation persistence in Luxembourg using disaggregate price index data from the Harmonised Index of Consumer Prices. The degree of inflation persistence is then compared to estimates for the EU15 and for the euro area as well as for the individual member countries according to a unified approach.

3.3.4 The BCL's Website

The BCL's website, **www.bcl.lu**, carries news as well as information on the Bank's organisation and the services it provides. It contains links to the ECB and of the other central banks of the ESBC.

A new version of the site, aimed at a wider public, went online in 2004. Aside from presentational improvements, the site benefits from a new structure and updated technology. The new version offers visitors a performing research engine, individualised mailing lists, as well as clearly structured information tailored to the different categories of web users: financial sector professionals, media, academics, numismatists…

The new website is designed to play an increasing role in the dissemination of the BCL's publications. It exists in a French and an English version. Documents are published in their original language (French, English, German).

All BLC publications may be consulted and downloaded on www.bcl.lu. Hard copies can be obtained while stocks are available.

3.3.5 The Library

In 2004 the BCL inaugurated its new library. Thanks to its cooperation with the *Bibliothèque nationale* (BnL), the BCL was able to join the network of Luxembourg libraries and to adopt the Aleph programme for library management, which is used by many other central banks. At this stage, the library consists of some 9 000 publications covering monetary, financial, economic and legal matters pertaining to the euro area. These are mainly published by international organisations (BIS, European Commission, IMF, OECD, World Bank…) and central banks. The library stocks numerous CD-ROMs (of specialised publications, analyses, statistics, legislation…) and offers access possibilities to various databases.

The library is open to the public upon prior request. Requests may be submitted either by e-mail (bibliotheque@bcl.lu), or by fax (+352 4774 4910).

4. THE BCL AS AN ORGANISATION

4.1 The BCL's organisation

4.1.1 The Council and the Audit Committee

The Council

Article 6 of the law of 23 December 1998 defines the powers of the Council of the Bank.

The members of the Board are ex officio members of the Council; in 2004, the members of the Council were:

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

On 4 June 2004, the appointment of Mr Patrice Pieretti as a member of the Council has been renewed for a period of 6 years by the Government.

The emoluments of Council members amount to 100 index points (employee value) for the President and 40 index points (employee value) for other members.

During 2004, the Council held 5 meetings.

- Within the framework of **monitoring the financial situation** of the Bank, the Council has approved the financial accounts as of 31 December 2003, the budgetary trends and, subsequently, the budget and the organisation chart of the Bank for the 2005 financial exercise. At its meeting of 16 April 2004, the Government in Cabinet has decided to give its discharge to the organs of the Bank for the financial exercise 2003. The Council has proposed the appointment of the external auditor to the Government and has appointed the members of the Audit Committee for 2005. The Council has also assisted in the drafting of this Central Bank annual report.

- Regarding the **business policy of the Bank**, the Council has decided on a broad outline for the BCL asset management policy and has been kept informed of the outcome of BCL business cases, i.e. coin minting and the marketing of Luxembourg numismatic products, international cooperation and service providing for third parties, training policy and the remuneration of oversight of payment and securities settlement systems.

- In its role as an **observer of ESCB missions**, the Council regularly observed and commented on economic and financial evolution at national and international levels and has been kept informed of the decisions made by the Governing Council of the ECB.

The Audit Committee

The Audit Committee was created by the Council at its meeting of 13 December 2001. Its objective is to assist the Council in the performance of its missions related to the approval of the financial accounts (articles 6 (c) and 29 (1) of the law) and to the work of the statutory auditors of the BCL (article 6 (f) and 16 of the law).

The Committee has a preparatory role only and thus has no decision-making power. It reports to the Council and is composed of 3 non-executive members of the Council and the President of the Council. It may invite the head of the internal audit unit and the statutory auditor of the Bank to participate in its work. Each member of the Council has the right to request invitation to the committee's meetings.

Members are appointed by the Council for a renewable mandate of one year. Being chaired by one of its non-executive members, the Committee has several missions:

- It assists the Council in its choice of the statutory auditor to be proposed to the Government;

- In addition to the legal mandate of the statutory auditor, the Committee assists the Council in specifying the scope of the potential specific controls to be performed by the statutory auditor (article 16 of the Law);

- It is kept informed of the audit programme of the statutory auditor in order to assist the Council in its analysis of the reports issued by the statutory auditor;

- It is kept informed of the internal audit plan in order to assist the Council in the analysis of the internal audit activity report;

- It is kept informed of the follow-up of the statutory auditor's and internal audit's recommendations.

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

In 2004, the Audit Committee held three meetings. During its meeting on 9 December 2004, the Council renewed the mandates of the non-executive members of the Audit Committee for 2005: Messrs. Mathias Hinterscheid, Pit Hentgen and Nico Reyland. Mr. Mersch is an ex officio member in his function as President of the Council.

4.1.2 The Board of Directors

The Board of Directors is the superior executive authority of the BCL. It draws up the measures and takes the decisions required for the fulfilment of the tasks of the Central Bank.

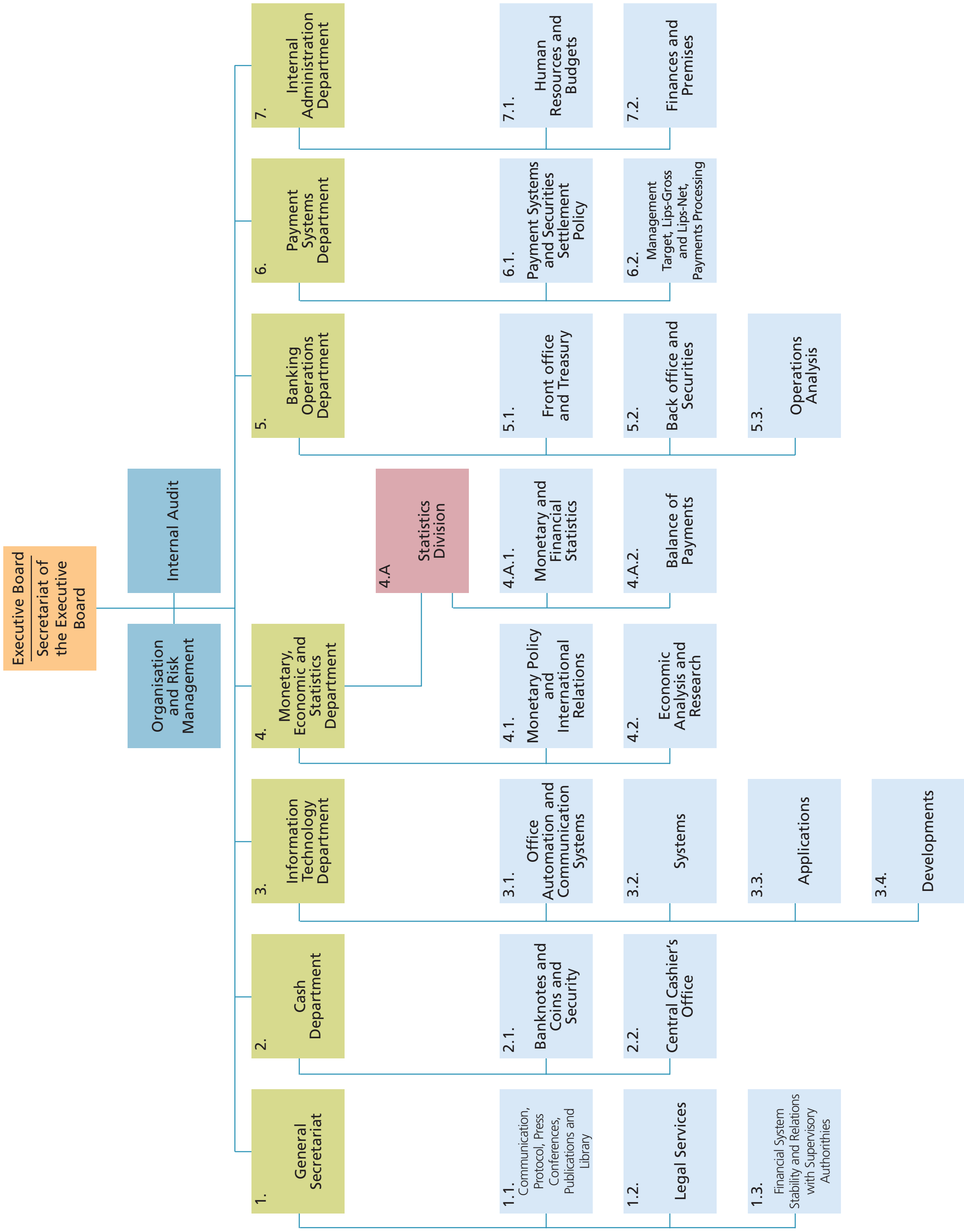
The Board of Directors comprises of the Director-General and two Directors. The three members of the Board are appointed by the Grand Duke, on a proposal from the Government in Cabinet for a six-year period and their appointments shall be renewable (art 11). During 2004, the appointments of the members of the Board have been renewed for a period of 6 years. In accordance with the decree of the Grand Duke of 8 June 2004, the appointment of the Director general due, on the 31 of May, has been renewed. The appointments of the two Directors have also been renewed by decree of the Grand Duke of 21 December 2004.

