EUROPEAN MONETARY INSTITUTE

THE SINGLE MONETARY POLICY IN STAGE THREE

Specification of the operational framework

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1 The EMI's preparatory work on the single monetary policy

In accordance with Article 7 of its Statute, the EMI is required to report annually on the adaptation of monetary policy instruments and the preparation of the procedures necessary for conducting a single monetary policy in Stage Three of Economic and Monetary Union (EMU). Furthermore, Article 109f (3) of the Treaty establishing the European Community (the "Treaty") requires the EMI to specify, at the latest by 31 December 1996, the regulatory, organisational and logistical framework necessary for the European System of Central Banks (ESCB) to perform its tasks in Stage Three. The ESCB will comprise the European Central Bank (ECB) and the national central banks (NCBs) of the EU Member States. In publishing this report, the EMI aims at providing information of interest to the public and the counterparties of central banks in the operational aspects of monetary policy.

The EMI's preparatory work is progressing according to schedule and the conceptual phase has been concluded for all the main issues of relevance. The NCBs and the EMI have now to ensure that all the options described in the present report are designed in full detail, prepared and tested in due time. Following the decision by the Council, meeting in early 1998 in the composition of the Heads of State or of Government, on which Member States fulfil the necessary conditions to adopt the euro, the ESCB and the ECB will be set up. The framework, as prepared by the EMI, will then be submitted to the ECB for decision. In the remainder of 1998, the ESCB will prepare for its full operation. The ESCB will conduct the single monetary policy as from 1 January 1999.

In the course of 1997 the EMI intends to publish further material relating to the specification of the ESCB's operational framework for the conduct of the single monetary policy. In particular, documents will be forthcoming with respect to preparatory work in the fields of monetary policy strategy, monetary policy instruments and procedures, TARGET and securities settlement systems.

2 Strategic aspects of the single monetary policy

The Treaty unambiguously states that the primary objective of the ESCB is to maintain price stability. In the pursuit of this final objective, the ESCB will have to develop a monetary policy strategy. Five possible strategies (exchange rate targeting, interest rate pegging, nominal income targeting, monetary targeting and direct inflation targeting) have been considered by the EMI as potential candidates to recommend to the ESCB. Taking into account a number of guiding principles (effectiveness, accountability, transparency, medium-term orientation, continuity and consistency with the ESCB's independence) and considering the environment likely to prevail in the euro area, the list of potential candidate strategies has been narrowed down to two, namely monetary targeting and direct inflation targeting.

While pure forms of monetary and direct inflation targeting can be clearly distinguished at a theoretical level, their application in different countries has shown that several variants integrating elements of both strategies exist. Moreover, all central banks that pursue either of these two strategies monitor a wide and similar set of economic and financial variables as indicators in the determination of the monetary policy stance. The EMI does not consider it possible, or necessary, to determine more specifically at this stage which strategy should be the preferred one to be adopted by the Governing Council of the ECB.

Whichever choice will be made in terms of monetary policy strategy, a number of key elements have been identified as being an indispensable part of any strategy: a quantified definition of the final objective of price stability and of the specific targets against which to assess the ESCB's performance in terms of meeting the objective; a communication policy for the ESCB to explain its strategy to the general public; the availability of a broad set of indicator variables to help assess the risks to future price stability; detailed information on monetary aggregates for the euro area; and tools to allow forecasts for inflation and other economic variables pertaining to the euro area.

The EMI and the NCBs are undertaking preparatory work to ensure that the ESCB will have the statistical and analytical infrastructure at its disposal to pursue either of the above strategies.

3 Implementation of the single monetary policy

For the implementation of its monetary policy strategy, the ESCB will need to rely on a set of monetary policy instruments and procedures which, combined, will constitute its operational framework. This framework should enable the ESCB to control its operational target, normally a short-term interest rate, efficiently. It should allow signals of monetary policy intentions to be given with an adequate degree of precision and differentiation. It should be capable of providing basic refinancing, absorbing liquidity and influencing the structural position of the banking system vis-à-vis the ESCB. It would also be desirable that the framework helps to control monetary aggregates, allows adequate information to be extracted from market developments and contributes to the smooth functioning of the payment system. In addition to enabling the above functions to be performed efficiently, the selection of the operational framework has been guided by the following general principles: conformity with market principles, equal treatment, simplicity and cost efficiency, decentralisation, continuity, harmonisation and conformity with the setting of the ESCB's decision-making.

3.1 Instruments and procedures

The EMI Council has defined a set of monetary policy instruments that will be made available to the ESCB. It is envisaged that the ESCB will mainly use open market operations, but that it will also offer two standing facilities. In addition, preparations are being made for an infrastructure that will allow the ECB to impose minimum reserve requirements.

Four types of open market operations will be at the disposal of the ESCB: main refinancing operations (viz. regular liquidity-providing reverse transactions with a weekly frequency and a maturity of two weeks); longer-term refinancing operations (viz. liquidity-providing reverse transactions with a monthly frequency and a maturity of three months, intended to cater for a limited part of the global refinancing volume); fine-tuning operations (adapted to the prevailing circumstances and to the specific objectives of managing the liquidity situation in the market or of steering interest rates); and structural operations (intended to affect the structural liquidity position of the banking system vis-à-vis the ESCB).

Two standing facilities will be available to provide (in the case of the marginal lending facility) or to absorb (in the case of the deposit facility) overnight liquidity. These facilities will bound overnight market interest rates and the interest rates applied to them will help signalling the general stance of monetary policy.

The minimum reserve system which will also be made available may serve the purpose of stabilising money market interest rates, creating or enlarging a structural liquidity shortage in the money market and possibly contributing to the control of monetary expansion. The EMI is undertaking the necessary technical preparatory work in order to put the ECB in a position to use this instrument.

3.2 Eligible counterparties and assets

In order to secure a single monetary policy stance and a level playing-field for counterparties across the whole of the euro area, the EMI has worked out common eligibility criteria, both for the counterparties and for the assets to be used by those counterparties in their operations with the ESCB. Remote access to monetary policy operations, allowing counterparties in the euro area to have direct access to operations with an NCB of a jurisdiction where they have no physical presence, is not being developed as an option at this stage.

It is envisaged that an appropriate legal instrument will cover the uniform conditions under which a broad range of counterparties will participate in the ESCB's open market operations and standing facilities. A broad range of eligible counterparties is consistent with the principle of decentralisation in the execution of the ESCB's monetary policy operations, it will enhance policy efficiency and equal treatment, and it will facilitate the smooth functioning of the payment system. Only in the case of fine-tuning operations may operational efficiency advocate dealing with a limited range of counterparties.

The Treaty requires all ESCB credit operations to be based on adequate collateral. With regard to the actual choice of assets eligible for use in the ESCB's liquidity-providing monetary policy operations, the ESCB will establish two types of lists. Both of them will contain public and private assets which as a rule will be eligible throughout the euro area. The tier one list will consist of marketable assets which fulfil uniform euro area-wide eligibility criteria specified by the ECB. In addition, the list will include debt certificates issued by the ESCB, if any. The list will be established and maintained by the ECB. Tier two lists will consist of additional assets, either marketable or non-marketable, which NCBs consider particularly important for their national financial markets and banking systems. Subject to ECB guidelines, NCBs will establish and maintain national lists of eligible tier two assets. Together, the lists will allow for the use of a wide set of assets, which is also desirable for the smooth functioning of the domestic real-time gross settlement (RTGS) systems and TARGET. All lists will be available to the public.

3.3 Foreign exchange intervention

In addition to intervening on the domestic financial market, the ESCB will also have the capacity to conduct foreign exchange intervention. To this end, the ESCB will use the pool of foreign assets transferred from the NCBs to the ECB.

An exchange rate mechanism is being elaborated as part of the future exchange rate policy co-operation between Member States participating in the euro area and other EU countries. In this context, intervention should be used only as a supportive instrument, in conjunction with other policy measures, including appropriate fiscal and monetary policies conducive to economic convergence and exchange rate stability within the EU.

Preparatory work is being conducted by the EMI and the NCBs with a view to ensuring that the ESCB will be in a position to use either a centralised or a decentralised arrangement for the conduct of its foreign exchange intervention operations. Irrespective of the chosen organisational arrangement, the selection of counterparties will follow a uniform approach, based primarily on prudence and efficiency. The pool of potential counterparties will be sufficiently large and diverse to guarantee the necessary flexibility in the conduct of the ESCB's intervention operations.

4 Supporting framework for the single monetary policy

4.1 Area-wide statistics

The Treaty requires the ECB to collect, with the assistance of the NCBs, the statistical information needed for the conduct of the single monetary policy. Given the fact that the objectives of the ESCB resemble those of the present NCBs in the EU, the statistical requirements for the euro area resemble the national statistics currently available. However, for the compilation of aggregates covering the euro area, harmonisation of national definitions and practices is required, and appropriate consolidation to take account of cross-border flows has to be carried out. The EMI has, where appropriate in consultation with the European Commission, prepared the statistical requirements for the euro area, on which a separate document was released in July 1996.

4.2 A cross-border payment system (TARGET)

To support the integration of the money market and thereby the singleness of the monetary policy, the EMI and the NCBs are in the process of developing an interbank funds transfer system, called TARGET, that will be able to process cross-border payments denominated in euro as smoothly as if they were domestic payments. The EMI has already published several documents on the TARGET system. It will interlink the domestic RTGS systems which NCBs have agreed to implement in their respective countries.

Participation in the national RTGS systems will be determined by the NCBs. To avoid impediments to the efficient conduct of the single monetary policy, a certain degree of harmonisation of the features of the national RTGS systems within the euro area will be ensured in three respects: the provision of intraday liquidity, operating hours, and pricing policy.

The value of payment orders being sent through TARGET may, for any participant at any given point in the course of the day, exceed the value of payment orders being received. To counter the ensuing liquidity shortfall which might delay settlement, intraday liquidity will be provided by NCBs, either by granting participants the right to make use of their reserve deposits with them or by providing them with intraday credit. At the end of the day, RTGS participants in the euro area that are eligible counterparties for monetary policy operations of the ESCB may draw on the marginal lending facility with their NCB in order to balance the position in their accounts. NCBs of EU Member States which do not participate in the euro area but which may nevertheless be connected to TARGET will not have the possibility of extending overnight credit in euro to RTGS participants in their countries. The options for NCBs outside the euro area to grant intraday credit in euro to TARGET participants are still under discussion. Mechanisms are being prepared to prevent intraday credit, if granted to non-euro area NCBs, from spilling over into overnight credit.

NCBs are currently developing a common calculation method for payment processing costs in order to allocate these costs, whenever possible, to the appropriate source and to avoid unfair competition between NCBs' and other payment arrangements. Care will also be taken to arrive at a TARGET pricing policy that will not interfere with the efficient conduct of the single monetary policy.

In terms of operating hours, a harmonisation, based on the current longest operating hours in the EU, will allow for a larger overlap between TARGET and the payment systems of the major financial centres in North America and the Far East.

4.3 Securities settlement systems

Securities settlement procedures will have to ensure that no liquidity is provided by the ESCB before eligible assets are transferred to it with finality, also on an intraday basis. Intraday finality may be achieved by different operational mechanisms and NCBs will choose, from among different options, the most appropriate solution on the basis of the existing infrastructures. The same tier one and tier two lists of eligible assets will be used by the ESCB for collateralising or securing open market operations and for granting end-of-day and intraday credit.

In order to enhance the efficiency of the single monetary policy and ensure equal treatment among the ESCB's counterparties, eligible assets located in another Member State of the euro area may be used in refinancing operations as well as intraday credit and repos with the domestic NCB. Direct linkages between central securities depositories in EU Member States would be one way of facilitating such cross-border use of eligible assets. However, such linkages do not yet cover the whole EU and may require considerable time to develop. Therefore, two models are being prepared by the NCBs and the EMI for the cross-border use of collateral, whereby NCBs act as correspondent banks for one another (with or without guarantee).

Introduction

1 Introduction

Article 109f (3) of the Treaty establishing the European Community (the "Treaty") stipulates in its last paragraph that: "at the latest by 31 December 1996, the EMI shall specify the regulatory, organisational and logistical framework necessary for the ESCB to perform its tasks in the third stage. This framework shall be submitted for decision to the ECB at the date of its establishment". The core task to be carried out by the European System of Central Banks (ESCB), comprising the European Central Bank (ECB) and the national central banks (NCBs) of the EU Member States, consists in defining and implementing the monetary policy of the Community, with the primary objective of maintaining price stability. This is laid down in Article 105 of the Treaty which also lists a number of additional tasks.[1]

By publishing the present special Report, the EMI complies with the reporting requirements in accordance with Article 7 of its Statute and with the aforementioned Article 109f (3) of the Treaty.[2]

1.1 The time frame for the finalisation of the EMI's preparatory work

It is the EMI's responsibility to ensure that the preparatory work for the establishment of the ESCB is accomplished in due time, i.e. by the time the ECB and the ESCB are set up and the EMI goes into liquidation. In view of the complexity of this task, the interaction between many areas of activity and the number of institutions involved, the EMI Council organised the work on the basis of a comprehensive plan with the aim of arriving at a broad conceptual framework by end-1996, as envisaged in the above-mentioned Article 109f (3) of the Treaty.

In December 1995 the European Council in Madrid agreed on a reference scenario for the move to Stage Three and the introduction of the euro. This scenario circumscribes rather precisely the time frame for the finalisation of all preparatory work. As soon as possible in 1998, the Council, meeting in the composition of the Heads of State or of Government, will confirm which EU Member States fulfil the necessary conditions to participate in the euro area,[3] which will be created on 1 January 1999 when Stage Three will begin and the ESCB will start to exercise its duties. As early as possible after that decision the ECB and the ESCB will be established, at which point in time the EMI will have to submit to the ECB for decision its final set of proposals for the regulatory, organisational and logistical framework necessary for the ESCB to perform its tasks in Stage Three. This framework must be elaborated in such a way that, following all relevant decisions by the ECB, it can be made operational within the limited number of months remaining in 1998.

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1 *Annex 1 to this Report addresses the tasks and functions of the ESCB in greater detail.*

2 *In November 1996, in accordance with Article 109j (1), the EMI published a report on the progress towards convergence and the statutory requirements to be fulfilled for NCBs to become an integral part of the ESCB. The report thus covered two of the obligations set out in Article 7 of the EMI Statute, under which the EMI must address a report to the Council once a year on the state of preparations for Stage Three. The third topic mentioned in Article 7 concerns an annual report on the adaptation of monetary policy instruments and the preparation of the procedures necessary for conducting a single monetary policy in Stage Three. This is covered in the present report.*

3 *The euro area is defined in this report as the area covering those EU Member States which, in accordance with the Treaty, have adopted the euro as the single currency.*

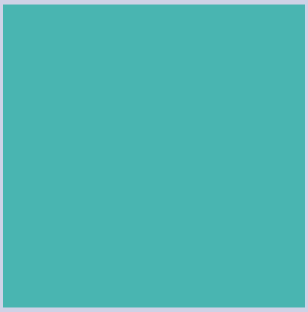
The EMI's preparatory work is progressing satisfactorily and the conceptual phase has now been concluded for all the main issues of relevance to the conduct of the single monetary policy. The NCBs and the EMI, as the precursor of the ECB, have now to ensure that all the conceptual options retained are designed in full detail and implemented in such a way that, if chosen by the ECB, they can be put to the operational test in the second half of 1998.

Counterparties of central banks in the operational aspects of monetary policy clearly have an interest in knowing, at an early stage, the general direction of the development of the framework preferred by the EMI for further elaboration. Such information will assist the counterparties when planning and preparing for the start of Stage Three.

1.2 Outline of the document

This report is organised as follows. Chapter I deals with the strategic aspects of the single monetary policy. Chapter II describes the broad features of the implementation of the single monetary policy and focuses on instruments and procedures, counterparties, collateral and foreign exchange interventions. Chapter III outlines the supporting framework for the conduct of the single monetary policy, i.e. the statistical information needed to define and implement the single monetary policy, and the cross-border payment system and securities settlement procedures needed to ensure the efficient performance of the ESCB's monetary policy operations.

A number of annexes have been included, which provide more technical detail on the material presented in the various chapters. Annex 15 contains a glossary of technical terms used.



Chapter I

Strategic aspects of the single monetary policy

1 Introduction

The monetary policy strategy may be defined, in broad terms, as the set of procedures according to which a central bank decides how to act in order to achieve its final objective. In general it encompasses two aspects. The first is the internal decision-making process within the central bank and the second is the presentation of the monetary policy actions to the public.

As regards the final objective itself, the Treaty provides unambiguous guidance that "the primary objective of the ESCB shall be to maintain price stability" (Article 105 (1)). However, in its pursuit of this objective, the ESCB, like all central banks, will face a complex transmission process from policy actions to price developments, which will be characterised by several interlinked transmission channels with long and variable lags. Thus policy decisions directed at price stability must inevitably be both pre-emptive and forward-looking, taking into account all relevant information regarding the prospective evolution of prices and taking appropriate and timely action to ensure that the final objective is achieved. In addition, the need for credibility and consistency of the decision-making process over time will require the ESCB to establish a clear framework to guide the use of its monetary policy instruments with a view to achieving its final target. In several countries this framework involves the setting of intermediate targets (e.g. monetary or exchange rate targets); in other countries experience is being gained with strategies involving direct inflation targeting, with projections of inflation playing an important role in guiding policy decisions.

Final decisions on strategy will be taken by the Governing Council of the ECB, taking into account the economic environment and financial market structure in the euro area. Extensive discussions have taken place within the EMI with a view to preparing those decisions. In this context, a number of major factors which will influence the ESCB's decisions have been identified, including general principles guiding the choice of strategy and key features of the economic and financial environment. Alternative strategies have been evaluated and a number of key elements and operational aspects common to the various strategies have also been elaborated. This chapter presents an overview of these issues.

2 Factors influencing the choice of strategy

In choosing a strategy for Stage Three, the ESCB will have to take into account a set of normative principles designed to guide its actions, on the one hand, and the economic and financial environment within which it is operating, on the other.

2.1 Guiding principles for assessing monetary policy strategies

The assessment of alternative monetary policy strategies for the ESCB is guided by the following general principles:

- *Effectiveness:* The strategy has to put the ESCB in a position to effectively pursue its final objective;
- *Accountability:* The strategy needs to involve the formulation and announcement of targets so that the ESCB can be held accountable to the public for its actions;
- *Transparency:* The process of setting targets and making decisions on the basis of the strategy must be clear to the public;
- *Medium-term orientation:* The strategy has to enable the ESCB to meet its final objective over the medium term, thereby providing an anchor for inflation expectations, but nevertheless providing the ESCB with some discretion in response to short-term deviations from the target;
- *Continuity:* The strategy of the ESCB must build on the experience gained by participating NCBs before the start of Stage Three;
- *Consistency with the independence of the ESCB:* The strategy must be consistent with the independent status granted to the ESCB by the Treaty.

Effectiveness is clearly a more general principle than the other principles as the latter can be seen as contributing in some specific aspects to the effectiveness of a strategy, for example, by helping to make announcements by the ESCB more credible, thereby anchoring the public's inflationary expectations and facilitating the maintenance of price stability.