Article 7 (1) of the law of 23 December 1998, which provides that the Board members are ex officio members of the Council has been renewed by degree also, as have the appointments of the Board members as members of the Council.

The salaries of members of the Board are classed respectively in Grade 18 of Heading "I. General Administration" of appendix A "classification of functions" for the Directors and in grade S1 of Heading "VI. Functions with fixed index", for the Director-General. Besides a basic salary, the two Directors are entitled to receive an allowance for representation purposes of 131 index points (employee value) and the Director-General is entitled to receive an allowance of 122 index points.

Director-General: Mr. Yves Mersch
Directors: Mrs. Andrée Billon and Mr. Serge Kolb

4.1.3 The BCL's organisation chart



4.2 The BCL staff

4.2.1 Growth of staff

During 2004, the BCL staff increased by 3% to reach a total of 209 on 31 December 2004 (including Executive Board members), equivalent to 198.5 full time positions (+1% from 2003). The introduction of part-time work in 2004 explains why the increase in staff exceeded the increase in the number of positions.

At the end of December 2004, 14 staff members worked part-time:

- Part-time work (50%): 5 staff members
- Part-time work (75%): 4 staff members
- Leave for half-time work: 5 staff members

During 2004, the BCL welcomed 10 new staff members, 9 of whom were offered a contract for an unlimited period of time and one a fixed-term contract. Six staff members have been recruited into the higher career bracket, 3 staff members into the intermediate career bracket, and 1 staff member into the junior career bracket. Four staff members have left the bank: of these 2 have been granted special leave and 1 benefits from unpaid leave.

Furthermore, 3 staff members were on part-time parental leave, and 3 more were on full-time parental leave.

Finally, 2 staff members were granted unpaid leave and 3 were on special leave.

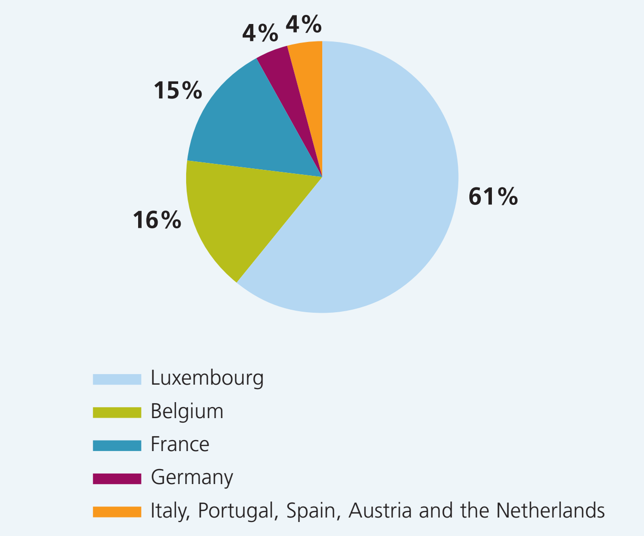
As a result of new activities, the Bank's organisational chart shows an increase of 6 posts relative to 2003.

A competitive entrance examination was held on 24 and 25 June 2004, for which 150 candidates applied. Additionally, the BCL received approximately 460 spontaneous applications and some 270 applications for internships or student jobs.

As in former years, the recruitment procedure mainly focused on university graduates as well as the applicants' potential.

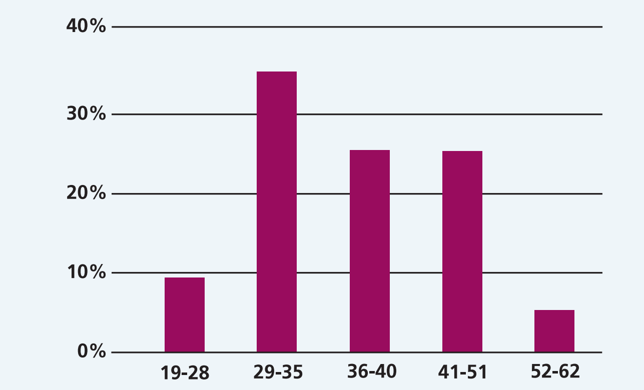
Staff members are of nine different nationalities, thus contributing to the diversity of the Bank's human capital and its cultural enrichment.

GRAPH 1: STAFF MEMBERS BY NATIONALITY

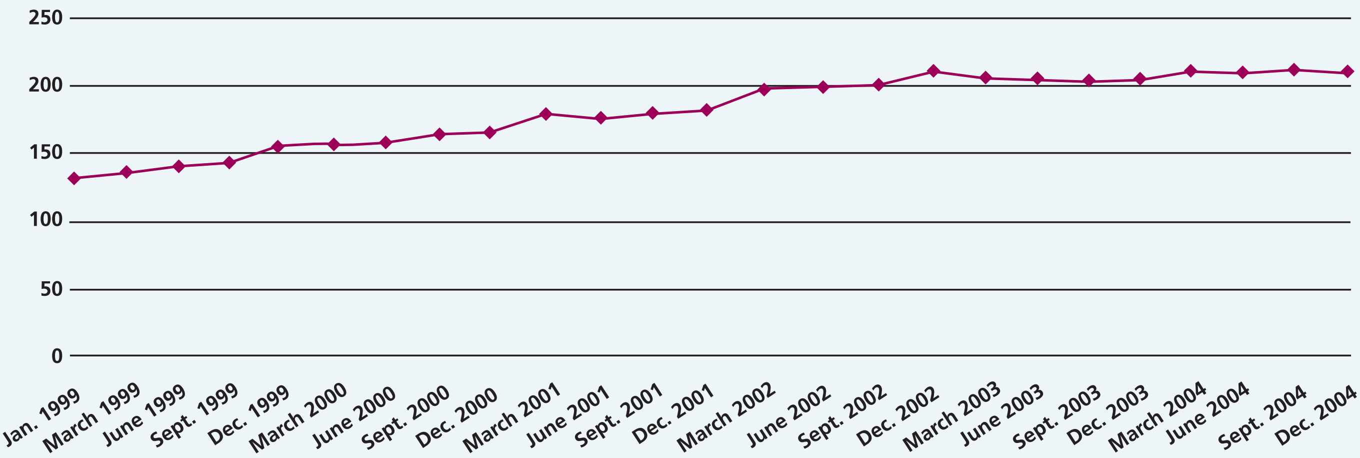


The average age of BCL staff members has slightly increased from 36.45 years in 2003 to 37.30 years at the end of December 2004. On this date, the staff numbered 34% women and 66% men.

GRAPH 2: BREAKDOWN OF STAFF MEMBERS PER AGE GROUP



GRAPH 3: STAFF NUMBERS SINCE JANUARY 1999



4.2.2 Human resources management

The annual assessment was introduced in 2003, and in 2004 the whole appraisal exercise was further developed. This exercise has allowed each staff member to establish clearly defined individual objectives for the year to come, in line with the corporate objectives of the Bank as defined in the Corporate Balanced Scorecard. Moreover, the introduction of a retrospective part allows an assessment of the extent to which the fixed objectives have been met.

Practical aspects of daily human resource management have also been improved thanks to the integration of HR software. After a series of tests and adaptations to the specificities of the Bank in terms of, for example, status and payment system, new HR software now allows staff members to forward their holiday and training requests on-line to their superior for approval.

4.2.3 Staff training

The Bank positions itself as a centre of competence, and by means of a constant quest for excellence it aims at gaining the public's confidence. The Bank's corporate values should enable it to adapt easily to the trends and needs of its environment. In order to meet these requirements, great emphasis has been given to the training of new recruits and the continuing education of the staff.

2004 has seen the consolidation of the Bank's training policy, which makes a distinction between the basic training programme, management training and continuing education.

The choice of internal training courses has been considerably broadened to reach a total of 16 by the end of 2004. The establishment of these courses called for extensive effort on the part of all those responsible. The courses on offer at the BCL concentrate on central bank activities. The objective pursued is to share the Bank's know-how with as many as possible of Luxembourg's financial specialists. Opening up these courses - which are already available for internal training needs - to third parties, provides considerable economies of scale. Thus, negotiations in order to strengthen cooperation with the "Agence de transfert de technologie financière" (ATTF) and the "Institut de formation bancaire, Luxembourg" (IFBL) have been held.