2.2 The environment facing monetary policy

In the assessment of a strategy for the ESCB, the environment for monetary policy in Stage Three and the specific situation at the start of Stage Three also have to be taken into account. One key feature of the ESCB's environment relates to the size of the euro area and the fact that participating countries will trade to a significant extent with one another, as is evidenced by the high degree of intra-EU trade. This implies that exchange rate developments will most likely constitute less of a concern for the conduct of monetary policy than is currently the case for many NCBs. A further important element, crucial to the choice of strategy, will be the characteristics of the average monetary policy transmission process in the euro area. The uncertainty surrounding this transmission process will be one of the main features of the specific situation of the ESCB at the start of Stage Three. Further challenges facing the ESCB arise from the fact that it will have no track record of its own at the start of its operations, and that it will have to devise its strategy while taking into account the need to integrate new participants in the euro area over time.

3 Possible strategies for Stage Three

Five possible strategies have been considered for Stage Three: exchange rate targeting; interest rate pegging; nominal income targeting; monetary targeting; and direct inflation targeting. On the basis of guidance provided by the general principles mentioned above and consideration of the environment likely to prevail in Stage Three, it is possible to eliminate the first three options, but not yet to determine which of the remaining two options would be more appropriate.

An exchange rate objective is not considered appropriate since, for an area potentially as large as the euro area, such an approach might be inconsistent with the internal goal of price stability. The use of an interest rate as an intermediate target is not considered appropriate given difficulties in identifying the equilibrium real interest rate which would be consistent with price stability. While a nominal income target would provide a clear nominal framework and could be consistent with the objective of price stability, nominal income would be difficult to control by the ESCB, could lead to misinterpretation of the ultimate goal of the ESCB, could be subject to substantial data revisions and might lead to an indeterminate price/volume division in the short run, thus creating uncertainty about the inflation performance of the economy.

During discussions, two potential candidate strategies have been identified, namely monetary targeting and direct inflation targeting. While pure forms of monetary and direct inflation targeting can be clearly distinguished at a theoretical level, their application in different countries has shown that several variants integrating elements of both strategies exist, with the borderlines between the two sometimes being less distinct than in theory. Common to both strategies is the fact that they are based on the same final objective - price stability; they are forward-looking; and in practice a wide range of indicators are employed under both strategies to assess the appropriateness of the monetary policy stance. The main factor distinguishing the two strategies is the role played by monetary aggregates.

A detailed assessment of the two strategies in terms of the guiding principles mentioned above, and in the light of the environment expected at the start of and during Stage Three, indicates that it is not possible, or necessary, to determine at this stage the strategy which would preferably be adopted by the ESCB. It can be argued that a particular strength of the monetary targeting strategy is that it clearly indicates the responsibility of the ESCB for developments which are both easily observable and under its more direct control and, therefore, can be interpreted by the public in a transparent manner. It also follows the strategy pursued by the central bank of the anchor country in the EMS' exchange rate mechanism before the start of Stage Three. At the same time, it is recognised that the long-term stability of money demand in the euro area is a crucial factor in determining the effectiveness and scope of monetary targeting. In this respect, stability of money demand is also important to guarantee that the ESCB's actions can confidently be interpreted by the public as following a consistent scheme, thus ensuring that the strategy provides a clear anchor for inflation expectations. Existing empirical studies carried out both within the EMI and elsewhere provide some evidence that, for selected groups of EU countries, area-wide money demand currently has desirable empirical properties. On the other hand, account needs to be taken of the fact that these studies are subject to data and methodological limitations and may not be representative of the situation in Stage Three. Uncertainty concerning the empirical properties of money demand in the euro area in Stage Three is the main argument against a monetary targeting strategy. The possibility of damage to the credibility of the ESCB under a monetary targeting strategy could not be excluded if monetary aggregates were highly volatile at the start of or during Stage Three. With respect to an inflation targeting procedure, it is argued that it directly stresses the responsibility of the ESCB for achieving and maintaining price stability. Furthermore, policy actions under such a strategy can be consistently and directly linked to prospective price behaviour, which, if the strategy is credible, will affect public expectations in a favourable way. It should be noted, however, that to be successful inflation targeting also requires stable relationships between various economic and financial indicators, on the one hand, and future inflation, on the other.

Overall, however, the similarities in the behaviour of central banks that pursue these two strategies are greater than the differences. Regardless of their choice of strategy, they all monitor a wide and similar set of economic and financial variables as indicators in the determination of the monetary policy stance.

4 Key elements of a monetary policy strategy in Stage Three

While it is not necessary to determine the precise details of the ESCB's strategy at this stage, experience suggests that the following five key elements would be an indispensable part of any strategy adopted by the ESCB:

- the public announcement of a quantified definition of the final objective of price stability in order to enhance the transparency and credibility of the ESCB's strategy;

- the public announcement of a specific target (or targets) against which the performance of the ESCB can be assessed on an ongoing basis by the general public, thereby enhancing accountability;

- the use of all available information relevant to the final target of monetary policy. In this sense the strategy is based on a broad set of indicator variables which would help when assessing the risks to future price stability. In line with current practice, it would seem appropriate for this set of variables to include financial variables (in particular the money market yield curve, money and credit aggregates, credit market conditions, bond yields, exchange rates and other asset prices) and various non-financial variables (such as price and cost variables, indicators of aggregate demand and supply conditions including the output gap, the balance of payments and expectations surveys). The ESCB itself will decide on how to use these (or other) indicators, both internally and in its communication with the public, in the light of the specific circumstances prevailing;

- within the set of indicators employed by the ESCB, monetary aggregates should be assigned a prominent role, with either targets or monitoring ranges set for their growth, provided that money demand is sufficiently stable in the long run;

- the ESCB should be in a position to make its own forecasts for inflation and other economic variables.

In practice, these elements could be combined in different ways. They would afford the ESCB the choice of pursuing either a monetary or direct inflation targeting strategy, but could also be used in frameworks which place strong emphasis on monetary targets while using supplementary elements from direct inflation targeting strategies, or vice versa. Any specification of the options for combining key elements would be premature at this stage since their assessment will largely depend on the circumstances prevailing in Stage Three.

5 Implementation of the monetary policy strategy in Stage Three

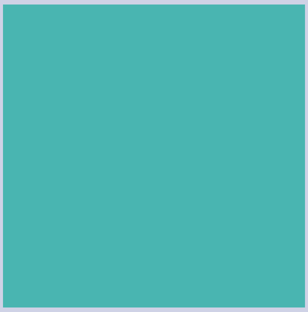
In order to implement its monetary policy strategy, there are several issues on which the ECB will have to take decisions. The main choices concern the precise identification of the target variable, the length of the target horizon, the width of the target range, and the response of the ECB to deviations from the target. Also crucial to the strategy will be communication with the general public. In line with current practice at NCBs, it appears desirable that the communication strategy of the ESCB should involve the following elements:

- the publication of its target(s) and details of their derivation;
- the regular publication of data and analyses relevant to monetary policy; and
- the explanation of deviations from target and of policy responses by the ECB.

Finally, the ESCB will be equipped with the statistical and analytical infrastructure needed to provide guidance for the conduct of the single monetary policy. The EMI and the NCBs are undertaking preparatory work to ensure that the ESCB will have such an infrastructure at its disposal by mid-1998.

Annex 2 contains a brief description of the EMI's preparatory work in the field of monetary policy strategy.[4]

[4] *It is the EMI's intention to provide more details on preparatory work in this field in a separate publication in the months ahead.*



Chapter II

Implementation of the single monetary policy

1 Introduction

The individual monetary policy instruments and procedures which, combined, will constitute the *operational framework of the ESCB* have to be consistent with each other in order to ensure the efficient conduct of monetary policy in Stage Three. Decisions on their choice will have to be made by the ECB with a view to the functions the set of instruments is expected to fulfil and, inter alia, against the background of considerations such as the link between the monetary policy strategy and the instruments, the structural liquidity deficit or surplus of the banking sector at that time, and the likely volatility of autonomous liquidity factors. The effects of these elements cannot be fully foreseen at this stage and a unique blueprint for the operational framework would therefore be premature. However, as preparations for new instruments or even new features to be added to the existing instruments used by NCBs involve considerable lead times, it was necessary - also from a Treaty perspective - to produce, by the end of 1996, the *conceptual design* of a set of monetary policy instruments that will be made available to the ESCB. This allows the first half of 1997 for the *design of the technical specifications* of the ESCB's operational framework. The *preparatory implementation* will take place from mid-1997 until mid-1998, leaving the latter half of 1998 for the ECB to decide on the final set of instruments and for the ESCB to test the operational framework.

The operational framework should enable the ESCB to fulfil a set of functions that will be essential for the performance of its tasks. First, it is of primary importance that the ESCB should be able to control its operational target efficiently, which, under normal circumstances, will be a short-term interest rate. Second, the monetary policy instruments should allow the ESCB to give signals of monetary policy intentions with an adequate degree of precision and differentiation. Moreover, the operational framework should be capable of providing basic refinancing, absorbing liquidity and influencing the structural position of the banking system vis-à-vis the central bank. A framework helping to control monetary aggregates by increasing the interest elasticity of money demand would also be advantageous, particularly if the ESCB were to use a monetary aggregate as an intermediate target, provided that such a framework does not, at the same time, distort the relationship between the monetary aggregate and the price level. Finally, it would be desirable for the framework to allow adequate information to be extracted from market developments and to contribute to the smooth functioning of the payment system.

2 General principles guiding the selection of the operational framework

On the basis of the experience gained by NCBs and following the provisions of the Treaty as well as the Statute of the ESCB, the EMI Council has adopted the following general principles to guide the selection of monetary policy instruments:

- the principle of *operational efficiency* implies that the instruments and procedures must enable the ESCB to perform the above functions efficiently;
- the set of instruments should *conform to the market principles* contained in the Treaty, i.e. monetary policy implementation should be "in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources" (Article 105(1));
- the principle of *equal treatment* should apply so that the ESCB will treat all financial institutions that have access to its facilities equally;
- the monetary policy instruments and procedures should, as far as possible, be *simple, transparent and cost-efficient*;
- according to the principle of *decentralisation*, the ECB should have recourse to the NCBs to carry out operations "to the extent deemed possible and appropriate" (Article 12 of the Statute of the ESCB). Such involvement of the NCBs in the execution of the operations decided by the ECB would enable the extensive operational experience of the NCBs to be used;
- in view of the desirability of *continuity*, the new operational framework should rely as much as possible on the existing infrastructure and on the NCBs' experience, provided that the application of this principle does not conflict with the other guiding principles;
- the instruments to be employed should be *harmonised to the extent necessary* across countries to ensure a single monetary policy stance across the euro area, as well as the equal treatment of counterparties and the avoidance of regulatory arbitrage. This harmonisation is also a necessary counterpart of decentralisation;
- in addition, the system of monetary policy instruments should ensure that the Governing Council of the ECB is in a position to control the overall stance of monetary policy at all times, in *conformity with the decision-making framework* of the ESCB.

3 ESCB monetary policy instruments and procedures

Following the above considerations, the EMI Council has defined a set of monetary policy instruments that will be available to the ESCB as from the start of Stage Three. According to this concept, the ESCB will mainly use open market operations, but it will also offer two standing facilities. In addition, preparations are being made for an infrastructure that will allow the ECB to impose minimum reserve requirements.

3.1 Open market operations

The ESCB will make use of open market operations for the purposes of steering interest rates, managing the liquidity situation in the market and signalling the stance of monetary policy. The ESCB will have at its disposal five main types of instruments, the most important of which will be reverse transactions, but it may also use outright transactions, the issuance of debt certificates, foreign exchange swaps and the collection of fixed-term deposits. The ECB will decide on the terms and conditions for the execution of the open market operations (see Annex 3). Three different procedures are envisaged, viz. standard tenders, quick tenders and bilateral procedures. The technical features of the ESCB's tender operations are specified in Annex 4.

These procedures would be used by the ESCB in order to carry out the following four types of monetary policy operations (see also Table 1):

- the *main refinancing operations* would be regular liquidity-providing reverse transactions with a weekly frequency and a maturity of two weeks. These operations will be executed by the NCBs on the basis of standard tenders. The main refinancing operations will play a key role in pursuing the purposes of ESCB open market operations, and will be used to provide the bulk of refinancing to the financial sector;

- in addition, there would be *longer-term refinancing operations*. These would represent a limited part of the global refinancing volume and would be carried out in the form of liquidity-providing reverse transactions with a monthly frequency and a maturity of three months. In these operations, the ECB, as a rule, would not intend to send signals to the market and would therefore normally act as a rate-taker;

- the ESCB may also carry out *fine-tuning operations* on an ad hoc basis. Fine-tuning operations will aim at managing the liquidity situation in the market and at steering interest rates, in particular in order to smooth the interest rate effects of unexpected liquidity fluctuations. Fine-tuning operations will primarily be executed as reverse transactions but may also take the form of outright transactions, foreign exchange swaps and the collection of fixed-term deposits. The instruments and procedures applied for the conduct of fine-tuning operations will be adapted to the prevailing circumstances and to the specific objectives to be pursued with the operations. Fine-tuning operations will normally be executed by the NCBs through quick tenders or bilateral procedures. The ECB Governing Council will decide if, under exceptional circumstances, fine-tuning operations may be executed in a centralised or decentralised manner by the ECB;

- the ESCB will also have the possibility of affecting the structural liquidity position of the banking sector vis-à-vis the ESCB by issuing debt certificates, using reverse transactions and conducting outright transactions. Operations in the form of reverse transactions and the issuance of debt certificates will be carried out according to standard tenders. Clearing and settlement of those instruments will be performed by NCBs on a decentralised basis. Outright transactions will be executed in the form of bilateral procedures.

3.2 Standing facilities

Standing facilities aim at providing and absorbing overnight liquidity, thereby bounding overnight market interest rates and signalling the general stance of monetary policy. Two standing facilities will be available to the ESCB's eligible counterparties on their own initiative (see also Table 1):

- the *marginal lending facility,* which will allow counterparties to obtain overnight liquidity from the NCBs at a pre-specified interest rate against eligible assets. Under normal circumstances, there will be no credit limits or other restrictions to counterparties' access to the facility except sufficient availability of underlying assets. The facility is intended to satisfy counterparties' temporary liquidity needs. The interest rate on the marginal lending facility will provide a ceiling for the overnight market interest rate under normal circumstances;

- the *deposit facility,* which will allow counterparties to make overnight deposits at a pre-specified interest rate with the NCBs. Under normal circumstances, there will be no limits on the corresponding deposit accounts or other restrictions to counterparties' access to it. The interest rate on the deposit facility will provide a floor for the overnight market interest rate under normal circumstances;

The two standing facilities will be administered in a decentralised manner by the NCBs. The terms and conditions of the facilities will be set by the ECB and will be identical throughout the euro area. All institutions fulfilling the counterparty eligibility criteria will be entitled to access both standing facilities. The ECB will reserve the right, at any time, to modify the conditions or to suspend the standing facilities. The technical features of both standing facilities are presented in Annex 5. The settlement procedures regarding standing facilities and open market operations are described in Annex 6.

3.3 Minimum reserves

According to Article 19.1 of the Statute of the ESCB, the ECB may require credit institutions to hold minimum reserves on accounts with the NCBs within the framework of the ESCB's minimum reserve system. In considering the efficiency of a potential minimum reserve system, the ECB might need to impose reserve ratios on a broad range of liabilities and institutions. Therefore, the EMI has seen a need to study further the extension of the definition of Article 19.1 so as to allow the ECB to subject a broader range of financial institutions than credit institutions alone to reserve requirements. The legal framework for the ESCB's minimum reserve system will have to be laid down in secondary Community legislation in accordance with Article 19.2 of the Statute of the ESCB. The ECB will need to submit a recommendation to the EU Council to this effect following its establishment. In view of lead-time considerations, the EMI has already prepared a proposal for a draft EU Council Regulation (see Annex 8). Should the ECB decide to employ a minimum reserve system, all relevant institutions established in the euro area would be legally subject to it. This implies that branches in the euro area of entities

Table 1

ESCB open market operations and standing facilities

Monetary policy operations	Types of transactions		Maturity	Frequency	Procedure
	Provision of liquidity	Absorption of liquidity			
OPEN MARKET OPERATIONS					
Main refinancing operations	• Reverse transactions	–	• Two weeks	• Weekly	• Standard tenders
Longer-term refinancing operations	• Reverse transactions	–	• Three months	• Monthly	• Standard tenders
Fine-tuning operations	• Reverse transactions • Foreign exchange swaps • Outright purchases	• Reverse transactions • Foreign exchange swaps • Collection of fixed-term deposits • Outright sales	• Non-standardised	• Non-regular • Non-regular	• Quick tenders • Bilateral procedures • Bilateral procedures
Structural operations	• Reverse transactions • Outright purchases	• Issuance of debt certificates • Outright sales	• Standardised/ non-standardised	• Regular and non-regular • Non-regular	• Standard tenders • Bilateral procedures
STANDING FACILITIES					
Marginal lending facility	• Reverse transactions	–	• Overnight	Access at the discretion of counterparties	
Deposit facility	–	• Deposits	• Overnight	Access at the discretion of counterparties	

with no registered office in the euro area would also be subject to the system.

The minimum reserve system that will be available to the ESCB could be used for stabilising money market interest rates, creating or enlarging a structural liquidity shortage and possibly contributing to the control of monetary expansion. The terms and conditions of the ESCB's minimum reserve system, including the rate of remuneration of required reserves, if any, would be uniform throughout the euro area. The amount of minimum reserves to be held by each institution would be determined in relation to the liability positions of its balance sheet as reported in accordance with the statistical requirements for Stage Three (see Chapter III A). For institutions with establishments in more than one Member State, each establishment would be required to hold minimum reserves on reserve accounts with the NCB in the relevant Member State in relation to its liability position. The ECB may apply a uniform reserve ratio to the whole reserve base or differentiate reserve ratios across categories and maturities of eligible liabilities. In order to help stabilise money market rates, the ESCB's minimum reserve system will include an averaging mechanism, implying that compliance with reserve requirements would be determined on the basis of an institution's average daily reserve holdings over a one-month maintenance period. The reserve base would be calculated on the basis of data reported within the framework of the ECB's money and banking statistics (see Annex 7). No carrying over of reserve shortfalls or surpluses to the next maintenance period would be allowed.

The ECB would establish and maintain a list of institutions subject to the ESCB's minimum reserve system. The list would be available to the public. The ECB might, on a non-discriminatory basis, exempt institutions from their obligations under the ESCB's minimum reserve system if the purposes of the latter system would not be satisfied by imposing the obligations on those particular institutions. The ECB would also make public a list of any institutions exempted (for reasons other than being subject to winding-up proceedings or reorganisation).

4 Counterparties and collateral for ESCB monetary policy operations

In order to secure a single stance of monetary policy across the whole of the euro area, eligibility criteria common to the whole ESCB both for its counterparties and for collateral for the ESCB's monetary policy operations are being defined. The harmonisation of eligibility criteria throughout the euro area will encourage the full integration of financial markets; it will also contribute to enhancing equal treatment and operational efficiency in the euro area. At the same time, due regard has to be paid to existing differences in central banks' practices and financial structures across EU Member States and to the need for the ESCB to use a wide range of collateral.

4.1 Counterparties

It is intended to involve a broad range of counterparties in ESCB open market operations and standing facilities, on the basis of uniform criteria applied by the ECB. In addition to enhancing policy efficiency and equal treatment, a broad range of counterparties is consistent with the principle of decentralisation in the execution of the monetary policy operations of the ESCB and may facilitate the smooth functioning of the payment system. In this respect, all institutions subject to minimum reserve requirements should, as a matter of principle, be eligible to access these monetary policy instruments. If no minimum reserves are applied, equivalent provisions to ensure a broad range of counterparties to standing facilities and open market operations will be established. Only in fine-tuning cases may operational efficiency advocate dealing with a limited range of counterparties.

In addition to giving a broad range of financial institutions access to the ESCB's monetary policy operations, uniform eligibility criteria to be fulfilled by counterparties throughout the euro area are being defined with a view to ensuring that counterparties satisfy certain prudential and operational requirements. In particular, counterparties must be financially sound institutions located in the euro area. They should be subject to at least one form of EU harmonised supervision by national authorities. Financially sound institutions subject to non-harmonised national supervision of a comparable standard could also be accepted as counterparties, e.g. branches located in the euro area of institutions that have their head office outside the European Union.[5]

It is envisaged that an appropriated legal instrument will cover uniform conditions under which counterparties will participate in ESCB monetary policy operations. In such an instrument, the ESCB will reserve the right to temporarily or permanently reject counterparties' access to monetary policy instruments on prudential grounds or if counterparties fail to comply with various obligations imposed upon them as monetary policy counterparties, including their obligations under the ESCB's minimum reserve system.

For foreign exchange swaps, counterparties will have to be able to conduct large-volume foreign exchange operations efficiently under all market conditions. The range of counterparties to foreign exchange swaps will correspond to the counterparties located in the euro area which are selected for ESCB foreign exchange policy operations (see Section 5.3).

[5] *Since the relevant directives have been implemented in the jurisdictions of the states of the European Economic Area, the same reasoning applies there.*

For outright transactions no restrictions will be placed a priori on the range of counterparties.

In other operations based on quick tenders and bilateral procedures, the ESCB will limit the number of counterparties on the basis of uniform qualitative and objective criteria. In this respect, activity in the money market will be the prime selection criterion. Other criteria which might be taken into account are, for example, the efficiency of the trading desk and the bidding potential.

4.2 Eligible assets

Article 18.1 of the Statute of the ESCB requires all ESCB credit operations to be based on adequate collateral. In line with this, all ESCB liquidity-providing operations will be based on underlying assets provided by the counterparties either in the form of the transfer of ownership of assets (in the case of outright transactions or repurchase agreements) or in the form of a pledge (in the case of collateralised loans).

With regard to the actual choice of assets eligible for ESCB monetary policy operations, the ESCB will have both public and private assets on its lists of eligible assets. Taking into account differences in national financial structures and in central bank practices, in particular concerning private assets, a two-tier system is envisaged. A first list (tier one) will consist of assets which fulfil euro area-wide eligibility criteria specified by the ECB. In addition, NCBs may consider as eligible other assets (tier two), which are of particular importance to their national financial markets and banking systems and for which eligibility criteria will be established by NCBs in accordance with ECB guidelines. As a rule, once they are included in the lists, either as tier one or tier two, assets will be eligible euro area-wide.

- the *tier one* list will consist of marketable assets which fulfil uniform euro area-wide eligibility criteria specified by the ECB. Tier one assets must, at least, be listed or quoted on a regulated market as defined according to the Investment Services Directive,[2] or listed, quoted or traded on certain non-regulated markets as specified by the ECB. Market liquidity may be taken into account by the ECB when determining the eligibility of individual assets. These assets must be denominated in euro (or in the national denominations of the euro) and issued (or guaranteed) by entities located in the European Economic Area (EEA).[3] They must also be located in the euro area and be transferable in book-entry form and deposited with an NCB or with a central securities depository (CSD) which fulfils the minimum standards established by the ECB (see Chapter III C). In addition, the list will include debt certificates issued by the ESCB, if any. Tier one assets will be eligible for all monetary policy operations which are based on underlying assets, i.e. reverse and outright open market transactions and the marginal lending facility. The ECB will establish and maintain a list of eligible tier one assets. It will be available to the public;

- the *tier two* list will consist of additional assets which the NCBs consider particularly important for their national financial markets and banking systems. The selection of the assets will be subject to ECB guidelines. Tier two assets could be either marketable or non-marketable financial obligations or equities traded on a regulated market. Normally they would have to be denominated in euro, located in the

[6] *Directive 93/22/EEC, Council Directive of 10 May 1993 on investment services in the securities field, OJ L 141 of 11.06.1993, p. 27 ff.*

[7] *The requirement of location does not apply to international and supra-national institutions.*

euro area and issued (or guaranteed) by entities located in the euro area. However, the ECB may authorise the inclusion in tier two lists of assets issued by entities in EEA countries outside the euro area, located outside the euro area but within the EEA and denominated in EEA currencies (other than euro) or other widely traded currencies.[8] Tier two assets will

Table 2

Eligible assets

Criteria	Tier one	Tier two
Type of asset	• ESCB debt certificates; • Other marketable financial obligations.	• Marketable financial obligations; • Non-marketable financial obligations; • Equities traded on a regulated market.
Settlement procedures	• Assets must be centrally deposited in book-entry form with an NCB or a CSD fulfilling ECB minimum standards.	• Assets must be easily accessible to the NCB which has included them in its tier two list.
Type of issuer	• ESCB; • Public sector; • Private sector. • International and supra-national institutions.	• Public sector; • Private sector;
Financial soundness	• The issuer (guarantor) must be financially sound.	• The issuer/debtor (guarantor) must be financially sound.
Location of issuer	• EEA.[9]	• Euro area; • Location in other EEA countries can be accepted subject to ECB approval.
Location of asset	• Euro area.	• Euro area; • Location in other EEA countries can be accepted subject to ECB approval.
Currency of denomination	• Euro.[10]	• Euro;[10] • Other EEA or widely traded currencies can be accepted subject to ECB approval.
Memo item: **Cross-border use**	• Yes.	• For "domestic" assets: yes; • For "foreign" assets:[11] possibly restricted.

8 *The cross-border use of "foreign" tier two assets might be restricted so that counterparties may use them only for receiving credit directly from the NCB which has included them in its tier two list.*
9 *The requirement of location in the EEA does not apply to international and supra-national institutions.*
10 *Euro or the national denominations of the euro.*
11 *"Foreign" assets are defined as assets fulfilling at least one of the following three criteria: they are issued by entities located outside the euro area; they are not denominated in euro; and they are not located in the neuro area.*

normally not be used in outright transactions. The NCBs will establish and maintain national lists of eligible tier two assets subject to approval by the ECB. These lists will be available to the public.

In order to simplify the operating procedures of ESCB counterparties, central securities depositories and central banks, and with a view to promoting an efficient use of eligible assets, the list of such assets for collateralising or securing intraday credit (see Chapter III B) should be the same as that adopted for monetary policy operations.

In conformity with the principle of equal treatment, it would be desirable that counterparties located in one Member State of the euro area can receive credit from their NCB using assets located in another Member State of the euro area as collateral. Given that international linkages between central securities depositories for that purpose do not yet cover the whole EU and may not be in place at the start of Stage Three, the EMI Council has initiated preparatory work for implementing a scheme by which transfers of information across the ESCB itself would allow for such a cross-border use of collateral in ESCB monetary policy operations. Chapter III C and Annex 13 provide a technical description of the EMI's preparatory work in this respect. Another possibility would be to allow remote access to refinancing from the NCB of the Member State where the collateral is deposited. No technical preparations are being envisaged for this solution. A decision on this subject will be taken by the Governing Council of the ECB.

In order to protect the ESCB from incurring losses in its monetary policy operations, all collateral must fulfil certain prudential criteria. In this respect, both tier one and tier two assets must be issued or guaranteed by financially sound entities. The ECB may reject financial obligations issued by entities with which the counterparty has close financial or legal links implying that the creditworthiness of the issuer is dependent on the creditworthiness of the counterparty.

4.3 Risk control measures

In order to protect the ESCB from the risk of financial loss in the event that underlying assets are realised as a result of the default of a counterparty, risk control measures will be applied to the assets underlying ESCB monetary policy operations. The main risk control measure at the disposal of the ESCB will consist of initial margins which may be varied on the basis of several criteria, among which the maturity of the monetary policy operation and the duration of the debt instrument play an important role.

In addition, in the case of tier two assets, the NCBs, following guidelines established by the ECB, may apply variation margins to marketable assets, limits in relation to issuers/debtors or guarantors, and additional guarantees.

5 Foreign exchange intervention

From the start of Stage Three, the ESCB will have the capacity to conduct foreign exchange intervention. Such operations might be effected in order to influence exchange rate developments between the euro, on the one hand, and other EU currencies or non-EU currencies (e.g. the US dollar), on the other. This section provides, first, a brief description of the general framework underlying the ESCB's foreign exchange policy operations. Second, it reviews the organisational framework needed to execute these operations. Finally, criteria to be applied when selecting potential counterparties and managing the associated risks are outlined.

5.1 General framework

5.1.1 Foreign reserve assets

The ESCB will conduct foreign exchange intervention by means of transactions on the foreign reserves transferred from the NCBs to the ECB. Article 30 of the Statute of the ESCB stipulates the conditions under which the ECB shall be provided by the NCBs participating in the euro area with foreign reserve assets, up to an amount equivalent to EURO 50 billion.[12] The management of foreign assets which are not pooled will be subject to guidelines issued by the ECB, pursuant to Article 31.3 of the Statute of the ESCB, so as, on the one hand, to ensure that the NCBs' operations related to these assets will not interfere with the monetary and exchange rate policies of the euro area and, on the other hand, with a view to facilitating NCBs' operations. Similar guidelines will apply to foreign currency working balances held by Member States of the euro area.

5.1.2 Exchange rate relationship between the euro and non-EU currencies

The Treaty does not prescribe any specific exchange rate arrangement vis-à-vis non-EU currencies. If a formal exchange rate regime for the euro vis-à-vis non-EU currencies were to be considered, the provisions of Article 109 of the Treaty would apply. In any event, the ESCB will have the technical capacity to conduct, if need be, intervention operations in order to counteract excessive or erratic exchange rate fluctuations of the euro against the major non-EU currencies.

5.1.3 Exchange rate policy co-operation between the euro area and other EU countries

As part of the future exchange rate policy co-operation between the euro area and other EU countries, a new exchange rate mechanism will be established. Membership will be voluntary; nevertheless, EU Member States with a derogation can be expected to join the mechanism once they have achieved a satisfactory degree of economic convergence. In the context of the new mechanism, intervention should be used as a supportive instrument, in conjunction with other policy measures, including appropriate fiscal and monetary policies conducive to economic convergence and exchange rate stability. The main features are as follows (see Annex 9 for further details):

- the new mechanism will be based on central rates, defined vis-à-vis the euro for the participating non-euro area

[12] *Further calls beyond the EURO 50 billion limit may be effected by the ECB within limits and under conditions to be laid down in Community secondary legislation.*

currencies, which implies that there will be no parity grid. A standard fluctuation band, which is expected to be relatively wide, will be established for these currencies around their central rates. Participating non-euro area Member States could establish, on a bilateral basis, fluctuation bands between their currencies and intervention arrangements aimed at limiting excessive bilateral exchange rate oscillations;

- central rates and the standard wide band would be set by mutual agreement between the ECB, the Ministers of the euro area Member States, and the Ministers and Governors of the central banks of the non-euro area Member States, following a common procedure involving the European Commission and after consultation of the Economic and Financial Committee. The Ministers and Governors of the central banks of the other EU Member States not participating in the exchange rate mechanism will not have the right to vote in the procedure;

- the sustainability of exchange rate relations within the new mechanism will be closely monitored on a permanent basis with a view to ensuring that any adjustment of central rates is conducted in a timely fashion so as to avoid significant misalignments. Against this background, all parties to the agreement, including the ECB, will have the right to initiate a strictly confidential procedure aimed at reconsidering central rates;

- foreign exchange intervention and financing at the standard wide margins will, in principle, be automatic and unlimited. However, the ECB and the participating non-euro area NCBs will have the possibility of suspending intervention and financing if these were to impinge on their primary objective of maintaining price stability. In deciding whether or not to resort to this safeguard clause, the ECB or a non-euro area NCB will take due account of all relevant factors, in particular the need to maintain price stability and the credible functioning of the new exchange rate mechanism;

- the possibility of co-ordinated intramarginal intervention decided by mutual agreement between the ECB and the respective NCB in parallel with other appropriate policy responses by the latter will be retained;

- the present Very Short-Term Financing facility (VSTF) will be broadly continued, following some appropriate adjustments;

- the exchange rate policy co-operation between non-euro area NCBs and the ECB could - in various forms - be strengthened further. The procedure to be followed would depend on the form of the closer link.

5.2 Organisation of foreign exchange intervention in the ESCB

The decisions related to intervention will be taken by the ECB. The implementation of such decisions will be either centralised or decentralised within the ESCB. Preparatory work is being conducted with a view to ensuring that the ESCB will be in a position to avail itself of the two basic organisational arrangements:

- *centralisation:* intervention operations will be carried out exclusively by the ECB, using its own technical infrastructure;

- *decentralisation:* all participating NCBs will execute intervention following instructions given by the ECB.

The final decision regarding the appropriate degree of centralisation/decentralisation will be taken by the Governing Council of the ECB. Depending on the centralised or decentralised nature of intervention operations, the role of the NCBs and the ECB might differ, although all members of the ESCB will be kept informed on an ongoing basis.

5.3 Selection of counterparties and risk management

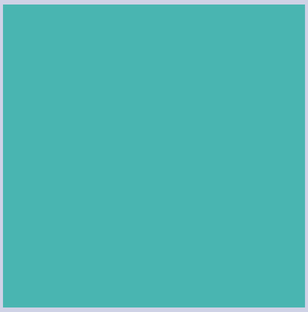
The selection of counterparties for foreign exchange intervention operations will follow a uniform approach irrespective of the chosen organisational set-up for the ESCB's external operations. Such a policy will not entail a substantial departure from existing market standards, as it will be derived by harmonising NCBs' current best practices. The selection of the ESCB's counterparties will be based, primarily, on two sets of criteria.

The first set of criteria is inspired by the principle of prudence. A first prudence criterion is creditworthiness, which will be assessed using a combination of different methods (e.g. using credit ratings available from commercial agencies and the in-house analysis of capital and other business ratios); a second criterion is that the ESCB will require all its potential counterparties to be subject to supervision by a recognised supervisor; as a third criterion, all the ESCB's counterparties will need to follow high ethical standards and have a good reputation.

Once the minimum prudence requirement is fulfilled, the second set of criteria inspired by efficiency considerations will be applied. A first efficiency criterion relates to competitive pricing behaviour and the counterparty's ability to handle large volumes, even in turbulent market conditions. The quality and coverage of information provided by counterparties feature among other efficiency criteria.

The pool of potential counterparties will be sufficiently large and diverse to guarantee the necessary flexibility when implementing intervention operations. It will enable the ESCB to choose from among different intervention channels. In order to be able to intervene efficiently in different geographical locations and time zones, the ESCB will be able to use counterparties in any international financial centre. However, in practice, it is likely that a substantial share of the counterparties will be located in the euro area.

Credit exposures related to foreign exchange intervention and reserve management operations will be managed using a limit-based system.



Chapter III

Supporting framework for the single monetary policy

A. Collection of statistical data

1 Statistical requirements to enable the ESCB to carry out its functions in Stage Three

The Treaty requires the ECB to collect, with the assistance of the NCBs, the statistical information needed for the conduct of the single monetary policy of the Community and of foreign exchange operations. One of the functions of the EMI is to make the necessary statistical preparations.

Given the fact that the objectives of the ESCB resemble those of the present NCBs in the EU Member States, the statistical requirements for the euro area also resemble the national statistics currently available to central banks. Even if relevant information is available at present, however, the compilation of aggregates covering the euro area will raise questions of harmonisation and consolidation.

The EMI and the ECB are specifically charged with the task of harmonising statistics where necessary. Harmonisation is required because there are differences of definition and statistical practice which, if not attended to, would yield inconsistent aggregates. The aim is to achieve consistent statistics of good quality, and not to impose uniform concepts disregarding differences in the structure and functioning of national financial systems.

Appropriate consolidation is necessary for the compilation of certain aggregates since - in particular - the money stock and the balance of payments of the euro area as a whole will not simply be the sums of the money stock and the balance of payments of the participating countries, as currently defined, even if the underlying concepts and statistical practices are fully harmonised. More information will be needed to enable appropriate consolidation to be carried out.

Although the ESCB's monetary policy responsibilities will relate to the euro area, the Treaty also refers to statistical responsibilities of the ESCB towards EU Member States which do not participate in this area at the outset.

The requirements will have to be met in time for Stage Three to start in January 1999. However, to prepare for the single monetary policy, serious policy planning will need to begin some months earlier, and some data will be needed, which should be as harmonised as possible, well in advance of the start of Stage Three.

The EMI, where appropriate in consultation with the Commission, has prepared a statement of statistical requirements for Stage Three. These were outlined in an explanatory booklet published in July 1996. At the same time, the EMI released a more detailed document for the use of banking associations and others involved in statistical preparations.[13] The requirements are thus only summarised briefly in this chapter and in Annex 10.

- *Money and banking statistics*

  A consolidated balance sheet will be established on a monthly basis, containing data on the business of the Monetary Financial Institutions (MFI) sector,[14] in sufficient detail to allow flexibility in the calculation of monetary aggregates and counterparts covering the euro area. Since money and its

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13 *See, respectively, EMI, The Statistical Requirements for Monetary Union, July 1996, and EMI, Statistical Requirements for Stage Three of Monetary Union (Implementation Package), July 1996.*

14 *The full definition of MFIs is "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 credits and/or to make investments in securities".*

counterparts will be closely monitored, irrespective of whether a monetary aggregate is targeted, reliable, closely harmonised and timely statistics will be needed. Further data will be required on a quarterly basis, including more information on the maturity of assets and liabilities and on the sector of counterparties. Minimum reserve requirements would rely on the framework of money and banking statistics. The statistical framework is designed to meet international standards, as set out in the European System of Accounts (ESA 95).

Balance of payments statistics

A monthly balance of payments of the euro area will be established, showing the main items affecting monetary conditions and exchange markets, as an input to monetary policy and foreign exchange operations. More detailed information will be provided on a quarterly basis to permit further analysis of external transactions.

For the purpose of monetary policy and exchange market analysis, and to assist in the compilation of balance of payments flows, a statement of the external assets and liabilities of the euro area as a whole, i.e. the international investment position, will be compiled annually.

As far as possible, data will correspond to international standards set out in the 5th edition of the IMF Balance of Payments Manual.