Following a detailed analysis of management skills, management-training courses have been organised. A total of 39 staff members attended this training programme, which had a total duration of 6.5 days. The first 2-day module tackled questions of staff supervision, the second module (2.5 days) dealt with communication and assertiveness, and the last (2-day) module deepened the study of teamwork and motivation.

All new recruits must follow the basic internal training programme, and all staff members are also encouraged to carry out external training, mainly with other central banks of the ESCB so as to consolidate their professional skills.

Within this context, it should be noted that during 2004 a total number of 5 475 training hours were registered, representing an average of 3.3 days per staff member.

Throughout 2004, some staff members were temporarily seconded to the ECB to carry out missions requested by the European Central Bank.

4.2.4 The Pension Fund

The statute[1] of the BCL provides that legal pension entitlements of BCL agents are determined by their status (*i.e.* civil servant, State employee, private employee or worker). The costs and financing of pensions are also governed by this statute, which reads as follows:

"Costs of pensions of BCL agents are incurred by the Bank. This charge shall be financed by a Central Bank pension fund. 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, and, on the other hand, by contributions from the Central Bank."

The statute[2] also organises the transitory regime applicable to BCL agents, who contributed previously to another pension fund, as follows: "Luxembourg pension funds which have received contributions for persons who are or become agents of the Central Bank on the day on which this law enters into force, shall pay those contributions to the Central Bank pension fund". In addition, "the periods within which these agents contributed to these pension funds are automatically validated as contribution periods with the BCL." With regard to the default on payment of the "*Caisse de Pensions des Employés Privés*" and the "*Etablissement d'Assurance contre la Vieillesse et l'Invalidité*", the BCL sued these two bodies before the Luxembourg court[3], in order to obtain the payment of the contributions owed. At the time of the drafting of this report, the trial is still in progress.

The BCL pension fund, which became operational in 2001, adopted internal rules and created both a decision-making Executive Committee (*Comité directeur*) and a consultative Tactical Benchmark Committee. The Executive Committee is composed of the BCL Executive Board members, two elected representatives of BCL agents, two co-opted members acting as delegated managers and one member designated by the Staff committee.

The Bank manages the assets of its pension fund in accordance with the rules of the said fund. The pension fund's guidance is set by the Executive Committee. The asset manager is appointed by the Executive Committee and this mandate is carried out in-house.

The Tactical Benchmark Committee determines the investment policy in strict compliance with parameters specified by the Executive Committee, especially with regard to the strategic composition of the global portfolio of the pension fund by currency and by asset class. It is a mixed pension fund, mainly holding bonds, liquidities and shares. It can also contain other financial tools. The pension fund's management is done in order to generate a minimal performance such as is determined by a long-term actuarial calculation. The fund's assets have been put in the care of an external bank assuming the function of custodian. The actual transfer of the fund's assets, equalling an amount of 44.4 million euro, was completed on 27 July 2001. The fund has the benefit of monthly capital inflows.

With regard to the default on payment of the "*Caisse de Pensions des Employés Privés*" and the "*Etablissement d'Assurance contre la Vieillesse et l'Invalidité*" and the legal duty imposed by article 14 upon the BCL, the latter withheld an amount of 33.8 million euro, in addition to the withdrawal from its reserve fund[4].

During 2004, one BCL staff member has been granted a disability pension.

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[1] Article 14, indent (4) (b) of the statute of 23 December 1998 relating to the monetary status of the BCL.

[2] Article 35, indent (4) (a).

[3] *Tribunal d'arrondissement de Luxembourg.*

[4] According to article 35 (a) (c) of the law.

4.3 Buildings/Facilities

In 2004, the BCL made further efforts to reduce costs as well as manage and maintain its buildings.

The BCL received the necessary permission to tear down the former building of the National Bank of Belgium and to construct a new one. The objective is to create a backup solution for the bank's vital e.g. computer systems, payment systems, monetary policy and the issuing of banknotes and coins.

On 29 October 2004, Mr. Yves Mersch, the Governor of the BCL and Mr. Paul Helminger, the city's mayor, placed the first symbolic brick of the new building situated on the "Prince Henri" boulevard.

The building is planned to be completed by end-2006, within the projected budget and timetable.

4.4 Accounting and the Budget

4.4.1 Accounting and Finance

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

The Bank regularly checks the development of balance sheet, off-balance-sheet and profit & loss items. Investments, revenues and expenses are particularly closely monitored with respect to the internal procedures of authorised signatures.

The implementation of a cost accounting system was continued in 2004. At this stage, the methodology consists of allocating the BCL's operational expenses according to their destination, e.g. to the respective sections and entities. An activity-based costing system developed in 2004 will be finalised in 2005.

The monthly balance sheet of the Bank is published on its internet site. The Eurosystem requires daily reports of the Eurosystem members' balance sheet data according to harmonised rules.

The "management information system" allows for the monitoring of 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 Bank activities. The analysis of the profit & loss items is completed by a result analysis of the various activities. The Bank strictly controls the development of the interest margin and compares the profitability of its investments to benchmarks.

The BCL regularly checks its risk exposure and controls the appropriateness of its own funds and of its short-, middle- and long-term provisions. The Bank has adopted a prudent policy of constituting and maintaining provisions for general and specific bank risks.

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

The council and the management are regularly informed of the results in order to be in a position to decide on the Bank's future orientation and the actions to be undertaken.

The asset/liability committee monitors more closely the risk exposure and the financial situation during the year, and in particular the risk resulting from the appropriateness of assets and liabilities. This committee checks the investment limits imposed by the respective NCBs and the ECB's balance sheet positions.

4.4.2 Budget

Every year in December, the BCL's Council approves the budget for the coming year. The elaboration of the 2004 budget was done in accordance with the budgetary procedure that aims to manage the Bank's resources in a rational manner.

The budgetary procedure ensures that the limit set beforehand will not be exceeded. Within this limit, expenses can be engaged only as far as they are abiding by the Bank's rules regarding profitability and economic efficiency. The operational costs for 2004 have stayed within the budgetary limit approved by the Council.

The elaboration of the 2005 budget, just like the previous year, was completely done using specific software for electronic data processing, which has considerably reduced the reaction time regarding all last minute changes and therefore to produce an updated version of the amended budget enabling the decision-makers to take appropriate measures.

Furthermore, the access to budgetary data for users via their computers represents a simplification in budget monitoring. Indeed, the software allows for daily monitoring in real time. The data listed in the accounting system is injected on a daily basis in the software, which allows an immediate charging of the invoices to a budgetary item, thus shortening considerably the margin for possible overspending.

The budgetary planning is perfectly in line with the Bank's management cycle and takes the strategic objectives, as fixed within the Balanced Scorecard, fully into account. This BSC defines the Bank's main task and the ensuing objectives. While respecting the financial constraints imposed by a difficult economic context, the budgetary directives that have underlain the elaboration of the budget should enable the Bank to fulfil all its assigned missions.

4.5 The internal audit activities

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

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

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

Based on the annual internal audit plan, comprising audit engagements that are coordinated by the Internal Auditor's Committee at the level of the ESCB, as well as audit engagements at a national level, the Internal Audit unit performed during the year 2004 various reviews. These covered the fields of minimum reserves and foreign reserve management, oversight related to payment systems, banknotes and coins, accounting, as well as information systems.

4.6 Financial statements as at 31 December 2004

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 Directors. In case of differences between the French version and the translation, the French version should be retained."

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

	2003	2004	Change in % 2004/2003
Total assets	27 856 509 647	34 795 519 545	25%
Banks' current accounts	6 765 571 187	5 063 321 077	-25%
Claims on credit institutions	23 402 735 897	28 353 710 277	21%
Own funds (1), revaluation accounts, administrative provisions and specific banking risks	416 004 599	456 816 923	10%
Net result of banking activities (2)	99 947 756	81 998 162	-18%
Total net revenues	39 119 616	36 851 687	-6%
Administrative expenses	27 282 863	29 225 981	7%
Net profit	3 105 175	2 605 967	-16%
Cash Flow (3)	74 171 100	56 200 003	-24%
Personnel	200	206	3%
BCL's part in the capital of the ECB	0.15%	0.16%	
BCL's part in the Eurosystem's monetary policy operations	**7.85%**	**8.21%**	

(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 attached financial statements of the Banque centrale du Luxembourg for the year ended December 31, 2004. The financial statements are the responsibility of the Directors and are approved by the Council. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the attached financial statements give, in conformity with the generally accepted accounting principles and those defined by the European System of central banks, a true and fair view of the financial position of the Banque centrale du Luxembourg as at December 31, 2004 and of the results of its operations for the year then ended.