Financial and related statistics other than money and banking and balance of payments statistics

These statistics include requirements for data on interest rates; for data on financial intermediaries which are not MFIs, and on capital issues, commercial paper and similar assets; government finance statistics; and financial accounts conforming to the ESA 95.

Statistics relating to prices and costs; background economic statistics

Background economic statistics include national accounts, monthly statistics on output and demand, and labour market statistics.

2 Organisation of statistical work at the European level

The EMI, and prospectively the ECB, will have primary responsibility at the European level for money and banking and related statistics, and should share responsibility with the Commission (EUROSTAT) for balance of payments statistics and financial accounts. These are the types of statistics for which central banks are usually responsible in EU Member States, or share responsibility with the national statistical institute, and in which they are likely to take the lead, or be closely involved, in making the necessary statistical changes in preparation for the euro area. Statistics relating to the convergence criteria and other economic statistics are the Commission's responsibility. The EMI and EUROSTAT have undertaken to co-operate closely in all areas of common interest.

As far as the organisation of statistical work within the ESCB in Stage Three is concerned, Article 5.2 of the Statute of the ESCB states that NCBs should carry out the task, as far as possible. To provide the statistics needed for the ESCB to perform its functions, the NCBs will collect data from reporting agents in their national territory, within a common framework, aggregate the data, and send the aggregates to the ECB, where statistics covering the euro area will be compiled. While the ECB will take the lead in developing statistical concepts, the NCBs will continue to be involved at the conceptual stage, since they will retain considerable expertise in statistical matters, remain close to the reporting agents and continue to be responsible for most of the practical statistical work.

The ESCB will need a rapid, secure and reliable means of exchanging statistical data with the NCBs, the Commission (EUROSTAT) and certain other bodies. An electronic data exchange project is under way.

3 Legal aspects

Article 5.4 of the Statute of the ESCB states that the EU Council must define the natural and legal persons subject to reporting requirements, the confidentiality regime and the appropriate provisions for enforcement. The ECB will submit a recommendation to the EU Council to this effect following its establishment. In view of lead-time considerations, the EMI has already prepared a proposal for a draft EU Council Regulation which meets these requirements (see Annex 11).

Within the limits of the Treaty and the aforementioned forthcoming Council Regulation, the ECB will be allowed to issue regulations in the field of statistics where this is necessary for the ESCB to undertake its tasks, with binding power in the EU Member States participating in the euro area. Articles concerning the right of verification of data, the compulsory collection of statistical information, and sanctions in the event of non-compliance (see Annex 12) will apply only in participating EU Member States. The forthcoming Regulation will require EU Member States not participating in the euro area to design and implement at the national level all the measures they consider appropriate in order to collect the statistical information needed to fulfil the ECB's statistical reporting requirements and the timely preparations with a view to their entry into the euro area. There are strict provisions to protect the confidentiality of individual reported data.

B. The TARGET system

1 A new payment mechanism for Stage Three

TARGET, the acronym for Trans-European Automated Real-time Gross settlement Express Transfer, is the name of the interbank funds transfer system that will support the integration of the money market and thereby the implementation of the single monetary policy in Stage Three of EMU. To this end, the system has been designed in such a way that it will be able to process cross-border payments denominated in euro as smoothly as if they were domestic payments. The aim is to allow payments - and especially money market payments - to be made through the euro area at low cost with high security and very short processing times.

In addition to providing the payment procedures necessary for carrying out the single monetary policy, the TARGET system also contributes to the development of sound and efficient payment mechanisms in the Single Market area. This is achieved through the use of real-time gross settlement procedures within TARGET, which are the safest payment mechanism for processing large-value payments, since they enable participants in the system to settle their payments irrevocably and in real time.

The following sections provide a description of the main features of the TARGET system.[15] Further details are provided in Annex 14.

[15] *The description draws on three documents which were published by the EMI in the last two years, namely: the note on "The EMI's intentions with regards to cross-border payments in Stage Three" (November 1994), the report on "The TARGET System" (May 1995) and the "First Progress Report on the TARGET Project" (August 1996). The latter report was complemented by a set of technical documents comprising an overview of the current stage of the technical work on TARGET.*

2 TARGET overall structure

2.1 TARGET architecture

TARGET will interlink the domestic RTGS systems which NCBs have agreed to implement in their respective countries. It provides the banking sector with a payment mechanism which will enable it to process cross-border RTGS payments in euro, using infrastructures and procedures which will already be in place in each Member State. Thus, the costs of adaptation to TARGET will be minimised for the participating credit institutions. RTGS facilities in the NCBs will be interconnected through a communication network exchanging payment messages according to a common format and common procedures (the Interlinking system). In order to reconcile the willingness to maintain domestic communication standards between credit institutions and NCBs, on the one hand, and to adopt a single standard between NCBs, on the other, each participating NCB needs to set up an "Interlinking component" which ensures the "translation" of messages from the domestic environment to the Interlinking one (and vice versa).[16]

RTGS systems of EU Member States outside the euro area may be connected to TARGET, provided that they are able to process the euro.

2.2 TARGET project plan

As part of the preparatory work for Stage Three, the whole TARGET project provides for five different phases:

- the preliminary phase, entailing the definition of payment arrangements for Stage Three;
- the specification phase, during which the detailed specification of the euro area-wide payment system was undertaken;
- the development phase, which involves the implementation of the system;
- the testing phase;
- the simulation phase.

The preliminary phase was finalised in March 1995 by the EMI Council's approval of the TARGET Report. The specification phase ended in July 1996, when the development phase started. The latter phase involves, in particular, the implementation of domestic RTGS systems, the Interlinking system and the test centre.

2.2.1 The implementation of domestic RTGS systems

In Denmark, Germany, Sweden and Finland RTGS systems were already in operation in 1995. In the United Kingdom, Belgium and Portugal RTGS systems came into operation in 1996. In all other countries, RTGS systems will be implemented or the existing systems will incorporate significant technical modifications to meet TARGET's specifications in the course of 1997.

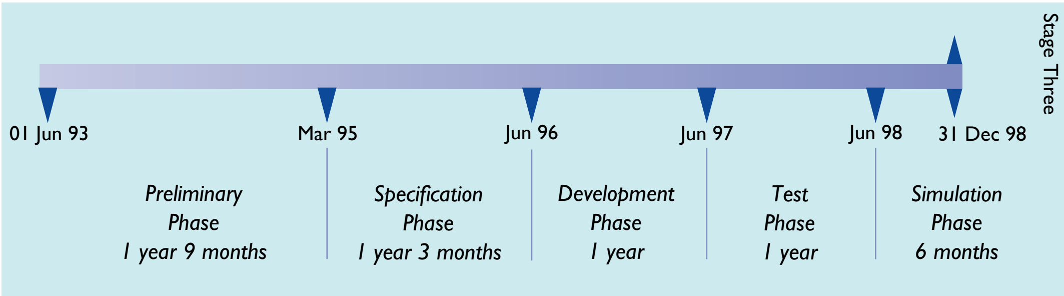
2.2.2 The implementation of the Interlinking system

The Interlinking system is currently in the implementation phase. The network provider will be chosen and NCBs will prepare their Interlinking components so that the test phase can start in mid-1997.

[16] *The "Interlinking specifications" have been outlined in a technical annex to the First Progress Report on TARGET issued in August 1996.*

Chart 1

Target Overall Planning



2.2.3 The test centre

During the development phase, a test centre will be set up against which Interlinking components will be tested.

2.3 Participation in the system

Access criteria basically rely on national approaches. As a rule, only central banks and credit institutions, as defined under the Second Banking Co-ordination Directive, can be admitted as direct participants in funds transfer systems which process third-party payments. However, NCBs may allow certain other bodies authorised to hold accounts for customers to be direct participants in such systems provided that their public nature ensures little risk of failure or that they are supervised by a recognised competent authority.

2.4 Types of transactions handled

The use of TARGET is only mandatory for payments directly connected with monetary policy operations in which the ESCB is involved either on the recipient or on the sender side. In practice TARGET is expected to handle almost exclusively large-value payments to be transmitted between participants on their own behalf or on behalf of customers. There is no intention to set an upper or lower limit for the amounts to be transferred in TARGET. However, it can be expected that retail payments which do not require the high execution speed guaranteed by TARGET will tend to be processed by other funds transfer systems, which may offer lower costs but longer processing times.

3 Common organisational features of TARGET

Each RTGS system participating in TARGET will basically keep its specific features as far as it processes domestic payments. Nevertheless, a certain degree of harmonisation of some features of domestic RTGS systems is being achieved in order to avoid impediments to the efficient conduct of the single monetary policy and distortions in competition between banks. In particular, a certain degree of harmonisation of the features of RTGS systems will be ensured in the following three areas:

- the provision of intraday liquidity;
- operating hours;
- pricing policies.

3.1 The provision of intraday liquidity

Participants' intraday liquidity needs depend on the different schedule of payments made and received in the course of the day. If, in the course of the day, they send payment orders whose value exceeds the value of the payment orders they receive, they incur a liquidity shortfall which can be met either out of pre-constituted holdings at the central bank[17] or by obtaining credit from the central bank or from other participants in the payment system.

An RTGS system may function, in principle, without any required reserves, intraday overdraft facilities or repos. If, however, a shortage of liquidity occurs, payments are rejected or queued until sufficient funds are made available either via incoming payments or via funds borrowed in the market. Therefore the provision of intraday liquidity is considered an important feature of TARGET since inadequate liquidity mechanisms may lead to settlement delays and possibly even to gridlock (i.e. the impossibility of processing payments because of a lack of sufficient funds) which may have systemic implications and could discourage credit institutions from processing payments through TARGET.

3.1.1 Intraday credit in the euro area

The NCBs of the euro area will provide eligible ESCB counterparties participating in their domestic RTGS systems in TARGET with intraday credit (i.e. credit extended during the day and reimbursed before the end of the day) by making use of different techniques throughout the euro area. In particular, in some countries intraday credit is provided by granting RTGS participants the possibility of overdrawing their account with the central bank during the day, while in other countries intraday repurchase agreements are used. Although the two mechanisms have different technical and legal features, they have the same effect on the functioning of payment systems. Intraday credit to RTGS participants needs to be fully collateralised (see Chapters II and III C).

RTGS participants in the euro area may, to the extent that they are eligible counterparties for monetary policy operations of the ESCB, draw on the marginal lending facility with their NCB in order to balance the end-of-day position in their accounts.

[17] *It is assumed that if, for monetary policy reasons, required reserves in euro exist, credit institutions will be able to use them during the day for payment systems purposes.*

3.1.2 Intraday credit outside the euro area

The options for NCBs outside the euro area to grant intraday credit in euro to TARGET participants are still under discussion. In this respect, three mechanisms are being prepared which aim at preventing intraday credit, if granted to non-euro area NCBs, from spilling over into overnight credit. The final decision on which mechanisms to implement will be taken by the Governing Council of the ECB.

Under the first mechanism, non-euro area NCBs would receive, and would provide to participants in their respective RTGS systems, only limited intraday credit; the size of the limit can be zero. Should a non-euro area NCB incur an overnight overdraft on one of its accounts with a euro area NCB, overnight credit would be granted at a penalty rate, as would be the case under the second mechanism.

Under the second mechanism, non-euro area NCBs would be allowed to incur unlimited intraday overdrafts in euro and could, in turn, grant unlimited collateralised intraday credit to participants in their respective RTGS systems. The risk of spillover of intraday credit into overnight credit would be contained through a system of penalties and sanctions applied in case of overnight overdrafts.

Under the third mechanism, participants in RTGS systems in non-euro area countries would be required to complete their operations some time before the closing time of TARGET, to allow any shortage of funds to become clear early enough for non-euro area NCBs to be able to offset their RTGS participants' spillovers by themselves, by borrowing euro in the money market while the latter is still open.

3.2 Operating hours

TARGET will have long operating hours. As a general rule, it will open at 7 a.m. and close at 6 p.m. CET. However, domestic RTGS systems may open at an earlier time for processing domestic payments only. Around one hour before the aforementioned closing time, participants in RTGS systems (in both euro area and non-euro area countries) will stop processing customers' payments in euro. Only interbank payments aimed at transferring liquidity in euro between participants - at the domestic and at the cross-border level - will be allowed thereafter.

This harmonisation, based on the current longest operating hours in the EU, will allow for a larger overlap between TARGET and the payment systems of the major financial centres in North America and the Far East, thereby supporting the efforts made by credit institutions and central banks world-wide to limit cross-currency settlement risk. A common closing time may be seen as a means to obviate the risk of substantial payments taking place outside the common operating hours and will therefore prevent the occurrence of "regional"/segmented movements in interest rates affecting the conduct of the single monetary policy, which calls for an identical level of interest rates throughout the euro area.

At the end of the day, a system will ensure that all transactions entered in TARGET are dealt with before TARGET closes.

3.3 Pricing policies

The pricing policies of NCBs, for payment system functions, aim at avoiding competitive distortions in the context of the Single Market and EMU. Within this framework, the TARGET pricing policy is directed at cost recovery while complying with three main requirements: it should not hinder the integration of the money market and thus affect the implementation of the single monetary policy; it should maintain a level playing-field between participants; and it should contribute to risk reduction policies in payment systems.

The recovery of central bank costs involved in TARGET will enable the ESCB to avoid the inappropriate use of economic resources; to allocate costs, whenever possible, to the appropriate source; and to avoid unfair competition between central banks' and other payment arrangements.

In order to prepare a pricing policy based on cost recovery, NCBs are currently developing a common calculation method for payment processing costs.

From a monetary policy point of view, attention is being paid to the possible effects of price differentials on market arbitrage, i.e. the impact of transactions costs on effective interest yields. Overly high transaction charges or excessive price differentials would discourage interest rate arbitrage and threaten the singleness of the ECB's monetary policy in Stage Three.

Moreover, the TARGET pricing policy has to be compatible with EU competition law and avoid a situation in which overly wide price differentials affect the level playing-field between credit institutions.

Finally, the TARGET pricing policy must not induce institutions to use less secure payment mechanisms.

C. Securities settlement systems

1 Stage Three requirements for securities settlement systems

In Stage Three securities settlement systems and procedures will have to make it possible to achieve two major objectives: first, to ensure that monetary policy operations are settled according to a set of minimum conditions of operational viability; and second, to support the integration of the money market and thereby the implementation of the single monetary policy.

The minimum conditions for the execution of monetary policy operations, as mentioned in the first objective, entail, in particular, that securities settlement systems and procedures have to ensure that:

- the ESCB can establish links with a broad range of counterparties;
- securities transactions are speedy, smooth and reliable;
- a broad range of assets can be used for collateralising/securing central bank credit.

Moreover, ESCB counterparties should be able to obtain credit from their NCB against eligible assets deposited in another Member State of the euro area (see Chapter II, Section 4.2).

The existing infrastructure already enables the ESCB to establish links with a broad range of counterparties. Some adaptation of securities settlement systems and central bank procedures is required to ensure speedy, smooth and reliable transactions and the use of a broad range of assets in a cross-border context.

The following sections provide a description of the main features of securities settlement systems and procedures in Stage Three.

2 Minimum conditions for operational viability

2.1 Links between the ESCB and a broad range of counterparties

All types of institutions that are likely to be eligible to be counterparties already have access either directly or indirectly to the local central securities depository (CSD) or hold securities accounts with the central bank (operational safe custody accounts). Thus, no further adaptation of infrastructure is needed.

2.2 Speedy, smooth and reliable transactions

In the context of the ESCB's monetary policy operations, securities settlement procedures have to ensure that no proceeds of monetary or intraday credit operations are disbursed before securities (or other eligible assets) are transferred to the central bank with finality (i.e. with irrevocable and unconditional transfers) and that eligible assets associated with monetary policy or intraday credit operations may be settled with finality on an intraday basis.

This will safeguard central banks against incurring inappropriate risk in conducting monetary policy operations and/or in providing liquidity for the smooth functioning of payment systems, and will ensure the same level of safety for all central bank operations, which are currently settled in different ways throughout the EU.

Moreover, intraday finality for securities transactions will ensure consistency between the settlement of the collateral and of the cash leg of transactions processed via the TARGET system, which is a system based on the real-time gross settlement of funds.

Intraday finality may be achieved by means of four different operational mechanisms:

- pre-depositing of securities on operational safe custody accounts held with the central bank;
- net settlement systems with several processing cycles during the day;
- real-time gross settlement systems for securities transactions;
- intraday free delivery (i.e. without payment) of securities.

From among these options, each NCB will find the most appropriate solution for achieving this objective at the domestic level on the basis of the existing infrastructures.

In the first mechanism (i.e. pre-depositing of securities) eligible assets will have to be deposited in advance by ESCB counterparties on a safe custody account held at the central bank. The securities held on these accounts will be deposited with the national CSD in the name of the NCB, so that the transfer to the safe custody account results in a transfer between the counterparty's and the NCB's account with the CSD.

In the second mechanism, assets will be settled in net settlement systems (NSSs) with several processing cycles during the day. The processing cycle is the mechanism through which the securities settlement system (SSS) settles transactions and debits/credits the securities accounts of each counterparty. In some NSSs several processing cycles with intraday finality take place each day. In this case, credit can be granted via TARGET during the day just after the settlement of each intraday processing cycle for securities.

SSSs which settle final balances at the end of the day cannot be used for the settlement of all monetary policy operations for the following reasons:

- it could be technically dangerous to have a concentration of payments to be settled at the very end of the settlement process; and

- the central bank would, in practice, be unable to provide liquidity to TARGET participants during the day.[18]

The third mechanism consists in the use of real-time gross settlement systems for securities settlement. In such systems, securities are settled as soon as they are available according to the requirements of the system. In this case, credit can be granted on a continuous real-time basis after securities have been delivered.

In the first three operational mechanisms above, securities transactions are settled through a "delivery versus payment" (DVP) mechanism, i.e. through a mechanism which ensures that the final transfer of one asset occurs if and only if the final transfer of the other asset has occurred. In the fourth solution (i.e. free delivery), no DVP mechanism is in place and securities are transferred without a link to the cash leg of the transaction, the latter taking place through a separate funds transfer system. The checking of credit cover then also has to be performed in a separate procedure.

Finally, work is in progress involving CSDs to ensure that the operating hours of CSDs or of central bank procedures will be consistent with those of the single money market and with the operating hours of the TARGET system.

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18 *However, where monetary policy operations are settled on a T+1 basis, securities may be settled in an end-of-day NSS since settlement will occur the day before credit is granted by the NCB.*

3 Other features

3.1 Use of a broad range of assets

Securities settlement procedures used by the ESCB will allow for both pledging and the full transfer of ownership of eligible assets for collateralising or securing open market operations and end-of-day and intraday credit. Both intraday repos and collateralised intraday overdrafts can be considered as acceptable alternative methods of providing liquidity to the different national systems (see Chapter III B). In both cases, settlement of the securities transfer will take place using the normal settlement procedures for the securities concerned. For securities included in the tier one list of eligible assets (see Chapter II, Section 4.2), settlement will take place at the central bank or in the national or international CSD where the asset deposited by the counterparty was issued, provided that where a CSD is used, it is located in the euro area and meets certain minimum standards to be defined by the ECB. Additional standards may be necessary to address the risks involved in settlement procedures arising from securities issued in one (national or international) CSD but held by a counterparty in another CSD within the euro area. In order to ensure that eligible assets that do not meet these conditions may also be used as collateral, other settlement procedures may be used, for example for non-marketable assets that are not deposited with a CSD, subject to ESCB guidelines. ESCB-issued certificates (see Chapter II, Section 3.1) will be settled in a decentralised way at the national NCB or CSD, according to the same rule.

Assets located outside the euro area but within the EEA could be used if they are included in the tier two list of an NCB (see again Chapter II, Section 4.2). For this purpose, arrangements have to be made between the central bank that included the eligible asset on its tier two list and the central bank where the paper is located.

3.2 Cross-border use of eligible assets

The use of assets deposited in another Member State for securing (intraday and overnight) central bank credit is currently rare among NCBs. Although some links between domestic securities systems are in place, they do not cover the whole EU area and they cannot ensure that the cross-border use of collateral occurs under the same conditions throughout the euro area on a regular basis. Moreover, NCBs are not direct members of settlement systems in EU Member States other than their own. Therefore, existing arrangements are inadequate to enable central banks' counterparties in monetary policy operations to use securities deposited in another Member State in a systematic way.

The implementation of direct linkages between CSDs (domestic and international ones) on an EU-wide basis would enable each participant in a domestic CSD to utilise securities deposited in another CSD. NCBs and the EMI are looking with interest at any initiative in this regard, but the realisation of this approach on an EU-wide basis involves considerable lead times and is therefore unlikely to be implemented prior to the start of Stage Three.

Against this background, two models are being prepared so as to be able to allow for the cross-border use of collateral for monetary policy and payment systems operations from the start of Stage Three: the correspondent central banking model and the guarantee model. A detailed description of both models for the cross-border use of securities is provided in Annex 13.

The two models for the cross-border use of collateral are in line with the principle of "equal treatment" included in the Treaty and facilitate the integration of financial markets, since banks would no longer have an incentive to hold specific securities (traded at the domestic level) to cover their possible liquidity needs.

The recourse to additional arrangements for the cross-border use of collateral will not be excluded, provided that these arrangements are able to ensure the timely and sound execution of monetary policy operations.

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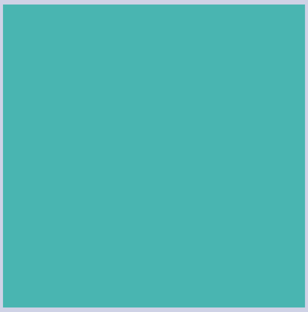

Annexes

Annex 1

Tasks and functions of the ESCB

The European System of Central Banks (ESCB) will be composed of the European Central Bank (ECB) and of the national central banks (NCBs) of the EU Member States. The latter are an integral part of the ESCB and, as far as the respective country participates in the euro area, will have to act in accordance with the guidelines and instructions of the decision-making bodies of the ECB. As soon as the members of the Executive Board of the ECB are appointed, the ECB will be legally established and at the same time also the ESCB. Unlike the ECB and the NCBs, however, the ESCB will not have a legal personality.

In accordance with Article 105 (2) of the Treaty,[1] the basic tasks to be carried out through the ESCB shall be:

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

In accordance with Article 105 (4) of the Treaty, the ESCB shall be consulted on any proposed Community act in its fields of competence and on any draft legislative provision in its fields of competence originating from national authorities, within the limits and conditions set out by the EU Council. A draft EU Council decision establishing these limits and conditions has been prepared by the EMI and forwarded to the European Commission, which will propose it to the EU Council. The ECB may also submit opinions to the appropriate Community institutions or bodies or to national authorities on matters in its fields of competence.

In accordance with Article 105 (5) of the Treaty, the ECB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.

In accordance with Article 105a of the Treaty, the ECB shall have the exclusive right to authorise the issue of banknotes within the Community. Only banknotes issued by the ECB and the NCBs will have the status of legal tender within the Community. It is to be recalled that the EMI is in the process of preparing the euro banknotes. Moreover, subject to approval by the ECB of the volume, EU Member States may issue coins.

Other tasks, such as the collection of statistics, reporting or tasks to be taken over from the EMI, are described in more detail in the Statute of the ESCB which is annexed to the Treaty as Protocol No. 4. More information on this topic is provided in Chapter 3 of this document.

The ESCB will be governed by the decision-making bodies of the ECB, viz. the Executive Board and the Governing Council.[2] The Executive Board will comprise between four and six members, including a President and Vice-President, all of whom must be nationals of EU Member States which participate in the euro area. The Governing Council will comprise the members of the Executive Board and the governors of the

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1 *Article 105 of the Treaty does not apply to those Member States which have not adopted the single currency in accordance with the Treaty.*

2 *See Article 106 (3) of the Treaty.*

NCBs of EU Member States which participate in the euro area. Another body of the ECB will be the General Council, which will comprise the President and Vice-President of the ECB and the governors of the NCBs of all EU Member States, including those which do not participate in the euro area.

Each of these bodies has specific responsibilities in the execution of the tasks and functions attributed to the ESCB and the ECB. The Governing Council shall adopt the guidelines and take the decisions necessary to ensure the performance of the tasks entrusted to the ESCB under the Treaty and the Statute; it shall formulate the single monetary policy including, as appropriate, decisions relating to intermediate monetary objectives, key interest rates and the supply of reserves in the ESCB, and it shall establish the necessary guidelines for their implementation.

The Executive Board shall implement monetary policy in accordance with the guidelines and decisions laid down by the Governing Council and will give the necessary instructions to NCBs to this end.

The General Council shall perform the tasks deriving from the situation in which not all EU Member States participate in the euro area right from the start; more specifically, it will take over the tasks of the EMI which still need to be performed and will give advice in the preparations for the abrogations of derogations, particularly for irrevocably fixing the exchange rates of the currencies joining the euro area.

The Treaty empowers the ECB to adopt several legal instruments for the carrying-out of the tasks entrusted to the ESCB: regulations, decisions, recommendations and opinions (Article 108a). If the obligations imposed on undertakings by ECB regulations and decisions are violated, the ECB is entitled to impose on them fines or periodic penalty payments, within the limits and under the conditions established by the EU Council. In this respect, the EMI has prepared a proposal for a draft EU Council regulation on the imposition of sanctions by the ECB, the text of which can be found in Annex 12.

Annex 2

Preparatory work in the field of monetary policy strategy

In the field of monetary policy strategy, a number of projects have been launched with a view both to facilitating the discussions on strategy and also, over the longer term, to providing the ESCB with the necessary econometric infrastructure to assist in the formulation of monetary policy in Stage Three. This preparatory work has concentrated on the development of tools to assist in the analysis and monitoring of area-wide monetary developments, to identify and quantify the likely features of the transmission mechanism in the euro area and to produce forecasts of variables of interest.

Two approaches for a monetary policy strategy have been analysed in detail, namely monetary targeting and direct inflation targeting. In view of the importance of the empirical properties of monetary aggregates in the effectiveness of a money targeting strategy, background work has also addressed the crucial issue of the stability of money demand, leading indicator properties of money for inflation, and the controllability of monetary aggregates at the area-wide level. Some results pointing to favourable properties of monetary aggregates with respect to all three issues have been identified. However, the fact that the move to Stage Three itself may disturb previously stable relationships suggests that it is difficult at this stage to draw definitive conclusions regarding the empirical properties of money in Stage Three. Further work will include studies of the empirical properties of different monetary aggregates as well as the examination of the determinants of the counterparts of money, particularly private sector credit.

There is a consensus among NCBs that the ESCB, in formulating its policy, should have at its disposal a broad range of indicators which it can examine in order to identify possible risks to price stability at an early stage. Work to date in this area suggests that, while many variables have been found at various times to contain leading indicator information for future inflation, their usefulness has varied over time, across countries and over different forecasting horizons, suggesting the need for the ongoing and continuous monitoring of their empirical properties. Empirical work on assessing the information content of alternative indicators has commenced and will continue over the course of 1997.

As noted in the text, the transmission mechanism facing a central bank exerts a crucial influence on the appropriateness of alternative strategies, and some knowledge of the area-wide transmission mechanism will be indispensable for the analysis and formulation of monetary policy in Stage Three. Various econometric methods can be employed for this purpose. As a starting-point, area-wide structural econometric models have been developed and estimated for different EU country groupings. In such models, equations are specified and estimated for area-wide variables, i.e. variables which are a weighted average of the corresponding national variables. The results obtained so far point to some differences across country groupings and further work on these models will be carried out with a view to assessing and improving their performance. In addition to this approach, it is also envisaged that additional approaches - ranging from reduced form modelling to multi-country structural modelling - will be carried out in the future in order to ensure that the ESCB will have a comprehensive econometric infrastructure at its disposal.

Annex 3

Technical features of the ESCB's open market instruments

The four types of monetary policy operations, described in Chapter II, can be carried out using five types of instruments, namely reverse transactions, outright transactions, issuance of debt certificates, foreign exchange swaps and collection of fixed-term deposits. For each of them, this annex describes the type, the legal nature as well as interest or price terms.

1 Reverse transactions

Reverse transactions refer to operations where the NCBs (or the ECB) buy or sell eligible assets under repurchase agreements or conduct credit operations against eligible assets as collateral. Reverse transactions will be used for ESCB main and longer-term refinancing operations. In addition, the ESCB can use reverse transactions for fine-tuning and other operations.

The NCBs may, depending on jurisdiction, execute reverse transactions either in the form of repurchase agreements (i.e. the ownership of the asset is transferred to the creditor whilst the parties agree to reverse the transaction through a re-transfer of the asset to the debtor at a future point in time[3]) or as collateralised loans (i.e. an enforceable security interest is provided over the assets but, assuming fulfilment of the debt obligation, the ownership of the asset is retained by the debtor). Further provisions for reverse transactions based on repurchase agreements will be specified in a standardised Master Repurchase Agreement. Arrangements for reverse transactions based on collateralised loans will take account of the different procedures and formalities required to enable establishment and subsequent realisation of a relevant interest in the collateral (or pledge) which apply in different jurisdictions.

The difference between the purchase price and the repurchase price in a repurchase agreement corresponds to the interest due on the amount of money borrowed or lent, over the maturity of the operation. The interest on a reverse transaction in the form of a collateralised loan is determined by applying the specified interest rate on the credit amount over the maturity of the operation. The interest rate applied to ESCB reverse open market operations will be a simple interest rate with the day-count convention "actual/360".

2 Outright transactions

Outright open market transactions refer to operations where the NCBs (or the ECB) buy or sell eligible assets outright in the market. Outright open market operations would only be executed for structural and fine-tuning purposes.

An outright transaction implies a full transfer of ownership from the seller to the buyer. The transactions will be based on standard agreements adapted to the market conventions for the debt instrument used in the transaction.

In the calculation of prices, the ESCB will act in accordance with the most widely accepted market convention for the eligible assets used in the transaction.

3 Issuance of debt certificates

Debt certificates can be issued with the aim of influencing the structural position of the ESCB vis-à-vis the banking system so

[3] *Note that for accounting and statistical purposes the assets remain on the balance sheet of the institution repoing the security in question.*

as to create (or enlarge) a liquidity shortage in the market.

The certificates will be issued and held in a book-entry and/or dematerialised form in securities depositories in the euro area. The certificates will have a maximum maturity of twelve months and will be transferable without restrictions.

The certificates will be issued in discount form, i.e. they will be issued at below the nominal amount and will be redeemed at maturity at the nominal amount. The difference between the issue amount and the redemption amount will equal the interest accrued on the issue amount, at the agreed interest rate, over the maturity of the certificate. The interest rate applied will be a simple interest rate with the day-count convention "actual/360".

4 Foreign exchange swaps

Foreign exchange swaps refer to operations where the NCBs (or the ECB) buy (or sell) euro spot against a foreign currency and at the same time sell (or buy) it back forward at a specified repurchase date. These operations will only be used for fine-tuning purposes. Further provisions for foreign exchange swaps will be specified in a standardised Master Foreign Exchange Swap Agreement.

As a rule, the ESCB will operate only in widely traded currencies and in accordance with standard market practices.

In each foreign exchange swap operation, the NCBs (or the ECB) and the counterparties will agree on the swap points for the transaction. The swap points are the difference between the exchange rate of the forward transaction and the exchange rate of the spot transaction. The swap points of the euro vis-à-vis the foreign currency are quoted according to general market conventions.

5 Collection of fixed-term deposits

The ESCB may offer counterparties the opportunity of placing remunerated fixed-term deposits with the national central bank in the country where the counterparty is located. The collection of fixed-term deposits is envisaged only for fine-tuning purposes in order to absorb liquidity in the market.

The collection of fixed-term deposits takes the form of uncollateralised lending by the counterparties to the NCBs for a fixed term and with a fixed rate of interest.

The interest rate applied to the deposit is a simple interest rate with the day-count convention "actual/360". Interest is paid at the end of the maturity of the deposit.

Annex 4

Technical features of the ESCB's tender operations

1 General considerations

Preparatory work is being carried out by the EMI to enable the ESCB to use both tender and bilateral procedures for open market operations. However, the ESCB open market operations will normally be executed in the form of tenders. The ESCB will distinguish between two different types of tender procedures: standard tenders and quick tenders, which are described in the following sections. The procedures for standard and quick tenders will be identical except for the time frame and the range of counterparties. Standard tenders will be executed within 24 hours from the announcement of the tender to the certification of the allotment result (of which the time between the submission deadline and the announcement of the allotment result is approximately 2 hours). All counterparties fulfilling the general eligibility criteria will be entitled to participate in standard tenders. Quick tenders will normally be executed within one hour from the announcement of the tender to the certification of the allotment result. The ESCB will reserve the right to select a limited number of counterparties to participate in quick tenders.

The ESCB will have the option of conducting either fixed rate (volume) or variable rate (interest) tenders. In a fixed rate tender, the ECB will specify the interest rate in advance and participating counterparties bid the amount of money they want to transact at the fixed interest rate.[4] In a variable rate tender, counterparties will bid the amount of money and the interest rate at which they want to enter into a transaction with the NCBs.[5]

2 Announcement of tender operations

ESCB standard tenders will be publicly announced by means of wire services. In addition, NCBs may announce the tender operation directly to counterparties without access to wire services. The public tender announcement message will contain, at least, the following information:

- the reference number of the tender operation;
- the date of the tender operation;
- the type of operation;
- the type of auction (fixed rate or variable rate tender);
- the method of allotment ("Dutch" or "American" auction);
- the fixed tender interest rate/price/swap point (only in the case of fixed rate tenders);
- the minimum/maximum accepted interest rate/price/swap point (if any);
- the start date and the maturity date of the operation (when applicable) or the value date and maturity date of the instrument (only in the case of issuance of debt certificates);
- the currencies involved and the currency whose amount is kept fixed (only in the

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4 *In fixed rate foreign exchange swap tenders, the ECB fixes the swap points of the operation and the counterparties offer the amount of currency kept as fixed that they wish to sell (and buy back) or buy (and sell back) at that rate.*

5 *In variable rate foreign exchange swap tenders, the counterparties bid the amount of the currency kept as fixed and the swap point quotation at which they wish to enter into the operation.*

case of foreign exchange swap operations);

- the maximum bid limit (if any);
- the time schedule for the submission of bids.

The ECB will normally announce quick tenders publicly in advance. However, under exceptional circumstances, the ECB will reserve the right not to publicly announce the tender in advance. The announcement of quick tenders would follow the same procedures as for standard tenders. In case the quick tender is not publicly announced, the selected counterparties will be contacted directly by the NCBs.

3 Counterparties' preparation and submission of tender bids

Counterparties' bids will have to be in a form that follows the specimen that will be provided by the NCBs for the relevant operation. Bids will be submitted to NCBs. Bids submitted after the deadline specified in the announcement message will be discarded. Compliance with the deadline will be judged by the NCBs.

For fixed rate tenders, counterparties shall state in their bid the amount of money that they are willing to transact with the NCBs.[6]

For variable rate tenders, counterparties shall state in their bids the amount of money that they are willing to transact with the NCBs, and the respective interest rate.[47] Counterparties would be entitled to submit several bids in variable rate tenders. The interest rates bid would be a multiple of 0.01 percentage point. In case of a variable rate foreign exchange swap operation, the swap points would be quoted according to standard market conventions and bids must be a multiple of 0.01 swap points.

Bids would be submitted for a minimum amount established by the ECB, and multiples of this amount. The ECB may, at its discretion, impose a maximum bid limit in order to discard disproportionally large bids.

Counterparties are expected to always be in a position to cover their tender bids by a sufficient amount of eligible underlying assets. An appropriate legal instrument will provide the right for the ESCB to impose penalties in case a counterparty were not able to transfer a sufficient amount of underlying assets to settle the amount of liquidity it has been allotted in a tender operation. This instrument will also give the ESCB the right to check availability of counterparties' underlying assets in order to detect cases of excessive bidding, and to impose penalties if such excessive bidding were evidenced.[8] However, no systematic ex ante checking of underlying assets is envisaged.

4 Tender allotment procedures

Fixed rate tender operations

In the allotment of a fixed rate tender, the bids received from counterparties will be summed up. If the aggregate bid exceeds the total amount of liquidity to be allotted, the submitted bids will be satisfied pro rata, according to the ratio of the amount to be allotted to the aggregate bid amount. The ECB will reserve the right to decide

[6] *In fixed rate foreign exchange swap operations, the amount of the currency kept as fixed that the counterparty is willing to transact with the ESCB shall be stated.*

[7] *In variable rate foreign exchange swap operations, the amount of the currency kept as fixed in the swap operation that the counterparty is willing to transact with the ESCB and the respective swap point quotation shall be stated.*

[8] *Excessive bidding would be evidenced when the counterparty could not possibly have delivered sufficient underlying assets to cover its tender bid, taking account of its holdings of securities and borrowing potential.*

to allot a minimum amount to each bidder in fixed rate tenders.

Variable rate tenders in euro

In the allotment of liquidity-providing or liquidity-absorbing variable rate tenders in euro, bids will be listed in diminishing or, respectively, increasing order of offered interest rates. Bids with the highest (lowest) interest rate levels will be satisfied with priority and successively lower (higher) bids will be accepted until the exhaustion of the total liquidity to be allotted (absorbed). If, at the lowest (highest) interest rate level accepted (the marginal interest rate), the aggregate bid amount exceeds the remaining allotment, the latter amount will be allocated pro rata among these bids according to the ratio of the remaining amount to be allotted to the total bid amount at the marginal interest rate.

The ECB will reserve the right to decide to allot a minimum amount to each bidder in variable rate tenders.

Variable rate foreign exchange swap tenders

In the allotment of liquidity-providing or liquidity-absorbing variable rate foreign exchange swap tenders, bids will be listed in increasing or, respectively, diminishing order of offered swap point quotations.[9] The bids with the lowest (highest) swap point quotations will be satisfied with priority and successively higher (lower) swap point quotations will be accepted until the exhaustion of the total amount of the fixed currency to be allotted (absorbed). If, at the highest (lowest) swap point quotation accepted (the marginal swap point quotation), the aggregate bid amount exceeds the remaining allotment, the amount will be allocated pro rata among these bids according to the ratio of the remaining amount to be allotted to the total bid amount at the marginal swap point quotation.