DELOITTE S.A.
Réviseur d'entreprises

Luxembourg, March 3, 2005

Pascal Pincemin
Partner

Vafa Moayed
Partner

4.6.3 Balance sheet as at 31 December 2004

(IN EURO)

	Note	2004 EUR	2003 EUR
ASSETS			
Gold and gold receivables	3	23 860 617	24 880 800
Claims on non-euro area residents denominated in foreign currency	4	218 661 158	221 599 940
- Receivables from the IMF		113 377 895	151 431 221
- Balances with banks, security investments, external loans and other external assets		105 283 263	70 168 719
Claims on euro area residents denominated in foreign currency	5	51 831 953	19 794 150
Claims on non-euro area residents denominated in euro	6	466 612 637	290 550 224
- Balances with banks, security investments and loans		466 612 637	290 550 224
Lending to euro area credit institutions related to monetary policy operations denominated in euro	7	28 353 620 150	23 402 139 150
- Main refinancing operations	7.1	21 478 000 000	20 368 177 200
- Long-term refinancing operations	7.2	6 875 620 150	3 033 961 950
Other claims on euro area credit institutions denominated in euro	8	90 127	596 747
Securities of euro area residents denominated in euro	9	1 463 985 126	828 959 524
Intra-Eurosystem claims	10	3 488 282 255	2 408 352 832
- Participating interest in ECB	10.1	9 660 235	7 460 000
- Claims related to the transfer of foreign reserves	10.2	87 254 014	74 600 000
- Other claims within the Eurosystem	10.3	3 391 368 006	2 326 292 832
Items in course of settlement		192	42
Other assets	11	728 575 330	659 636 238
- Tangible and intangible fixed assets	11.1	58 365 712	58 701 026
- Other financial assets	11.2	582 682 793	530 602 520
- Off-balance sheet instruments revaluation differences		607 500	-
- Accruals and prepaid expenses	11.3	60 940 395	44 790 875
- Sundry	11.4	25 978 930	25 541 817
Total assets		**34 795 519 545**	**27 856 509 647**

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

Balance sheet as at 31 December 2004 (continued)

(IN EURO)

	Note	2004 EUR	2003 EUR
LIABILITIES			
Banknotes in circulation	12	1 012 539 140	739 426 800
Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	13	5 063 321 077	6 765 571 187
- Current accounts (covering the minimum reserve system)		5 063 321 077	6 765 571 187
Liabilities to other euro area residents denominated in euro	14	554 852 262	592 064 411
- General government	14.1	554 852 262	592 064 411
Liabilities to non-euro area residents denominated in euro	15	58 327 526	51 907 491
Liabilities to non-euro area residents denominated in foreign currency	16	51 854 230	19 796 162
Counterpart of special drawing rights allocated by the IMF	17	19 321 918	19 972 990
Intra-Eurosystem liabilities	18	27 341 616 355	19 077 543 570
- Net liabilities related to the allocation of euro banknotes within the Eurosystem	18.1	27 341 616 355	19 077 543 570
Items in course of settlement	19	3 947 631	6 812 500
Other liabilities	20	160 572 809	104 097 466
- Off-balance sheet instruments revaluation differences		664 000	346 300
- Accruals and income collected in advance		141 871 653	89 766 149
- Sundry		18 037 156	13 985 017
Provisions	21	355 941 192	305 678 333
Revaluation accounts	22	27 802 136	30 821 436
Capital and reserves	23	142 817 302	139 712 126
- Capital	23.1	25 000 000	25 000 000
- Reserves	23.2	117 817 302	114 712 126
Profit for the year		**2 605 967**	**3 105 175**
Total liabilities		**34 795 519 545**	**27 856 509 647**

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

4.6.4 Off-balance sheet as at 31 December 2004

(IN EURO)

	Note	2004 EUR	2003 EUR
Custody deposits	24	132 113 030 126	106 433 616 407
Commitments and similar instruments	25	1 900 000 000	1 400 000 000
Foreign currency reserve assets administrated on behalf of the ECB	26	76 187 489	69 213 290
Forward transactions	27	694 214 750	43 355 000
Numismatic collection		122 709	107 972
		134 783 555 074	**107 946 292 669**

4.6.5 Profit and loss account for the year 2004

(IN EURO)

	Note	2004 EUR	2003 EUR
Interest income	28	669 225 751	610 386 573
Interest expense	28	(585 693 474)	(512 430 452)
Net interest income	**28**	**83 532 277**	**97 956 121**
Realised gains/(losses) arising from financial operations	29	5 951 518	9 072 330
Write-downs on financial assets and positions	30	(7 422 706)	(6 542 502)
Transfer to/from provisions for foreign exchange rate and price risks	31	(41 498 079)	(55 865 813)
Net result of financial operations, write-downs and risk provisions		**(42 969 267)**	**(53 335 985)**
Fees and commissions income	32	7 648 934	6 524 275
Fees and commissions expense	32	(7 711 862)	(7 062 469)
Net result from fees and commissions	**32**	**(62 928)**	**(538 194)**
Income from participating interest	33	-	1 131 889
Net result of pooling of monetary income	34	(14 320 344)	(18 641 870)
Other income	35	10 671 948	12 547 655
Total net income		**36 851 686**	**39 119 616**
Staff costs	36	(17 858 894)	(16 524 525)
Other administrative expenses	37	(7 622 472)	(7 777 336)
Depreciation of tangible and intangible fixed assets	11.1, 38	(5 019 739)	(6 984 340)
Banknote production services	39	(497 560)	(316 697)
Other expenses	40	(3 247 054)	(4 411 543)
Profit for the year		**2 605 967**	**3 105 175**

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

4.6.6 Notes to the financial statements as at 31 December 2004

Note 1 - General

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

Note 2 - Accounting policies

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

2.1 Layout of the financial statements

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

2.2 Accounting principles

The following accounting principles have been applied:

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

2.3 Basic principles

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

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

2.4 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. Proceeds and costs are converted at the exchange rate prevailing on the date of the transaction.

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

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

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

2.5 Securities

Negotiable securities denominated in foreign currencies and in 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 were not considered in the profit and loss account, but transferred to a revaluation account on the liabilities side of the balance sheet.

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

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

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

2.7 Post balance sheet events

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

2.8 Banknotes in circulation

The European Central Bank ("ECB") and the 12 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" (see "Intra-ESCB balances" in the notes on accounting policies).

From 2002 until 2007 the intra-system balances arising from the allocation of euro banknotes are adjusted in order to avoid significant changes in NCBs' relative income positions 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 in the period from July 1999 to June 2001 and the average value of banknotes that would have been allocated to them during that period under the ECB's capital key. The adjustments will be reduced in annual stages until the end of 2007 after which income on banknotes will be allocated fully in proportion to the NCBs' paid-up shares in the ECB's capital.

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

The Governing Council of the ECB has decided that the seigniorage income of the ECB, which arises from the 8% share of euro banknotes allocated to the ECB, shall be distributed separately to the NCBs in the form of an interim distribution of profit. It shall be so distributed in full unless the ECB's net profit for the year is less than its income earned on euro banknotes in circulation and subject to any decision by the Governing Council to reduce this income in respect of costs incurred by the ECB in connection with the issue and handling of euro banknotes. With respect to 2004, the Governing Council decided in the light of their estimate that the full amount of such income should be retained by the ECB.

2.9 Intra-Eurosystem claims and liabilities

Intra-Eurosystem balances arising from the allocation of euro banknotes within the Eurosystem are included as a net single asset or liability under "Net claim/ liability related to the allocation of euro banknotes within the Eurosystem".

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

2.10 Treatment of tangible and intangible assets

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

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

2.11 Pension fund

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

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

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

2.12 Provision for banking risks

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

Note 3 - Gold and gold receivables

As at 31 December 2004, the BCL holds 2 202.23 ounces of fine gold amounting to 0.7 million euro (3 313.29 ounces of fine gold amounting to 1.1 million euro as at 31 December 2003) and a first rated gold bond issued by the International Bank for Reconstruction and Development purchased in 2002 and valued at 23.2 million euro (23.8 million euro as at 31 December 2003).

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 31 December 2004.

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

	2004 EUR	2003 EUR
Receivables from the IMF	113 377 895	151 431 221
Balances with banks, security investments, external loans and other external assets	105 283 263	70 168 719
	218 661 158	**221 559 940**

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's holder. The reserve tranche position corresponds to the net amount of the quota and the IMF's currency holding and takes into account the revaluation of the general account.

- balances held on accounts with banks which do not belong to the euro area as well as securities, loans and other foreign currency assets issued by non-residents of the euro area. This sub-item includes in particular the US Dollar securities portfolio, built up from 2003, which could be used, if needed, for monetary policy operations.

This portfolio, which amounts to 52.8 million euro as at 31 December 2004 (39.9 million euro as at 31 December 2003), only contains government bonds and first rated bonds issued by international and supranational institutions denominated in US Dollars. Securities are valued at market prices. As at 31 December 2004, their value at market prices included an unrealised loss amounting to 0.2 million euro (compared to an unrealised loss amounting to 0.4 million euro on 31 December 2003).

Balances with banks amount to 52.5 million euro as at 31 December 2004 (30.2 million euro as at 31 December 2003).

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

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

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

	2004 EUR	2003 EUR
Balances with banks	589 696	1 240 587
Security investments	466 022 941	289 309 637
	466 612 637	**290 550 224**

This item contains balances held on accounts with banks which do not belong to 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 which do not belong to the euro area denominated in euro. Securities are valued at market prices. As at 31 December 2004, their value at market prices included an unrealised loss amounting to 4.9 million euro (unrealised gain amounting to 0.6 million euro as at 31 December 2003).

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:

	2004 EUR	2003 EUR
Main refinancing operations	21 478 000 000	20 368 177 200
Longer-term refinancing operations	6 875 620 150	3 033 961 950
Fine-tuning reverse operations	-	-
Structural reverse operations	-	-
Marginal lending facility	-	-
Credits related to margin calls	-	-
	28 353 620 150	**23 402 139 150**

7.1 Main refinancing operations

This sub-item records the amount of liquidity provided to credit institutions by way of weekly one-week tenders (two weeks in 2003).

7.2 Long-term refinancing operations

This sub-item records the amount of credit extended to credit institutions by way of monthly 3-month tenders. These operations were growing fast in the Eurosystem in 2004.

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 operations took place during the year just ended.

7.5 Marginal lending facility

A standing facility enabling counterparties to obtain 24 hours credit from the Bank at a pre-specified interest rate, against eligible collateral.

7.6 Credits related to margin calls

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 operations 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 which belong to 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 amounts to 1 464 million euro as at 31 December 2004 (829 million euro as at 31 December 2003).

This portfolio only contains government bonds in euro issued by member states of the European Union and first rated bonds issued by companies of the euro area. Securities are valued at market prices. As at 31 December 2004, their value at market prices included an unrealised loss amounting to 1.5 million euro (unrealised gain amounting to 0.3 million euro as at 31 December 2003).

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 must be adjusted 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 10 Member States.

Based on the Council Decision of 15 July 2003 on the statistical data to be used for the determination of the key for subscription of the capital of the European Central Bank, the capital keys of NCBs were adjusted as follows on 1 January 2004 and 1 May 2004, by means of transfers among the NCBs:

	Key for subscription of the ECB's capital		
	until 31 December 2003	from 1 January 2004 au 30 avril 2004	From 1 May 2004
Nationale Bank van België/Banque Nationale de Belgique	2.8658	2.8297	2.5502
Deutsche Bundesbank	24.4935	23.4040	21.1364
Bank of Greece	2.0564	2.1614	1.8974
Banco de España	8.8935	8.7801	7.7758
Banque de France	16.8337	16.5175	14.8712
Central Bank and Financial Services Authority of Ireland	0.8496	1.0254	0.9219
Banca d'Italia	14.8950	14.5726	13.0516
Banque centrale du Luxembourg	0.1492	0.1708	0.1568
De Nederlandsche Bank	4.2780	4.4323	3.9955
Oesterreichische Nationalbank	2.3594	2.3019	2.0800
Banco de Portugal	1.9232	2.0129	1.7653
Suomen Pankki - Finlands Bank	1.3970	1.4298	1.2887
Total euro area NCBs	***80.9943***	***79.6384***	***71.4908***
Ceská národní banka	0.0000	0.0000	1.4584
Danmarks Nationalbank	1.6709	1.7216	1.5663
Eesti Pank	0.0000	0.0000	0.1784
Central Bank of Cyprus	0.0000	0.0000	0.1300
Latvijas Banka	0.0000	0.0000	0.2978
Lietuvos bankas	0.0000	0.0000	0.4425
Magyar Nemzeti Bank	0.0000	0.0000	1.3884
Central Bank of Malta/Bank Centrali ta' Malta	0.0000	0.0000	0.0647
Narodowy Bank Polski	0.0000	0.0000	5.1380
Banka Slovenije	0.0000	0.0000	0.3345
Národná banka Slovenska	0.0000	0.0000	0.7147
Sveriges Riksbank	2.6537	2.6636	2.4133
Bank of England	14.6811	15.9764	14.3822
Total non-euro area NCBs	***19.0057***	***20.3616***	***28.5092***
Total euro area and non-euro area NCBs	**100.0000**	**100.0000**	**100.0000**

Consequently, on 1 January 2004, the share that the BCL held in the subscribed capital of the ECB (5 billion euro in total) increased from 0.1492% to 0.1708% and participating interest in the ECB increased by 7.5 million to 8.5 million euro.

In accordance with Article 49.3 of the Statute of the ESCB, which was added to the Statute by the Treaty of Accession, the ECB's subscribed capital is automatically increased when a new member joins the EU and its NCB joins the ESCB. The increase is determined by multiplying the prevailing amount of the subscribed capital (5 billion euro) by the ratio, within the expanded capital key, between the weighting of the entering NCBs and the weighting of those NCBs that are already members of the ESCB. Therefore, on 1 May 2004 the subscribed capital of the ECB was increased to 5.565 billion euro. Consequently, on 1 May 2004, the share that the BCL held in the increased subscribed capital of the ECB (5.565 billion euro in total) decreased from 0.1708% to 0.1568% and participating interest in the ECB increased by 8.5 million euro to 8.7 million euro.

As a result of the aforementioned capital key changes, the relative shares of NCBs in the accumulated net profits of the ECB as at 31 December 2003 and 30 April 2004 changed. Sub-item "participating interest in ECB" also reflects the net increase of the BCL's share in this respect (repayment of 0.9 million euro part of the capital contribution by the ECB), this participation amounts to 9.7 million euro from 1 May 2004.

10.2 Claims equivalent to the transfer of foreign reserves

This sub-item represents the euro-denominated claims on the ECB in respect of the transfer of part of the BCL's foreign reserves. The claims are denominated in euro at a value fixed at the time of their transfer. They are remunerated at the latest available marginal rate for the Eurosystem's main refinancing operations, adjusted to reflect a zero return on the gold component.

The adjustments to the capital key weightings of the ECB on 1 January 2004 and 1 May 2004 also resulted in the adjustment of the claim of the BCL with respect to the foreign reserve assets transferred to the ECB. In order to reflect its increased capital key share, the euro-denominated claim of the BCL increased by 74.6 million to 85.4 million euro on 1 January 2004 and increased by 85.4 million to 87.3 million euro on 1 May 2004.

10.3 Other claims within the Eurosystem

This sub-item represents the BCL's net claims towards the Eurosystem, mostly from transactions resulting from cross-border payments initiated for monetary or financial operations, made via the TARGET system, between the BCL and the other NCBs as well as the ECB. This claim amounts to 3.4 billion euro as at 31 December 2004 (2.3 billion euro as at 31 December 2003).

Net position vis-à-vis the ECB is remunerated at the marginal interest rate on the main refinancing operations.

Note 11 - Other assets

11.1 Tangible and intangible assets

Tangible and intangible fixed assets developed as follows:

	Buildings EUR	Furniture and equipment EUR	Software EUR	Total EUR
Cost as at 01.01.2004	70 261 360	8 909 654	3 560 229	82 731 243
Acquisitions	3 530 348	780 192	373 885	4 684 425
Cost as at 31.12.2004	**73 791 708**	**9 689 846**	**3 934 114**	**87 415 668**
Accumulated depreciation as at 01.01.2004	15 942 366	5 687 981	2 399 870	24 030 217
Depreciation	3 118 003	1 320 149	581 587	5 019 739
Accumulated depreciation as at 31.12.2004	19 060 369	7 008 130	2 981 457	29 049 956
Net book value as at 31.12.2004	**54 731 339**	**2 681 716**	**952 657**	**58 365 712**

The sub-item "Buildings" comprises the acquisition cost of the premises located on the 2, boulevard Royal, the costs incurred in relation to the reconstruction and transformation of the new site ("Pierre Werner" building) and the renovations made on the main building ("Siège Royal"). The building located on the boulevard Prince Henri has been completely amortised in 2003 because of its destruction in order to construct a new one. Construction started in 2004 and after having organised tenders, the Bank reached agreements with suppliers.