Type of auction

For variable rate tenders, the ECB may decide to use either single-rate or multiple-rate auction procedures. In a single-rate auction ("Dutch auction"), the allotment interest rate applied for all satisfied bids is equal to the marginal interest rate (i.e. the interest rate at which the total allotment was exhausted). In a multiple-rate auction ("American auction"), the allotment interest rate is equal to the interest rate offered for each individual bid.

5 Announcement of tender results

The results of standard and quick tenders will be publicly announced by means of wire services. In addition, NCBs may announce the allotment result directly to counterparties without access to wire services. The public tender result message will contain, at least, the following information:

- reference number of the tender operation;
- the date of the tender operation;
- the type of operation;
- the total amount bid by ESCB counterparties;

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[9] *Swap quotations are listed in increasing order taking into account the sign of the quotation, which depends on the sign of the interest rate differential between the foreign currency and the euro. If, for the maturity of the swap operation, the foreign currency interest rate is higher than the corresponding interest rate for the euro, the swap point quotation is positive (euro quoted at a premium against the foreign currency). If, on the contrary, the foreign currency interest rate is lower than the corresponding interest rate for the euro, the swap point quotation is negative (euro quoted at a discount against the foreign currency).*

- the number of bidders;
- the currencies involved (only in the case of foreign exchange swap operations);
- the total amount allotted;
- the percentage of allotment (only in the case of fixed rate tenders);
- the spot exchange rate (only in the case of foreign exchange swap operations);
- the marginal interest rate/price/swap point accepted and the percentage of allotment at the marginal interest rate/price/swap point (only in the case of variable rate tenders);
- the minimum bid rate, maximum bid rate and weighted average allotment rate (only in the case of multiple-rate auctions);
- the start date and the maturity date.

The NCBs will directly certify the individual allotment result to all counterparties that have submitted bids.

Annex 5

Technical features of the ESCB's standing facilities

1 The marginal lending facility

Type and legal nature of instrument

Counterparties may use the marginal lending facility to obtain overnight liquidity from NCBs at a pre-specified interest rate against eligible assets. The facility is intended to satisfy counterparties' temporary liquidity needs. Under normal circumstances, the interest rate on the facility provides a ceiling for the overnight market interest rate. Terms and conditions of the facility are identical throughout the euro area.

The NCBs may, depending on jurisdiction, provide the liquidity under the marginal lending facility either in the form of repurchase agreements (i.e. the ownership of the asset is transferred to the creditor whilst the parties agree to reverse the transaction through a re-transfer of the asset to the debtor on the next business day) or as collateralised loans (i.e. an enforceable security interest is provided over the assets but, assuming fulfilment of the debt obligation, the ownership of the asset is retained by the debtor). Further provisions for repurchase agreements will be specified in a standardised Master Repurchase Agreement. Arrangements for providing the liquidity in the form of collateralised loans take account of the different procedures and formalities required to enable establishment and subsequent realisation of a relevant interest in the collateral (a pledge) which apply in different jurisdictions.

Access procedures

At the end of the day, counterparties' unsettled intraday debit positions with the NCBs would automatically be considered to be a request for recourse to the marginal lending facility. At any time during the business day, counterparties may access the marginal lending facility by sending a request to the relevant national central bank. In the request, the amount of credit shall be stated and, if underlying assets for the transaction are not already pre-deposited or pre-delivered with the national central bank, the underlying assets for the transaction shall be specified.

The ECB will reserve the right to suspend individual counterparties' access to the facility in special circumstances.

Maturity and interest terms

The maturity of credit extended under the facility will be overnight. The credit is repaid at the beginning of the following business day (i.e. at the opening of the TARGET system). The interest rate on credit extended under the facility will be an official ESCB interest rate. The interest rate will be announced in advance by the ECB and will be calculated as a simple interest rate with the day-count convention "actual/360". The ECB may at any time change the interest rate, with effect not earlier than the following business day. Interest under the facility will be payable each business day with the repayment of the credit.

2 The deposit facility

Type and legal nature of instrument

Deposits under the facility will take the form of uncollateralised lending by the counterparties to the NCBs.

Access procedures

Counterparties may access the deposit facility by sending a request, at any time during the business day, to the relevant national central bank. In the request, the amount to be deposited under the facility shall be stated.

Maturity and interest terms

The maturity of deposits under the facility will be overnight. Deposits held under the facility will mature at the beginning of the following business day. The interest rate on the deposits under the facility will be an official ESCB interest rate. The interest rate will be specified and announced in advance by the ECB and will be calculated as a simple interest rate with the day-count convention "actual/360". The ECB may at any time change the interest rate, with effect not earlier than the following business day. Interest on the deposits will be payable each business day at the maturity of the deposit.

Annex 6

Settlement procedures of monetary policy operations

Money transactions involved in ESCB standing facilities and open market operations will be settled on the counterparties' accounts with the NCBs.[10] The ESCB will aim at settling money transactions relating to its open market operations simultaneously for all counterparties participating in the operations, irrespective of their location within the euro area.

Underlying assets must be pre-deposited, pre-delivered or settled on an intraday delivery-versus-payment basis with the NCBs. The transfer of underlying assets will be executed either through the counterparties' safe custody accounts with NCBs or through their securities settlement accounts with a securities depository easily accessible to the relevant NCB. Counterparties without either a safe custody account with an NCB or a securities settlement account with a securities depository easily accessible to the relevant NCB may settle the transactions of underlying assets through the securities settlement account of a sub-custodian.

Further provisions related to the settlement procedures will be defined in the Master Agreements and other standard documentation to be used by the ESCB for the specific monetary policy instruments. The settlement procedures may differ slightly between NCBs owing to differences in national law and operational practices.

Table 3

Normal value dates for ESCB open market operations

Monetary policy instrument	Value date for operations based on standard tenders	Value date for operations based on quick tenders or bilateral procedures
Reverse transactions	T or T+1	T
Outright transactions	–	According to the market convention for underlying assets
Issuance of debt certificates	T or T+1	–
Foreign exchange swaps	–	T, T+1 or T+2
Collection of fixed-term deposits	–	T

The ESCB will aim to settle its monetary policy operations as soon as possible after concluding the trade. However, the normal value date would differ for operational reasons between the different categories of ESCB open market instruments, as summarised in Table 3. (T refers to the trade date. The value date connotation refers to business days only.)

[10] *The settlement procedures for foreign exchange swap operations are consistent with the procedures applied to ESCB foreign exchange intervention and may, thus, differ from the settlement procedures of other ESCB monetary policy operations.*

Annex 7

Technical features of the minimum reserve requirement system to be made available to the ESCB

1 Determination of minimum reserves

Definition of the reserve base

The reserve base of an institution would be defined in relation to elements of its balance sheet (using end-of-month data). The data on end-of-month balances would normally be reported to the NCBs within the general framework of money and banking statistics (see Annex 10). According to the proposed complementary legislation to Article 19.2 of the Statute of the ESCB (see Annex 8 for more details), the ESCB would be entitled to include in the reserve base liabilities resulting from the acceptance of funds and liabilities resulting from off-balance-sheet items. Liabilities vis-à-vis other institutions subject to the ESCB minimum reserves system and liabilities vis-à-vis the ECB and the NCBs may not be included in the reserve base. The ECB may decide to define certain eligible liabilities in net terms.

Reserve ratios

The reserve ratios would be determined by the ECB. The ECB may apply a uniform reserve ratio to the whole reserve base or differentiate reserve ratios across categories and maturities of eligible liabilities. The ECB may at any time change the reserve ratios. Changes in the reserve ratios would be announced by the ECB in advance of the first maintenance period for which the change is effective.

Calculation of reserve requirements

The reserve requirement of each individual institution would be calculated by applying, on the amount of eligible liabilities, the reserve ratios for the corresponding categories of liabilities. The ECB may allow a uniform lump-sum allowance either from the counterparties' reserve requirement or from their reserve base. The granting of such an allowance shall be without prejudice to the legal obligations of institutions subject to the ESCB minimum reserves system.

2 Maintenance of reserve holdings

Maintenance period

The maintenance period would be one month, starting at a fixed date each month (not necessarily the first day).

Reserve holdings

Each institution would have to hold its minimum reserves on a reserve account with the NCB in the Member State where it is established. For institutions with establishments in more than one Member State, each establishment would be required to hold minimum reserves with the NCB in the relevant Member State in relation to its liability position. Institutions' settlement accounts with the NCBs may be used as reserve accounts. Reserve holdings held on settlement accounts may be used for intraday settlement purposes. The daily reserve holding of an institution would be calculated as the end-of-day balance on its reserve account.

An institution may apply to the national central bank in the country where it is resident for permission to hold all its minimum reserves indirectly through an intermediary. The intermediary would have to be an institution subject to the ESCB minimum reserves system which would be resident in the same country as the institution for which it would be acting as an intermediary (e.g. networks of domestic savings banks or co-operative banks may request permission to centralise their reserve holdings on one reserve account with the NCB in the same country). The NCBs would decide, subject to ECB guidelines, whether to allow such indirect holdings of minimum reserves. For institutions acting as intermediaries for indirect reserve holdings of other institutions, special reporting requirements would be applied.

Remuneration of reserve holdings

If the ECB were to decide to remunerate minimum reserves, the rate of interest would be set according to a fixed formula related to a market or an official interest rate chosen by the ECB.

3 Reporting and verification of the reserve base

The reserve base for the application of minimum reserves would be calculated on the basis of the reporting provided by MFIs to NCBs within the general framework of the ECB money and banking statistics.[11]

Institutions that would be allowed to act as intermediaries for indirect reserve holdings of other institutions would be obliged to report reserve base data and reserve holdings for all the institutions for which they would act as intermediaries. These data would have to be provided to the NCB where the reserves are held according to the same format, frequency and deadline as established within the general framework of the ECB money and banking statistics. The holding of reserves through an intermediary would not change the statistical reporting obligations of institutions holding reserves via an intermediary.

The ECB and the NCBs would have, within the scope of complementary legislation to Article 19.2 of the Statute of the ESCB , the right to collect the necessary data from the institutions subject to the ESCB minimum reserves system and to verify the accuracy and quality of collected data. The right to verify data includes the right to examine the books and records of the institutions, to take copies or extracts from books and records, to ask for written or oral explanation, and to enter the premises of institutions in pursuance of these objectives.

4 Non-compliance with minimum reserve obligations

Non-compliance with the minimum reserve obligations would be evidenced if an institution's average end-of-calendar-day balances on its reserve account(s) over the maintenance period were less than its reserve requirement for the corresponding maintenance period.

If an institution failed to maintain all or part of the reserve requirement, the ECB would have the right in accordance with Article 19.1 of the Statute of the ESCB and related complementary legislation to impose sanctions in the form of either a penalty significantly above the interest rate on the marginal lending facility or a requirement for the institution to establish non-interest-bearing deposits with the ECB or the NCBs.[12]

In cases where an institution failed to comply with other obligations under ECB

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11 *See Annex 10 of this Report and EMI, "The Statistical Requirements for Monetary Union" (July 1996).*

12 *See Article 6 of the draft complementary legislation to Article 19.2 of the Statute of the ESCB , reproduced in Annex 8.*

regulations and decisions related to the ESCB minimum reserves system (for example, if relevant data were not transmitted in time or were inaccurate), the ECB would be empowered to impose sanctions in accordance with complementary legislation to Article 34.3 of the Statute of the ESCB (see Annex 12 for further details).

In addition, the ECB may decide to suspend counterparties' access to the ESCB standing facilities and open market operations in the event of non-compliance with obligations under the ESCB minimum reserves system. The ECB may also require institutions not complying with these obligations to fulfil their reserve requirements each day, thus suspending their opportunity to make use of the averaging provision.

Annex 8

The EMI's proposal for a draft EU Council Regulation on minimum reserves

The legal framework for the ESCB's minimum reserve system will have to be laid down in secondary Community legislation in accordance with Article 19.2 of the Statute of the ESCB. The ECB will need to submit a recommendation to the EU Council to this effect following its establishment. In view of lead-time considerations, the EMI has already prepared a proposal for a draft EU Council Regulation which is reproduced hereafter.

PREAMBLE

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular to Article 106 (6) thereof,

Having regard to the recommendation from the European Central Bank,

Having regard to the opinion of the European Parliament,

Having regard to the opinion of the Commission,

(1) Whereas for the application of the arrangements envisaged by Article 19.1 of the Statute of the ESCB, Article 42 of the Statute of the ESCB, in accordance with Article 106 (6) of the Treaty, provides for the Council to adopt, inter alia, provisions referred to in Article 19.2 of the Statute of the ESCB;

(2) Whereas Article 19.2 of the Statute of the ESCB requires the Council, inter alia, to define the basis for minimum reserves to be held by institutions on accounts with the ECB and/or NCBs and to define the maximum permissible ratios between those reserves and their basis;

(3) Whereas Article 19.2 of the Statute of the ESCB also requires the Council to define the appropriate sanctions in cases of non-compliance with those requirements, and whereas specific sanctions are set out herein, whilst the administration and mechanics relating to the imposition of sanctions deriving from this Regulation are set out in EU Council Regulation [*... on sanctions, a draft of which is reproduced in Annex 12*] the application of which is subsidiary to this Regulation;

(4) Whereas Article 19.1 of the Statute of the ESCB provides that the Governing Council of the ECB may establish regulations concerning the calculation and determination of reserve requirements;

(5) Whereas the system for the imposition of reserve requirements, to be effective as an instrument for the performance of money market management and monetary control functions, needs to be structured so that the ECB has the ability and flexibility to impose reserve requirements within the context of and dependent upon changing economic and financial conditions among participating EU Member States;

(6) Whereas the ECB, in establishing detailed regulations for the imposition of reserve requirements, including in determining the actual reserve ratios and any remuneration of reserves and any exemptions from reserve requirements or any modifications to such requirements applicable to any specific group or groups of institutions, shall be bound to act in pursuance of the objectives of the ESCB as set out in Article 105 (1) of the Treaty and as reflected in Article 2 of the Statute of the ESCB, which implies, inter alia, the principle of not inducing significant undesirable delocation or disintermediation; whereas the imposition of such

reserve requirements may constitute an element of the definition and implementation of the monetary policy of the Community, being one of the basic tasks of the ESCB as specified in Article 105 (2), first indent, of the Treaty and as reflected in Article 3.1, first indent, of the Statute of the ESCB;

HAS ADOPTED THIS REGULATION

ARTICLE 1

Definitions

For the purposes of this Regulation:

1 *institution* shall mean any entity which, under the terms of Article 19.1 of the Statute of the ESCB, the ECB may require to hold minimum reserves;

2 *participating Member State* shall mean a Member State which has adopted the single currency in accordance with the Treaty;

3 *reserve ratio* shall mean such percentage of the basis for the reserve requirement, as specified in Article 2 hereof;

4 *reserve requirement* shall mean the requirement for institutions to hold minimum reserves on accounts with the ECB and NCBs of participating EU Member States.

ARTICLE 2

Basis for minimum reserves

The basis for the reserve requirement which the ECB may impose on institutions according to Article 19.1 of the Statute of the ESCB shall be liabilities of an institution resulting from the acceptance of funds together with liabilities resulting from off-balance-sheet items, but excluding (i) liabilities which are owed to any other institution and (ii) liabilities which are owed to the ECB or to a national central bank of a participating Member State.

ARTICLE 3

Maximum permissible ratios

1 Reserve ratios which the ECB may specify according to Article 19.1 of the Statute of the ESCB shall not exceed [....] per cent of any relevant liabilities forming part of the basis for the reserve requirement but may be zero per cent.

2 The ECB may, on a non-discriminatory basis:

(a) exempt specific classes of institution from the reserve requirement;

(b) specify differing reserve ratios for specific categories of liabilities forming part of the basis for the reserve requirement;

(c) allow the deduction of specific types of assets from categories of liabilities forming part of the basis for the reserve requirement.

3 For the purposes of the paragraphs above, the ECB shall adopt, as appropriate, regulations or decisions.

ARTICLE 4

Regulatory power

Regulations concerning the calculation and determination of reserve requirements, including specification of the operation and organisation of reserve requirements not set out in this Regulation, shall be determined by the ECB by means of ECB regulations and decisions, in accordance with the powers granted to the ECB under Article 108a of the Treaty and Article 19.1 of the Statute of the ESCB. Such specification shall include, but not be restricted to, the operation of relevant accounts and the determination of whether, and if so how much, remuneration should be provided in respect of such accounts.

ARTICLE 5

Right to collect and verify information

1 The ECB shall have the right to collect from institutions the information necessary for the application of reserve requirements. Such information shall be confidential.

2 The ECB shall have the right to verify the accuracy and quality of the information which institutions provide to demonstrate compliance with the reserve requirement.

3 The right to verify data shall include the right:

(a) to require submission of documents;

(b) to examine the books and records of the institutions;

(c) to take copies or extracts from such books and records;

(d) to ask for written or oral explanations;

(e) to enter the premises of institutions in pursuance of the objectives in (a) to (d) above.

4 The ECB may delegate to the NCBs the execution of the tasks to which the previous paragraphs refer. In accordance with Article 34.1, first indent, of the Statute of the ESCB, the ECB shall be empowered to specify further in a regulation the conditions under which rights for verification may be exercised.

ARTICLE 6

Sanctions for cases of non-compliance

1 Where an institution fails to maintain all or part of the reserve requirement imposed in accordance with this Regulation and ECB regulations or decisions associated herewith, the ECB may impose either of the following sanctions, in accordance with Article 5 of EU Council Regulation [*... on sanctions, a draft of which is reproduced in Annex 12*]:

(a) a payment of up to [...] percentage points above the ESCB's marginal lending rate or [...] times the ESCB's marginal lending rate, in both cases applied to the amount of the reserve requirement which the relevant institution fails to provide;

(b) the requirement for the relevant institution to establish non-interest-bearing deposits with the ECB or the NCBs of participating EU Member States up to [...] times the amount of the reserve requirement which the relevant institution fails to provide. The maturity of the deposit shall not exceed the period during which the institution fails to maintain the reserve requirement.

2 Where an institution fails to comply with obligations deriving from this Regulation or ECB regulations or decisions associated herewith, other than as set out in paragraph 1 above, sanctions for such failures are set out in EU Council Regulation [*... on sanctions, a draft of which is reproduced in Annex 12*].

ARTICLE 7

Final provision

This Regulation shall enter into force on 1 January 1999.

Annex 9

Monetary and exchange rate policy co-operation between the euro area and other EU countries – Report to the European Council session in Dublin on 13-14 December 1996

Introduction

In accordance with the mandate given by the European Council meeting in Madrid and building on the agreement reached at the European Council session in Florence[13] as well as on the broad support expressed at the Informal ECOFIN Council session in Dublin,[14] the EMI has finalised the first stage of its preparatory work on the future monetary and exchange rate relationships between the euro area and other EU countries. The report reflects the high level of consensus reached in the EMI Council on the objectives, principles and main operational features of the new exchange rate mechanism.

I Objectives, principles and overall structure

1 The need for monetary and exchange rate policy co-operation

Close policy co-ordination between the euro area and the other Member States from the very start of Stage Three of EMU is a matter of common interest and forms an integral part of the completion of the EMU process. In order to ensure the efficient functioning and development of the Single Market, it is especially important that real exchange rate misalignments between the euro and the other EU currencies be avoided, as well as excessive nominal exchange rate fluctuations, which would disrupt trade flows between Member States; hence the obligation under Article 109m to treat exchange rate policy as a matter of common interest.

The lasting convergence of economic fundamentals, in particular price stability, is a prerequisite for sustainable exchange rate stability. To this end, in Stage Three of EMU, all Member States will need to pursue disciplined and responsible monetary policies directed towards price stability. The co-ordination of monetary policies within the framework of the ECB General Council will, therefore, play a central role. Sound fiscal and structural policies in all Member States are, at least, equally essential for sustainable exchange rate stability. In the absence of a convergence of fundamentals, any attempt to co-ordinate exchange rate policies is bound to be unsuccessful. Exchange rate policy co-operation cannot be a substitute for stability-oriented domestic policies.

The final objective of economic, monetary and exchange rate policy co-operation is convergence towards macroeconomic stability, which would lead to exchange rate stability against the euro. A nominal exchange rate mechanism may provide a reference for the conduct of sound economic policies in Member States on their way towards full economic convergence. It may help to enhance the credibility of such policies by establishing a focal point for agents' expectations. Moreover, it may provide a framework for counteracting market pressures unwarranted in the light of underlying

[13] See "Conclusions of the Presidency on the European Council in Florence of 21 and 22 June 1996" (SN 300/96), including the attached "Progress report by the ECOFIN Council to the European Council on preparation for Stage Three of EMU" (7940/96), dated 4 June 1996.

[14] "Monetary and exchange rate policy co-operation between the euro area and other EU countries", Report to the Informal ECOFIN Council session in Dublin on 20-22 September 1996, dated 3 September 1996.

fundamentals. In particular, it may assist any Member State, the currency of which comes under pressure, to combine appropriate policy responses, including interest rate measures in the country the currency of which is under pressure, with co-ordinated intervention.

Monetary and exchange rate policy co-operation should be flexible enough to accommodate different degrees and strategies of economic convergence. As noted in the Conclusions of the European Council meeting in Florence, "Membership would continue to be voluntary; nevertheless, Member States with a derogation can be expected to join the mechanism" once they have achieved a satisfactory degree of economic convergence. In addition, the various Community mechanisms for the co-ordination of economic and monetary policies should ensure that exchange rate developments in all other Member States, irrespective of their participation in the exchange rate mechanism, are closely monitored and assessed with a view to the requirements of Article 109m of the Treaty and the smooth operation of the Single Market. While the remainder of this report focuses on the exchange rate mechanism, the necessary broader scope of the overall policy co-ordination framework should be borne in mind.

2 Principles for an exchange rate mechanism in Stage Three

In designing an exchange rate mechanism for Stage Three, the new economic and institutional environment which is expected to prevail by that time will have to be taken carefully into account. In particular, five elements must be underlined.

First, the statutory requirement for the ECB to maintain price stability will need to be safeguarded. It would be detrimental to the credibility of EMU if obstacles were to emerge as a consequence of exchange rate oriented measures which would hinder the newly-created ECB in the pursuit of its primary objective. These considerations would also apply to the non-euro area NCBs, which should also pursue the primary objective of price stability.

Second, the euro is expected to play the anchor role in monetary and exchange rate policy co-operation in the EU. This will be the natural consequence, first and foremost, of the stability of the euro and the fact that member countries with a derogation are expected to put in place the conditions to enable them to participate in the euro area at a later stage.

Third, sufficient flexibility would need to be allowed, in particular to accommodate the varying degrees, paces and strategies of economic convergence of the non-euro area Member States.

Fourth, it should be ensured that any adjustment of central rates is conducted in a timely fashion so as to avoid significant misalignments.

Finally, as a matter of principle, continuity and equal treatment among all Member States with respect to the fulfilment of the convergence criteria, including the exchange rate criterion, need to be ensured.

3 Overall structure of the mechanism

Given the respective competences and responsibilities, it would be appropriate to retain the two-pillar structure of the present exchange rate mechanism (ERM), which is based on two parallel agreements among governments, on the one hand, and among central banks, on the other: while a European Council Resolution would form the foundation of the new mechanism, the operating procedures would be laid down in an agreement between the ECB and the non-euro area NCBs.

II Main operational features of an exchange rate mechanism

In the light of the above-mentioned principles, the new mechanism could be designed along the following lines.

1 Central rates and fluctuation bands

The new exchange rate mechanism would be based on central rates, defined vis-à-vis the euro for the non-euro area currencies. A standard fluctuation band would be established for these currencies around their central rates. Although the exact size of the standard fluctuation band has yet to be decided, it is expected to be relatively wide.

If appropriate, non-euro area Member States could establish, on a bilateral basis, fluctuation bands between their currencies and intervention arrangements, with the aim of limiting excessive bilateral exchange rate oscillations. Prior to concluding such arrangements, the non-euro area Member States concerned would consult, on a strictly confidential basis, all the other parties to the new exchange rate mechanism.

Central rates and the standard wide band would be set by mutual agreement between the ECB, the Ministers of the euro area Member States, and the Ministers and Governors of the central banks of the non-euro area Member States, following a common procedure involving the European Commission and after consultation of the Economic and Financial Committee. The Ministers and Governors of the central banks of the other Member States not participating in the exchange rate mechanism will not have the right to vote in the procedure.

The sustainability of exchange rate relations will need to be closely monitored on a permanent basis. All parties to the agreement, including the ECB, would have the right to initiate a confidential procedure aimed at reconsidering central rates.

2 Monitoring the functioning of the system

Intra-EU monetary and exchange rate policy co-ordination between the euro area and the non-euro area Member States will, pursuant to the Treaty, be conceived as a continuation of the present mechanism. The Economic and Financial Committee will, together with the European Commission, be involved in economic policy co-ordination. Furthermore, if and as long as there are Member States with a derogation, the Economic and Financial Committee will keep under review the monetary and financial situation of these Member States.[15] At the level of the central banks, the ECB General Council will monitor the functioning of the exchange rate mechanism and will serve as a forum for monetary and exchange rate policy co-ordination as well as for the administration of the intervention and financing mechanisms.[16] While close co-operation between the Community bodies in the conduct of these various exercises will be necessary and useful, the division of responsibilities will need to respect the independence of the ECB and the non-euro area NCBs.

3 Intervention and financing facilities

Foreign exchange intervention and - after appropriate use of foreign reserve holdings - financing at the standard wide margins

[15] *See. Article 109c (4) of the Treaty.*

[16] *See Article 44 of the Statute of the ESCB in combination with Article 4.1 of the Statute of the EMI.*

will, in principle, be automatic and unlimited. Intervention should be used as a supportive instrument in conjunction with other policy measures, including appropriate fiscal and monetary policies conducive to economic convergence.

The ECB and the non-euro area NCBs would have the possibility of suspending intervention and financing if these were to impinge on their primary objective. In deciding whether or not to resort to this safeguard clause, the ECB or a non-euro area NCB would take due account of all relevant factors, in particular the need to maintain price stability and the credible functioning of the new exchange rate mechanism. Without prejudice to its independent assessment, in line with Articles 105 and 107 of the Treaty, as to whether there is a risk to its primary objective, the ECB would base its decision on factual evidence and, in this context, also give consideration to any conclusion which may have been reached by other competent bodies. It would appear neither advisable nor possible to define formally and ex ante the circumstances under which the possibility of suspending intervention might be used. The final decision would rest with the ECB or the non-euro area NCB concerned, but it would be understood that, time permitting, the ECB or the NCB concerned would signal as far ahead of time as possible its intention of suspending intervention and financing.

The possibility of co-ordinated intramarginal intervention decided by mutual agreement between the ECB, as the central bank issuing the intervention currency, and the respective NCB, in parallel with other appropriate policy responses by the latter, would be retained. As in the present ERM, unilateral intramarginal intervention would continue to be subject to prior approval by the central bank issuing the intervention currency concerned, should it exceed certain thresholds.

The present Very Short-Term Financing facility (VSTF) would be continued, following some appropriate adjustments. The initial duration (2 1/2 to 3 1/2 months), as well as the rules for extending maturities of VSTF financing operations (renewable twice for three months subject to certain ceilings and/or the agreement of the creditor central bank) would be retained. Outstanding balances would, as in the present ERM, be remunerated at a representative market interest rate corresponding to the duration and currency denomination of the credit. Financing balances would be denominated in the creditor's currency. VSTF balances would be settled in the creditor's currency, unless otherwise agreed between the creditor and debtor central banks.

The present ERM rules governing access to the VSTF facility for intramarginal intervention would be broadly continued, including the understanding that appropriate use of foreign reserve holdings would be made prior to resorting to the VSTF facility. The level of the ceilings for such access could, initially, be retained and adjusted in the light of experience of the practical operation of the mechanism.

The Short-Term Monetary Support Mechanism (STMS) should be discontinued, given its very limited practical relevance in the past. To the extent that the STMS quotas are relevant for the definition of VSTF ceilings, the latter may have to be redefined.

4 Closer exchange rate co-operation

The exchange rate policy co-operation between non-euro area NCBs and the ECB could be further strengthened. This might take various forms: inter alia, closer links may entail narrower fluctuation bands, which would be made public, with automatic intervention and financing at the narrow limits; alternatively, they may rely on informal narrower target ranges, which might be kept confidential, supported through an enhanced role for co-ordinated intramarginal intervention. However, a proliferation of ad hoc links should be avoided. To this effect, a standard arrangement could be used as a reference for closer links with NCBs of non-euro area Member States which have achieved a sufficiently high degree of convergence. The existence of such closer co-operation, in particular if it implied narrower fluctuation bands, would be without prejudice to the interpretation of the exchange rate criterion pursuant to Article 109j of the Treaty.

Closer exchange rate links would be agreed upon on a case-by-case basis at the initiative of the interested non-euro area Member State. The procedure to be followed would depend on the form of the closer link. Arrangements implying publicly announced narrower fluctuation bands would be agreed upon by the ECB, the Ministers of the euro area Member States and the Minister and Governor of the central bank of the non-euro area Member State concerned, after consultation of the Ministers of the other non-euro area Member States and the ECB General Council. All other closer arrangements of a more informal nature would be agreed upon by the ECB and the central bank of the non-euro area Member State concerned, after consultation of the Ministers of all Member States and the ECB General Council.

Closer exchange rate links would be subject to progress in economic convergence, although they should not be seen as the only possible strategy to be followed by non-euro area Member States on their way towards full economic convergence. They would require a continuous monitoring of the sustainability of the closer exchange rate link and an active use of accompanying policy measures by the non-euro area Member State. All parties having agreed upon a closer exchange rate arrangement, including the ECB, would have the right to trigger a confidential re-examination of the adequacy of such a closer exchange rate link and, if applicable, to suspend intervention and financing in the event of conflict with the primary objective of price stability.

Concluding remarks

The basic features of a mechanism to succeed the present ERM should be announced well ahead of the decision on the first wave of participants in the euro area. Thus, markets would be reassured about the continuity of monetary and exchange rate policy co-operation in the EU, preserving the role of the present ERM for non-euro area currencies during the interim period. This could help to allay any incipient market fears about the management of the exchange rates of non-euro area currencies after the start of Stage Three. Full specification of the operational details would have to await the establishment of the ECB.

Annex 10

Statistical data for the ESCB

A. Money and banking statistics – the consolidated balance sheet

Aim: monthly data on the business of Monetary Financial Institutions (MFIs),[17] in sufficient detail to allow flexibility in the calculation of monetary aggregates and counterparts covering the euro area. The balance sheet may also provide the statistical basis for a minimum reserve requirement system.

In addition to banknotes and coins in circulation, the money stock will comprise monetary liabilities (deposits and other instruments which are close substitutes for deposits) of MFIs. The counterparts to money will comprise all other items in the MFI balance sheet, suitably arranged.

The ECB will require properly articulated money and banking statistics on a monthly basis to support the definition and conduct of the single monetary policy. These statistics will need to include the data necessary to enable the ECB to compile monetary aggregates and their counterparts according to different options. These aggregates for the euro area can be expected to be compiled as amounts outstanding (i.e. stocks) and as flows derived from them, with procedures to adjust for different accounting practices where necessary. The ECB will also require some further details of the MFI balance sheet quarterly.

The ECB's prospective data requirements are best presented in terms of instruments, maturity categories, currencies and sector of MFIs' counterparties. As separate requirements apply to liabilities and assets, the two sides of the balance sheet must be considered separately. The separate categories are shown in Table 4 on the next page (monthly items are in bold with *).

The ECB will need to receive an aggregated monthly balance sheet covering the positions of MFIs in each country participating in the euro area by the close of business on the 15th working day following the end of the month to which the data relate. The ECB will need to receive quarterly data by the close of business on the 28th working day following the end of the quarter.

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[17] *The EMI Council has agreed the following definition, which has been incorporated in the European System of Accounts 1995:*
Monetary Financial Institutions (MFIs) comprise 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 credits and/or to make investments in securities.

Table 4

Survey of breakdowns for the purposes of the aggregated balance sheet of the MFI sector instrument / maturity categories, counterparties & currencies

*("Monthly data" breakdowns are indicated in bold with *)*

Instrument & maturity categories

Assets

1 Cash *
2 Loans *
- up to one year [1]
- over one year & up to five years [1]
- over five years [1]

3 Securities other than shares [2,3] *
- **up to one year [2] ***
- **over one year & up to two years [2] ***
- **over two years [2] ***

4 Money market paper [4] *
5 Shares & other equity *
6 Fixed assets *
7 Remaining assets *

Liabilities

8 Currency in circulation
9 Deposits
9.1 Overnight deposits [5] *
9.2 Deposits with agreed maturity *
- **up to one year ***
- **over one year & up to two years ***
- **over two years [6] ***

9.3 Deposits redeemable at notice *
- **up to three months [7] ***
- **over three months ***

9.4 Repurchase agreements *
10 Money market fund shares/units *
11 Debt securities issued 3 *
- **up to one year ***
- **over one year & up to two years ***
- **over two years ***

12 Money market paper [8] *
13 Capital & reserves *
14 Remaining liabilities *

Counterparties

Assets

A Domestic residents *
- **Monetary Financial Institutions (MFIs) ***
- **Non-MFIs ***
  - **General government ***
    - central government
    - state government
    - local government
    - social security funds
  - **Other residents ***
    - other financial intermediaries (S. 123)
    - insurance cos. & pension funds (S. 125)
    - non-financial corporations (S. 11)
    - household etc. (S. 14 + S. 15) [9]

B Residents of the other MUMS *
(Member States in the euro area)
- **MFIs ***
- **Non-MFIs ***
  - **General government ***
    - central government
    - state government
    - local government
    - social security funds
  - **Other residents ***
    - other financial intermediaries (S. 123)
    - insurance cos. & pensions funds (S. 125)
    - non-financial corporations (S. 11)
    - household etc. (S. 14 + S. 15) [9]

C Residents of the rest of the world *
- Banks
- Non-banks
  - General government
  - Other residents

D Not allocated

Liabilities

A Domestic residents *
- **MFIs ***
- **of which: credit institutions ***
- **Non-MFIs ***
  - **General government ***
    - central government *
    - state government
    - local government
    - social security funds
  - **Other residents ***
    - other financial intermediaries (S. 123)
    - insurance cos. & pension funds (S. 125)
    - non-financial corporations (S. 11)
    - household etc. (S. 14 + S. 15) [9]

B Residents of the other MUMS *
(Member States in the euro area)
- **MFIs ***
- **of which: credit institutions ***
- **Non-MFIs ***
  - **General government ***
    - central government *
    - state government
    - local government
    - social security funds
  - **Other residents ***
    - other financial intermediaries (S. 123)
    - insurance companies & pension funds (S. 125)
    - non-financial corporations (S. 11)
    - household etc. (S. 14 + S. 15) [9]

C Residents of the rest of the world *
- Banks
- Non-banks
  - General government
  - Other residents

D Not allocated

Currencies	**Euro**	Euro denomination (including national currency denominations of the euro area prior to the completion of the changeover to the single currency)
	Non-euro area currencies	Other currencies (other EU currencies, USD, JPY, CHF, remaining)

[1] *Maturity breakdown applicable only for loans to non-MFIs.*
[2] *Monthly data requirement relates only to holdings of securities issued by MFIs located in the euro area. As quarterly data, holdings of securities issued by non-MFIs in the euro area are split between "up to one year" and "over one year".*
[3] *Excluding money market paper.*
[4] *Defined as holdings of money market paper issued by MFIs. Money market paper here includes shares / units issued by MMFs.*
[5] *Including suspense balances representing amounts stored on pre-paid cards issued in the name of MFIs.*
[6] *Including administratively regulated deposits.*
[7] *Including non-transferable sight deposits.*
[8] *Defined as money market paper issued by MFIs.*
[9] *Households (S. 14) and non-profit institutions serving households (S. 15).*

B. Balance of payments statistics – key items

Aim: a monthly balance of payments of the euro area showing the main items affecting monetary conditions and exchange markets;[18] more detail at lower frequency to permit further analysis; an (annual) statement of external assets and liabilities.

The essential need is that the data contribute to calculation of the balance of payments of the euro area.

The requirement in Stage Three for each broad category of transaction is assets and liabilities (or credits and debits for current account items). This requires EU Member States participating in the euro area to distinguish within external transactions between transactions with residents of other participating countries and transactions outside the area, and each to do so consistently, in accordance with agreed harmonisation proposals.

The monthly balance of payments statistics will require no country breakdown of transactions outside the euro area.

The breakdown of the quarterly/annual *current account* (not shown here) will be similar to the requirements for the monthly figures. Only key items will be required for goods, services and transfer payments. For factor income, a detailed breakdown of investment income is proposed. The amount of detail for the *new capital account* is under consideration. For the *financial account*, the requirements of the IMF Standard Components will be followed with certain simplifications.

The ECB will need to receive monthly data from participating EU Member States by the close of business on the 30th working day following the end of the month to which the data relate. Quarterly data will be required within three months of the end of the quarter to which they relate.

The ESCB will also (annually) compile an international investment position for the euro area.

Table 5

Monthly balance of payments of the euro area (key items)

(credits and debits/sassets and liabilities separately)

I. Current Account	Goods Services Income Current transfers	
II. Capital Account		
III. Financial Account	Direct Investment:	Abroad In the reporting economy
	Portfolio Investment:	Equity securities Debt securities, of which: – Bonds and notes – Money market instruments – Financial derivatives
	Other Investment:	Banks – long-term – short-term General government Monetary authorities Other sectors
IV. Reserve Assets		
(Errors and omissions)		

[18] *The United Kingdom questions the need for a monthly balance of payments for policy and operational purposes in the euro area. The United Kingdom will review its situation in 1998.*

C. Statistics of prices and costs, and background economic statistics

Aim: price and cost data to provide the ESCB with a measure relating to its primary responsibility; economic statistics (demand, output, labour market) as background to the conduct of monetary policy and foreign exchange operations.