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

11.2 Other financial assets

The components of this item are as follows:

	2004 EUR	2003 EUR
Other participating interests	162 033	153 657
Pension fund	64 005 693	56 828 975
Securities portfolio	518 515 067	473 619 888
	582 682 793	**530 602 520**

The other participating interests comprise the entry fees in LIPS-Net together with 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 it was calculated by the depositary bank as at 31 December 2004.

The securities portfolio recorded under this heading corresponds to the securities held by the BCL for the purpose of the investment of the own funds and amounts owed to third parties amounting to a total of 518.5 million euro (473.6 million euro as at 31 December 2003). Securities are valued at market prices. As at 31 December 2004, their value at market prices included an unrealised gain amounting to 14.0 million euro (unrealised gain amounting to 13.3 million euro as at 31 December 2003).

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 of which salaries for January 2005 and other income receivable.

11.4 Sundry

	2004 EUR	2003 EUR
Withdrawals in advance	3 947 500	6 812 500
Others	22 031 430	18 729 317
	25 978 930	**25 541 817**

The sub-item "Withdrawals in advance" corresponds to the amount of euro banknotes ordered by the credit institutions as at 31 December 2004 and which were not yet put into circulation on that date.

The sub-item "Others" consists mainly of the counterpart of the unrealised loss on 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.

Note 12 - Banknotes in circulation

This caption includes the BCL's share of the total euro banknotes put into circulation by the 12 central banks of the Eurosystem according to their weightings in the capital of the ECB, which totalled 1 012.5 million euro (739.4 million euro as at 31 December 2003).

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

	2004 EUR	2003 EUR
Current accounts (including minimum reserves)	5 063 321 077	6 765 571 187
Deposit facility	-	-
Fixed-term deposits	-	-
Fine-tuning reverse operations	-	-
Deposits related to margin calls	-	-
	5 063 321 077	**6 765 571 187**

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 system)

Accounts denominated in euro of the financial 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 fixing interest rate.

13.2 Deposit facility

Standing facility allowing credit institutions to make 24-hour deposits with the bank at a pre-specified interest rate.

13.3 Fixed-term deposits

Deposits made at the Bank for the purpose of absorbing market liquidity in connection with fine-tuning operations in the Eurosystem.

13.4 Fine-tuning reverse operations

Other monetary policy operations aimed at tightening liquidity.

No such operations took place during the year just ended.

13.5 Deposits related to margin calls

Deposits made by credit institutions to compensate for the decrease in the value of securities pledged as collateral for other credits granted to these same institutions.

No such operations took place during the year just ended.

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

14.1 Liabilities to general government

This caption records the amounts owed to the Luxembourg Treasury including the following items:

	2004 EUR	2003 EUR
Current account	597 552	291 581
Account related to euro coins issued by the Treasury	104 254 710	81 772 830
Fixed-term deposit	450 000 000	510 000 000
	554 852 262	**592 064 411**

In accordance with the amendment of 10 April 2003 to the agreement between the State of Luxembourg and the BCL on their financial relations, 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 BNB 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 reinforce the BCL's own funds and in accordance with the articles of the agreement which foresee this possibility, the State renounced on the remuneration of its term deposit for the financial year 2004. An equivalent income amounting to 4.9 million euro (4.9 million euro as at 31 December 2003) 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 caption 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 19.3 million euro as at 31 December 2004 (SDR 17.0 million, or 20.0 million euro as at 31 December 2003).

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 towards the Eurosystem in relation to the allocation of euro banknotes within the Eurosystem. The net position bears interest at the marginal interest rate applying to the main refinancing operation.

Note 19 - Items in course of settlement

This item contains mainly the counterpart of the euro banknotes ordered by credit institutions as at 31 December which were not yet put into circulation on 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, of which accrued interest on intra-Eurosystem liabilities, as well as miscellaneous expenses payable, of which suppliers, and the Luxembourg banknotes not yet returned.

The Luxembourg banknotes still circulating as at 31 December 2004 amount to 5.8 million euro (6.0 million euro as at 31 December 2003).

Note 21 - Provisions

Provisions developed as follows:

	2004 EUR	**2003 EUR**
Provisions for banking risks	281 149 648	239 651 570
Provisions for pensions	71 758 670	65 342 291
Other provisions	3 032 874	684 472
	355 941 192	**305 678 333**

21.1 Provisions for banking risks

Provisions for banking risks include the following items:

	2004 EUR	2003 EUR
Provisions for specific banking risks		
Provision covering credit risk	112 937 113	87 236 373
Provision covering operational risk	13 000 000	14 400 000
Provision covering liquidity risk	11 658 367	9 826 033
Provision covering interest rate risk	200 000	200 000
	137 795 480	**111 262 406**
Provisions for general banking risks		
Provision for liabilities resulting from monetary agreements	32 341 954	35 324 827
Other provision for general banking risks	111 012 214	93 064 337
	143 354 168	**128 389 164**
	281 149 648	**239 651 570**

21.1.1 Provision covering credit risk

The provision for 112.9 million euro (87.2 million euro as at 31 December 2003) corresponds to:

- 4% of the BCL's own securities portfolio existing as at 31 December 2003 and still kept as at 31 December 2004, valued at market price (portfolio affected 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 2004, of the BCL's own securities portfolio and participations other than the participating interest in the ECB;
- 4% of the total amount lent by the Eurosystem as at year-end for monetary policy reasons multiplied by the capital key corresponding to the BCL (0.21933%).

  The BCL's aim is to reach 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 the default of procedures and processes, and relating to human factor and the BCL's systems or external causes. Because of a lack of relevant statistics on the measure of risk, the transfer to the provision is based on the Basic Indicator Approach described by the consultative working-paper of the Basle Committee as being 15% of the average of the last three years of the net banking product.

21.1.3 Provision for liabilities resulting from monetary agreements

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

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

21.1.4 Other provision for general banking risks

For prudence's sake and to safeguard its assets, the BCL has transferred 17.9 million euro (31.1 million euro for the financial year 2003) 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:

	2004 EUR	2003 EUR
Provision for pensions	69 366 800	62 678 000
Provision for equalisation and financial risks	850 252	850 252
Provision for increase of PBO	1 541 618	1 814 039
	71 758 670	**65 342 291**

21.2.1 Provision for pensions

The pensions claims of its agents are fully supported by the BCL. The corresponding liability is calculated on the basis of the actuarial method described in note 2.11 in consideration of current factors and amounts to 69.4 million euro as at 31 December 2004 (62,7 million euro as at 31 December 2003).

The increase of the provision during the year results from:

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

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

As of today, the Luxembourg pension funds did not fulfill their obligations mentioned in article 35 paragraph 4(a). Consequently, the unique transfer from the reserves in 2001 for 33.8 million euro was determined without considering the claim on the pension funds, which will be used for the reconstitution of the reserves.

21.2.2 Provision for equalisation and financial risks

A provision of 3 million euro for equalisation and financial risks has been created in 2001 to cover fluctuations in the pension fund's liabilities in the beginning years and/or to compensate a lower return on assets. During the year 2002, an amount of 2,1 million euro has been used. The provision did not change in 2003 and 2004.

21.2.3 Provision for increase of PBO

The provision of 1.5 million euro (1.8 million euro as at 31 December 2003) is based on the average expense in relation with pensions, infirmity and death for agents already being part of BCL personnel or included in the budgeted figures of 2004 but not included in the pension fund's liabilities calculation as at 31 December 2004. The liability ("Projected Benefit Obligation" or "PBO") equals the potential payments at their present value considering individual parameters and the actuarial method used. During the year 2004, this provision was reduced to 1.5 million euro by a reversal of 0.3 million euro resulting from less recruitment cost in 2004.

21.3 Other provisions

Pursuant to Article 33.2 of the ESCB Statute, the Governing Council of the ECB may decide to offset a loss incurred by the ECB against its general reserve fund, and if necessary, against the monetary income of the relevant financial year in proportion and up to the amounts allocated to the national central banks. At its meeting on 13 January 2005 the Governing Council decided in principle to retain 1 360 million euro of NCBs' monetary income pooled in January 2005 to offset the ECB's loss for 2004.

The BCL accordingly established a provision of 3 million euro in respect of its allocated monetary income for 2004 to be used to offset the ECB's loss, equivalent to its weighting in the capital key of the ECB (0.21933% as from 1 May 2004) relative to the other NCBs within the Eurosystem. The final decision on the precise amount of monetary income will be taken by the Governing Council on 17 March 2005.

Note 22 - Revaluation accounts

This item includes positive revaluation differences related to the spread between the exchange rate as at year-end and the average exchange rate of 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 unique shareholder of the BCL's capital which is fixed to 25 million euro (25 million euro as at 31 December 2003).

23.2 Reserves

The reserves amount to 117.8 million euro (114.7 million euro as at 31 December 2003). This amount has been increased by 3.1 million euro during the year following the allocation of profit of the year 2003 according to the decision of the BCL's Council and its institutional law (article 31).

Note 24 - Custody deposits

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

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

As at 31 December 2004, the market value of these securities amounts to 132.1 billion euro (106.4 billion euro as at 31 December 2003).

Note 25 - Commitments and similar instruments

	2004 EUR	**2003 EUR**
Commitments and similar instruments	1 900 000 000	1 400 000 000

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

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

This caption includes the foreign currency reserves at market value that have been transferred to the ECB and are managed by BCL on behalf of the ECB. These reserves are shown under asset item "Claims related to the transfer of foreign reserves".

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 modulate the duration of the existing portfolio depending on market conditions.

As at 31 December 2004, the total liabilities related to these forward contracts amount to 694.2 million euro (43.4 million euro as at 31 December 2003). One security has been given as a guarantee in order to cover the initial margin deposit. This security remains on the balance sheet of BCL for an amount of 5.2 million euro as at 31 December 2004 (5.3 million euro as at 31 December 2003).

Note 28 - Net interest income

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

Composition of interest income

	Amounts in foreign currency EUR		**Amounts in euro EUR**	
	2004	**2003**	**2004**	**2003**
IMF	2 201 200	2 262 546	-	-
Monetary policy	-	-	537 611 506	542 844 349
Intra-Eurosystem claims	-	-	67 627 565	6 870 656
Securities	846 835	331 513	59 758 435	57 424 382
Gold	371 258	402 602	-	-
Other	667 778	100 226	141 174	150 299
Total	**4 087 071**	**3 096 887**	**665 138 680**	**607 289 686**

Composition of interest expense

	Amounts in foreign currency EUR		**Amounts in euro EUR**	
	2004	**2003**	**2004**	**2003**
IMF	(368 866)	(343 789)	-	-
Current accounts (including minimum reserves) and deposits related to monetary policy operations	-	-	(136 206 536)	(159 682 971)
Liabilities related to the reallocation of euro banknotes in the Eurosystem	-	-	(441 887 406)	(281 518 341)
Other Intra-Eurosystem liabilities	-	-	(919 153)	(65 299 502)
Interests on term deposits	-	-	(4 903 472)	(4 863 958)
Other liabilities	(538 813)	(7 930)	(869 228)	(713 961)
Total	**(907 679)**	**(351 719)**	**(584 785 795)**	**(512 078 733)**

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

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

This item includes the result on transactions in foreign currencies, on securities and on financial instruments linked to interest rates and market prices, that is gains realised minus loss realised on this transactions. In 2004, they amounted to 15.4 million euro (24.1 million euro as at 31 December 2003) and to 9.4 million euro (15.0 million euro as at 31 December 2003) respectively, making a net income of 6.0 million euro (9 million euro as at 31 December 2003).

Note 30 - Write-downs on financial assets and positions

This item includes revaluation losses on foreign currencies for 6.0 million euro, on securities for 0.7 million euro and on financial instruments linked to interest rates and market prices for 0.7 million euro in 2004 (5.5, 0.9 and 0.1 million euro respectively in 2003).

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

This caption 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 detailed as follows:

	Fees and commissions income EUR		Fees and commissions expense EUR	
	2004	2003	2004	2003
Titres	7 309 392	6 262 926	(7 610 313)	(6 870 605)
Autres	339 542	261 349	(101 549)	(191 864)
Total	**7 648 934**	**6 524 275**	**(7 711 862)**	**(7 062 469)**

Note 33 - Income from participating interest

This item includes the dividend distributed by the European Central Bank.

No dividend was distributed in 2004 (dividend of 1.1 million euro for the year 2003). In 2004, the ECB's income on euro banknotes in circulation amounting to 733 million euro was fully retained by the ECB in accordance with a decision of the Governing Council and in view of the ECB 2004 result.

Note 34 - Net result of pooling of monetary income

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

- banknotes in circulation;
- liabilities to credit institutions related to monetary policy operations denominated in euro;
- net intra-Eurosystem liabilities resulting from TARGET transactions;
- net intra-Eurosystem liabilities related to the allocation of euro banknotes within the Eurosystem.

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

The earmarkable assets consist of the following items:

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

Gold is considered to generate no income.

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

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

Calculation of net monetary income allocated to the BCL (in million euro):

		(in million euro)
	2004	**2003**
Monetary income pooled by BCL	(29.2)	(32.9)
Monetary income reallocated to BCL	17.9	14.3
Retained monetary income by the ECB	(3.0)	0
Net result arising from the calculation of monetary income	**(14.3)**	**(18.6)**

The pooled net result of monetary income shows also the BCL'S share in the monetary income retained to cover the ECB's loss in 2004 (see Note 21.3).

Note 35 - Other income

Other income includes revenues for 4.9 million euro (4.9 million euro for 2003) that reflect the renunciation by the State of Luxembourg on the interests due for 2004 on its term deposit with BCL (see also note 14.1). 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 part of the contributions to the pension and social security regimes. The compensations paid to the Directors amount to 456 830 euro for the year 2004 (440 366 euro for the year 2003).

As at 31 December 2004, BCL's personnel amounts to 206 agents (200 as at 31 December 2003). The average number of persons working for BCL from 1 January to 31 December 2004 amounted to 205 agents (201 for the year 2003).

Note 37 - Administrative expenses

This caption includes all general and recurring expenses, meaning rents, cleaning and reparations of buildings and equipment, small goods and materials, fees paid and other services and furniture as well as training expenses. The compensations paid to the members of the Council amount to 68 237 euro in 2004 (66 147 euro in 2003).

Note 38 - Depreciation of tangible and intangible fixed assets

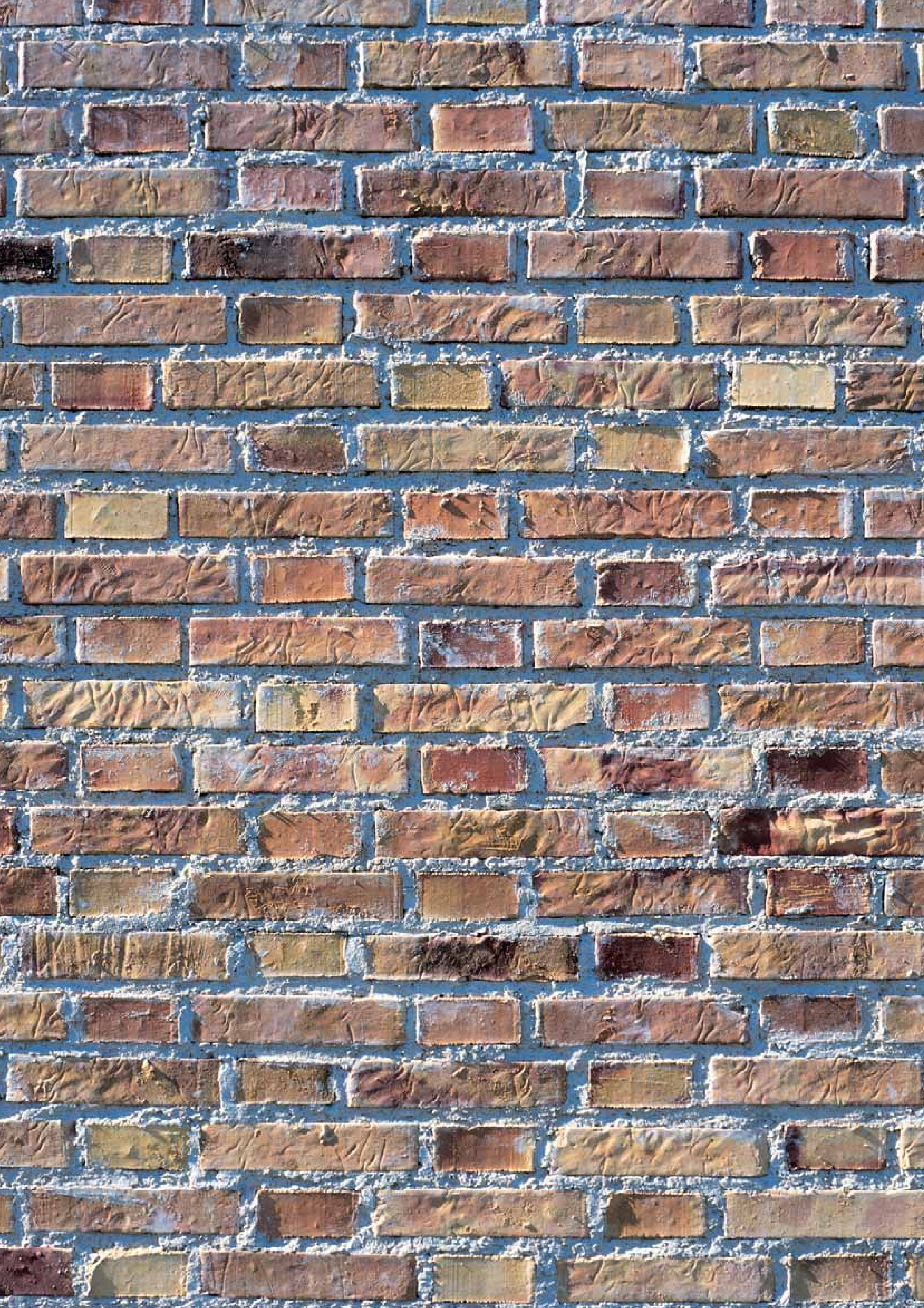
This item shows the depreciation applied on buildings, renovations on buildings, furniture and office equipment, computer hardware and software.

Note 39 - Banknote production services

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

Note 40 - Other expenses

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



5.1 List of BCL circular letters issued in 2004

- BCL circular letter 2004/184 of 5 March 2004 regarding the amendment of the BCL's terms and conditions - to all credit institutions and to the financial services of the Postal and Telecommunications Services Company (giro accounts service).
- BCL circular letter 2004/185 of 10 May 2004 regarding survey on foreign direct investment - to all credit institutions and to the financial services of the Postal and Telecommunications Services Company (giro accounts service).
- BCL circular letter 2004/186 of 5 November 2004 regarding the dates for the transmission of statistical reports to the Banque centrale du Luxembourg - to all credit institutions.
- BCL circular letter 2004/187 of 5 November 2004 regarding the dates for the transmission of statistical reports to the Banque centrale du Luxembourg as well as start and ending dates of the minimum reserve maintenance periods in 2005 - to all credit institutions.

5.2 BCL Publications

Paper copies of publications may be obtained at the BCL public counters within the limit of available stocks and according to its specified conditions. These publications may also be read and downloaded from the website **www.bcl.lu.**

For a complete list of the documents published by the ECB and for the versions in all official languages of the EU, please visit the ECB's web site www.ecb.int.

BCL Bulletins in 2004

- BCL Bulletin 2004/1, Special: Financial Stability, April 2004
  - *Le secteur financier luxembourgeois en 2003 ;*
  - *Risque de contagion du marché interbancaire luxembourgeois ;*
  - *Crises management.*
- BCL Bulletin 2004/2, June 2004
  - *Les finances publiques luxembourgeoises : état des lieux et perspectives ;*
  - *La courbe de Phillips néo-keynésienne : résultats empiriques pour le Luxembourg.*
- BCL Bulletin 2004/3, September 2004
  - *La mise en garantie de prêts bancaires auprès de la Banque centrale du Luxembourg au regard du secret bancaire luxembourgeois ;*
  - *Impact des mesures prises par les autorités publiques sur les prix à la consommation ;*
  - *Die Eurobargeldeinführung und regionale Preisunterschiede: Ist seitdem etwas passiert?;*
  - *La persistance de l'inflation au Luxembourg : une analyse au niveau désagrégé.*
- BCL Bulletin 2004/4, December 2004
  - *Utilisation des instruments de paiement au Luxembourg ;*
  - *Evolution de l'impact des fusions bancaires sur l'emploi dans les banques ;*
  - *La position extérieure globale du Luxembourg ;*
  - *Rigidités nominales et persistance de l'inflation.*

BCL Annual Reports

- Annual Report 2003 (French version), April 2004
- Annual Report 2003 (English version), May 2004
- Annual Report 2004 (French version), June 2005
- Annual Report 2004 (English version), July 2005

BCL Working papers in 2004

- Working paper no. 11, June 2004
  The New Keynesian Phillips curve: empirical results for Luxembourg, by Ieva Rubene and Paolo Guarda.

- Working paper no. 12, November 2004
  Inflation Persistence in Luxembourg: A Comparison with EU 15 countries at the disaggregate level, by Thomas Mathä and Patrick Lünnemann.

BCL brochures

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

- "Banque centrale du Luxembourg", presentation of the Bank and of its missions (French, English and German), June 2003.

General Conditions for BCL operations

5.3 Statistics series of the BCL

Statistical tables listed hereunder are available on the BCL Internet site www.bcl.lu ("Statistics") and are regularly updated. These tables are also published in the quarterly BCL Bulletin.

1 Monetary policy statistics

1.1 Luxembourg minimum reserve statistics

2 Monetary and financial developments in the euro area

2.1 Aggregated balance sheets of Luxembourg MFIs (excluding the BCL)
2.2 Outstanding MFI loans to households and non-financial corporations by type and original maturity
2.3 Luxembourg bank interest rates of euro denominated loans and deposits vis-à-vis euro area residents on new business
2.4 Luxembourg bank interest rates of euro denominated loans and deposits vis-à-vis euro area residents on outstanding amounts

3 General data on the Luxembourg financial system

3.1 Aggregated profit and loss account of the Luxembourg banks as at year-end
3.2 Interim aggregated profit and loss account of the Luxembourg banks
3.3 Long-term development of the profit and loss accounts of the Luxembourg banks
3.4 Aggregated balance sheets of the Luxembourg banks
3.5 Geographic origin of credit institutions
3.6 Employment in the Luxembourg credit institutions and other financial sector professionals
3.7 Significant domestic interest rates
3.8 Lending for purchase of houses located in Luxembourg
3.9 Evolution of undertakings of collective investment in Luxembourg

5.4 List of abbreviations

ABBL	*Association des Banques et Banquiers, Luxembourg*
AGDL	*Association pour la garantie des dépôts, Luxembourg*
BCL	*Banque centrale du Luxembourg*
BIS	Bank for International Settlements
BLEU	Belgian Luxembourg Economic Union
BNB	*Banque Nationale de Belgique*
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
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
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-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 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

5.5 Glossary

Acquis communautaire: term commonly used to refer to all Community law including EU treaties, regulations and directives. Countries joining the EU must have implemented the existing *acquis communautaire* by the time of accession.

Attractive price: Attractive prices means psychological prices, *i.e.* prices that end with the figures 9, 95, 98, fractional prices which end with the figures 0 and 5 and rounded prices which are multiples of 100.

Base effect: When analysing business cycles, the evolution of annual variation rates of a variable are often explained by "base effects". A base effect occurs when the evolution of a variable's annual rate from month t to month t+1 varies because of the evolution of the variable's level 12 months before and not because of the variation of the variable's level between month t and month t+1.

Central securities depository (CSD): an entity which holds and administers securities or other financial assets and enables securities transactions to be processed by book entry. Assets may exist either physically (but immobilised within the CSD) or in a dematerialised form (*i.e.* only as electronic records).

Collateral: assets pledged (*e.g.* by **credit institutions** with central banks) as a guarantee for the repayment of loans, as well as assets sold (*e.g.* to central banks by credit institutions) as part of **repurchase agreements**.

Consolidated MFI balance sheet: this is obtained by netting out inter-MFI positions (*e.g.* inter-MFI loans and deposits) on the aggregated MFI balance sheet. It provides statistical information on the MFI sector's assets and liabilities vis-à-vis non-MFI **euro area** residents (*i.e.* general government and other euro area residents) and on its external assets and liabilities (*i.e.* balances vis-à-vis non-euro area residents). This consolidated balance sheet is the main statistical source for the calculation of **monetary aggregates** and it provides the basis for the regular analysis of the counterparts of **M3**.

Correspondent central banking model (CCBM): a mechanism established by the **European System of Central Banks** with the aim of enabling **counterparties** to obtain credit from the central bank of the country in which they are based using **collateral** held in another country. In the CCBM, an NCB acts as custodian for the other NCBs with regard to the securities held in its domestic **securities settlement system (SSS)**.

Counterparty: the opposite party in a financial transaction (*e.g.* any party transacting with a central bank).

Credit institution: an institution covered by the definition in Article 1 of Directive 2000/12/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions. Thus, a credit institution is: (i) an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credit for its own account.

Currency in circulation: comprises of 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 of 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 of 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 requirement for **credit institutions** to hold minimum reserves with the central bank. In the minimum reserve framework of the **Eurosystem**, the reserve requirement of a credit institution is calculated by multiplying the **reserve ratio** for each category of items within the **reserve base** by the amount of those items on the institution's balance sheet. In addition, institutions are allowed to deduct a **lump-sum allowance** from their reserve requirement.

Reverse transaction: an operation whereby the central bank buys or sells assets under a **repurchase agreement** or conducts credit operations against **collateral**.

RTGS (real-time gross settlement) system: a settlement system in which processing and settlement take place on an order-by-order basis (without netting) in real time (continuously). See also **TARGET**.

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**.