1 General remarks

These areas of statistics are the prime responsibility of the Commission (EUROSTAT) at European level, and of national statistical institutes in most EU Member States. The EMI takes a close interest as a current user of such statistics and in view of its responsibility to enable the ESCB to carry out its functions in Stage Three.

Statistics of government deficits and debt are covered by application of the Excessive Deficit Procedure and are not discussed further here. National accounts (including financial accounts) data provide essential background data for the assessment of the economic situation in the EU Member States. They are covered by the implementation of ESA 95 and are also not considered further here. Since national accounts data are available at best only quarterly and with a delay of some months, the ECB will need monthly economic indicators so that developments may be identified without delay, and their possible implications for monetary policy ascertained. Short-term business indicators must be timely and provide a reliable picture of the economy. Since most of the required indicators are already available in many EU Member States, efforts should concentrate on improving timeliness and comparability.

The following paragraphs provide a brief description of the requirements.

2 Prices and costs

The preparation of a harmonised index of consumer prices (HICP) for all EU countries is already under way, for the purpose of assessing convergence. The ESCB will use the HICP in the form of an index covering the euro area as a whole (with sub-indices as necessary) as a main measure of prices.

In addition to the need to have inflation data as measured by the change in the consumer price index, the ECB will require a variety of other measures of prices to support its primary objective of maintaining price stability and in the context of general economic assessments. These include commodity prices, foreign trade prices, producer and wholesale prices, and construction prices. House prices and survey data may give advance indication of inflationary pressure. Wage costs (including pay settlements, average earnings, and unit labour costs) will also be used as indicators of inflationary pressures, and also for assessing competitiveness. The European Commission's plans to develop a European employment cost index are relevant in this connection. Sectoral wage data will be required for monitoring the effects of wage costs on output prices.

3 Demand

Monthly data give more timely information than the quarterly national accounts. For a clear and sufficiently timely picture of the underlying movements in aggregate demand, data on sectors of business such as manufacturing, construction and retail sales will be necessary. Some detail will be required in statistics of external trade. Data on orders, and business opinion surveys, will provide a leading indicator of the development of demand and so of possible inflationary pressures.

4 Output

Monthly production statistics, preferably sub-divided into main categories of output, will be necessary. Also important will be indicators of capacity utilisation. Indications of trends, such as expected production and activity, will be required. The requirement covers services as well as industry (including construction).

5 Labour market

Employment (in total and by sector) and unemployment data will be required. Other important labour market data include vacancies and hours worked.

Annex 11

The EMI's proposal for a draft EU Council Regulation concerning the collection of statistical information by the ECB

The legal framework for the collection of statistical information by the ECB will have to be laid down in secondary Community legislation in accordance with Article 5.4 of the Statute of the ESCB. The ECB will submit a recommendation to the EU Council to this effect following its establishment. In view of lead-time considerations, the EMI has already prepared the text of a draft EU Council Regulation which is reproduced hereafter.

PREAMBLE

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular to Article 106 (6) thereof,

Having regard to the Statute of the ESCB, and in particular to Article 5.4 thereof,

Having regard to the recommendation from the European Central Bank,

Having regard to the opinion of the European Parliament,

Having regard to the opinion of the Commission,

(1) Whereas Article 42 of the Statute of the ESCB, in accordance with Article 106 (6) of the Treaty, provides for the Council to adopt, inter alia, provisions referred to in Article 5.4 of the said Statute;

(2) Whereas Article 5.1 of the Statute of the ESCB requires the ECB, assisted by the NCBs, to collect the statistical information which is necessary to undertake the tasks of the ESCB either from the competent national authorities or directly from economic agents; whereas Article 5.2 of the Statute of the ESCB requires the NCBs to carry out, to the extent possible, the tasks described in Article 5.1; whereas Article 5.4 of the Statute of the ESCB requires the Council to define the natural and legal persons subject to reporting requirements, the confidentiality regime and the appropriate provisions for enforcement;

(3) Whereas definitions and procedures for the collection of statistical information, to be effective as an instrument for the performance of the tasks of the ESCB, need to be structured so that the ECB has the ability and flexibility to avail itself in a timely manner of high-quality statistics within the context of and dependent upon changing economic and financial conditions and taking account of the burden imposed on reporting agents;

(4) Whereas it is therefore desirable to define a reference reporting population in terms of categories of economic units and statistical applications involved, to which the statistical powers of the ECB shall be confined and from which the ECB shall determine the actual reporting population through its regulatory power;

(5) Whereas a homogeneous reporting population is necessary for the production of the "consolidated balance sheet of the banking system" of the participating EU Member States, the principal aim of which is to provide the ECB with a comprehensive statistical picture of monetary developments in the participating EU Member States seen as one economic territory, and whereas the ECB has established and maintains a "List of Monetary Financial Institutions for statistical purposes" based on a common definition of these institutions;

(6) Whereas the said common definition for statistical purposes specifies that Monetary Financial Institutions comprise 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 Monetary Financial Institutions, and, for their own account (at least in economic terms), to grant credits and/or to make investments in securities;

(7) Whereas in the European System of National and Regional Accounts 1995[19] the Monetary Financial Institutions therefore comprise the sub-sector "the central bank" and the sub-sector "other monetary financial institutions" and may be broadened exclusively through the inclusion of categories of institutions coming from the sub-sector "other financial intermediaries, except insurance corporations and pension funds";

(8) Whereas statistics on the balance of payments, the International Investment Position, securities, and payments systems are also central for enabling the ESCB to fulfil its tasks in an independent manner;

(9) Whereas the use of the terms "legal and natural persons" in Article 5.4 has to be construed in a manner that is consistent with the practices of EU Member States in the field of banking and balance of payments statistics and therefore also encompasses entities that are neither legal persons nor natural persons under their respective national laws but still fall within the relevant sub-sectors of ESA 95; whereas reporting requirements can therefore be imposed on entities like partnerships, branches, UCITS, funds, etc., that under their respective laws do not enjoy the status of a legal person; whereas in these cases the reporting obligation is imposed on those persons who, under the applicable national laws, legally represent the entities concerned;

(10) Whereas the statistical balance sheet reports of Monetary Financial Institutions may also be used to calculate the amount of minimum reserves which they may be obliged to hold;

(11) Whereas it is for the Governing Council of the ECB to specify the technical division of tasks between the ECB and the NCBs concerning the collection and verification of statistical information and their respective enforcement, taking into account the principle laid down in Article 5.2 of the Statute of the ESCB, as well as the tasks which will be assumed by national authorities within the limits of their competences, for the purposes of obtaining consistent high quality statistics;

(12) Whereas in the early years of the euro area cost-effectiveness may require that the ECB's statistical reporting requirements be satisfied through transitional procedures owing to existing constraints of the collection systems; whereas this may imply in particular that in the case of the Financial Account of the balance of payments, data on cross-border positions or transactions of the participating EU Member States seen as one economic territory may in the early years of the euro area be compiled using all positions or transactions between residents of a participating Member State and residents of other countries;

(13) Whereas the limits within and the conditions under which the ECB is entitled to impose sanctions on undertakings for failure to comply with obligations under regulations and decisions of the ECB have been defined, in accordance with Article 34.3 of the Statute of the ESCB, by Council Regulation [*... on sanctions, a draft of which is reproduced in Annex 12*] the application of which is subsidiary to this Regulation;

[19] *OJ No. L (enacted, in the process of publication).*

(14) Whereas, while it is recognised that the statistical information needed to fulfil the ECB's statistical reporting requirements is not the same for the participating and non-participating EU Member States, Article 5 of the Statute of the ESCB applies to the non-participating EU Member States as well; whereas this, together with Article 5 of the EC Treaty, implies an obligation to design and carry out at national level all the measures that they consider appropriate in order to collect the statistical information needed to fulfil the ECB's statistical reporting requirements and the timely preparations in the field of statistics to become participating EU Member States;

(15) Whereas confidential statistical information which the ECB and the NCBs must obtain for the exercise of the tasks of the ESCB must be protected in order to gain and maintain the confidence of the reporting agents; whereas once this Regulation is adopted there will be no further cause to invoke provisions on confidentiality preventing the exchange of confidential statistical information with the ECB;

(16) Whereas Article 38.1 of the Statute of the ESCB provides that members of the governing bodies and the staff of the ECB and the NCBs shall be required, even after their duties have ceased, not to disclose information of the kind covered by the obligation of professional secrecy, and Article 38.2 of the Statute of the ESCB provides that persons having access to data covered by Community legislation imposing an obligation of secrecy shall be subject to such legislation;

(17) Whereas any infringement of the rules binding members of the staff of the ECB, whether committed wilfully or through negligence, renders them liable to disciplinary sanctions and, if appropriate, legal penalties for violation of professional secrecy, pursuant to the combined provisions of Articles 12 and 18 of the Protocol on the Privileges and Immunities of the European Communities;

(18) Whereas the confidentiality regime defined in this Regulation is consistent with the provisions on statistical confidentiality in Council Regulation [... on Community Statistics, which is in the process of enactment]; whereas reporting agents are not entitled, in this context, to invoke the provisions of Directive 95/46/EC of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data for not providing the requested data;[20]

(19) Whereas the confidentiality regime defined in this Regulation applies only to confidential statistical information transmitted to the ECB for the exercise of the tasks of the ESCB, and whereas it does not affect special national or Community provisions relating to the transmission of other types of information to the ECB;

(20) Whereas, for the purposes of Article 5.1 of the Statute of the ESCB, the ECB is required to co-operate in the field of statistics with the Community institutions or bodies and with the competent authorities of the EU Member States or third countries and with international organisations;

HAS ADOPTED THIS REGULATION

ARTICLE 1

Definitions

For the purpose of this Regulation:

1 *ECB's statistical reporting requirements* shall mean the statistical information

[20] *OJ No. L 281, 23.11.95 p.31.*

which reporting agents have to provide, necessary to undertake the tasks of the ESCB;

2 *reporting agents* shall mean the legal persons, natural persons and other entities subject to the ECB's statistical reporting requirements;

3 *participating Member State* shall mean a Member State which has adopted the single currency in accordance with the Treaty;

4 *resident* and *residing* shall mean having a centre of economic interest in the economic territory of a country in accordance with the European System of National and Regional Accounts 1995[21] as described in Annex A[22] to this Regulation; in this context, *cross-border positions* and *cross-border transactions* shall mean respectively positions and transactions in the assets and/or liabilities of residents of participating EU Member States seen as one economic territory vis-à-vis residents of non-participating EU Member States and/or residents of third countries;

5 *International Investment Position* shall mean the balance sheet of the stock of cross-border financial assets and liabilities.

ARTICLE 2

Reference reporting population

1 For the fulfilment of the ECB's statistical reporting requirements, the ECB, assisted by the NCBs in accordance with Article 5.2 of the Statute of the ESCB, shall have the right to collect statistical information within the limits of the reference reporting population and of what is necessary to carry out the tasks of the ESCB.

2 The reference reporting population shall comprise the following reporting agents:

(a) legal persons and natural persons falling within the sub-sector "the central bank", the sub-sector "other monetary financial institutions" and the sub-sector "other financial intermediaries, except insurance corporations and pension funds" in accordance with the European System of National and Regional Accounts 1995 as described in Annex B[23] to this Regulation and residing in a Member State, to the extent necessary to fulfil the ECB's statistical reporting requirements in the field of money and banking statistics and payments systems statistics;

(b) legal persons and natural persons residing in a Member State, to the extent that they hold cross-border positions or carry out cross-border transactions and that statistical information relating to such positions or transactions is necessary to fulfil the ECB's statistical reporting requirements in the field of balance of payments statistics or the International Investment Position;

(c) other legal persons and natural persons residing in a Member State, to the extent that statistical information relating to the issuance by them of securities or of prepaid cards is necessary to fulfil the ECB's statistical reporting requirements.

3 An entity that would otherwise be covered by the definition in the previous

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[21] *OJ No. L (enacted, in the process of publication).*

[22] *Annex A of this Regulation covers the paragraphs 2.04-2.11 of the European System of National and Regional Accounts 1995 as published in the Official Journal of the European Communities No L 310, 30.11.96, p. 37-39.*

[23] *Annex B of this Regulation covers the paragraphs 2.32-2.56 of the European System of National and Regional Accounts 1995 as published in the Official Journal of the European Communities No L 321, 30.11.1996, p. 44-48.*

paragraph, but which, according to the national law of its residence, is neither a legal person nor a collection of natural persons although it can be the subject of rights and obligations, shall be part of the reference reporting population. Where a legal person, collection of natural persons or an entity as referred to in the previous sentence (each a "parent") has a branch resident in another country, the branch shall be a reporting agent in its own right irrespective of where the parent is resident insofar as the branch satisfies the conditions defined in paragraph 2 except that of possessing separate legal personality. Any number of branches set up in the same Member State by a parent resident in another Member State or in a third country shall be regarded as a single branch when they belong to the same sub-sector of the economy. The reporting obligation of a branch or of any entity covered by this paragraph shall be fulfilled by the persons legally representing such branch or entity, respectively.

ARTICLE 3

Modalities for the definition of statistical reporting requirements

In defining and imposing its statistical reporting requirements, the ECB shall:

(a) take into account the reporting burden involved;

(b) take into account, where appropriate, international statistical standards;

(c) specify the actual reporting population within the limits of the reference reporting population defined in Article 2 of this Regulation; it may also fully or partly exempt specific classes of reporting agents from its statistical reporting requirements.

ARTICLE 4

Obligations of Member States

In order to facilitate the achievement of the tasks of the ESCB, Member States shall take the appropriate measures, whether general or particular, in order to ensure the fulfilment of the obligations arising out of Article 5 of the Statute of the ESCB.

ARTICLE 5

Regulatory power of the ECB

1 In accordance with the terms of Article 34 of the Statute of the ESCB, the ECB may adopt regulations for the definition and imposition of its statistical reporting requirements on the actual reporting population of participating Member States.

2 Whenever links with the statistical competences of the Commission exist, the ECB shall consult the Commission on draft regulations concerning statistical reporting requirements. The Committee on Monetary, Financial and Balance of Payments Statistics shall take part, within the limits of its competence, in the process of co-operation between the Commission and the ECB.

ARTICLE 6

Right of verification and compulsory collection of statistical information

1 If a reporting agent residing in a participating Member State is suspected of breaching the ECB's statistical reporting requirements, the ECB and the national central bank of the participating Member State concerned, in accordance with Article 5.2 of the Statute of the ESCB, shall have the right to verify the accuracy and quality

of the statistical information and to carry out its compulsory collection. However, in the event that the data concerned are necessary to demonstrate compliance with minimum reserve requirements, the verification should be carried out in accordance with Article 5 of Council Regulation [... *on minimum reserves, a draft of which is reproduced in Annex 8*]. The right to verify data or to carry out their compulsory collection shall comprise the right:

(a) to require submission of documents;

(b) to examine the books and records of the reporting agents;

(c) to take copies or extracts from such books and records;

(d) to ask for written or oral explanations;

(e) to enter the premises of reporting agents in pursuance of the objectives in (a) to (d) above.

2 The ECB or the competent NCB shall notify the reporting agent of its decision to verify data. The decision shall specify the time limit for compliance with the verification requests, the sanctions applicable in case of non-compliance and the rights for review. The ECB and the NCBs shall inform each other ahead of such verifications.

3 National procedures shall be followed for the compulsory collection of statistical information. The costs of the procedure shall be borne by the reporting agent concerned if it is established that it has breached statistical reporting requirements.

4 In accordance with Article 34 of the Statute of the ESCB, the ECB may adopt regulations for the specification of the conditions under which rights for verification or for carrying out the compulsory collection may be exercised.

5 Within the limits of their competences, national authorities of participating Member States shall give the necessary assistance to the ECB and NCBs in the performance of the powers provided for in this Article.

6 When a reporting agent opposes or obstructs the verification process or the compulsory collection of the required statistical information, the participating Member State in which the relevant premises are located shall afford the necessary assistance to the ECB's or NCBs' officials to enable them to make the verification or compulsory collection.

7 Participating Member States shall adopt all the necessary measures to ensure that the provisions of this Article can be fully applied.

ARTICLE 7

Imposition of sanctions

1 In accordance with Council Regulation [... *on sanctions, a draft of which is reproduced in Annex 12*], the ECB shall have the power to impose the sanctions set out in this Article upon reporting agents subject to reporting requirements and residing in a participating Member State which fail to comply with obligations resulting from ECB regulations or decisions defining and imposing the ECB's statistical reporting requirements.

2 The obligation to transmit certain data to the ECB or to the NCBs shall be infringed by reporting agents if:

(a) no data are received by the ECB or national central bank by the established deadline;

(b) the data are incomplete or in a form not complying with the request;

(c) the data contain false information.

3 The obligation to allow the ECB and the NCBs to verify the accuracy and quality of the information submitted by reporting agents to the ECB or national central bank shall be violated whenever a reporting agent obstructs this activity. Such obstruction includes, but is not limited to, removal of documents and prevention of physical access for the ECB's or the national central bank's officials or agents.

4 The ECB may impose sanctions on a reporting agent as follows:[24]

(a) in the event of an infringement as defined in Article 7.2(a), a daily penalty payment not exceeding EURO [10,000], with the total fine not exceeding EURO [100,000];

(b) in the event of an infringement as defined in Article 7.2(b), a fine not exceeding EURO [100,000];

(c) in the event of an infringement as defined in Article 7.2(c), a fine not exceeding EURO [200,000].

5 In the event of the violation mentioned in Article 7.3, the ECB may impose a fine not exceeding EURO [200,000] on a reporting agent. In addition, the costs of the verification performed by the officials or agents of the ECB or NCBs shall be borne by the reporting agent.

6 In case a reporting agent persists in the infringement or consistently repeats it, the ECB may suspend or restrict the access of this reporting agent to the open market and credit operations provided for in Article 18 of the Statute of the ESCB.

7 Participating Member States shall adopt all the necessary regulatory and administrative measures to ensure the enforcement of the sanctions imposed by the ECB.

ARTICLE 8

Statistical confidentiality

1 For the purposes of the statistical confidentiality regime of the ESCB, statistical information shall be confidential when it allows reporting agents or any other legal person, natural person, entity or branch to be identified, either directly from their name, address or from an officially allocated identification code, or indirectly through deduction, thereby disclosing individual information. To determine whether a reporting agent or any other legal person, natural person, entity or branch is identifiable, account shall be taken of all the means that might reasonably be used by a third party to identify the said reporting agent or legal person, natural person or branch. Statistical information taken from sources which are available to the public in accordance with national law is not confidential.

2 Transmission from the NCBs to the ECB of confidential statistical information shall take place to the extent and with the detail necessary for the exercise of the tasks of the ESCB, including appropriate monitoring of compliance with any reserve requirements in the event that the latter are established on the basis of individual statistical information collected through the ECB's regulatory power. Reporting agents shall be informed of the uses to which statistical information provided by them is put.

[24] *The maximum figures in square brackets are indicative and may be changed in the light of policy considerations. However, it is important that the figures which are included are proportional while ensuring that it is not more attractive for a reporting agent to pay the penalty rather than to produce the data, and that the sanctioning regime has internal coherence.*

3 The ECB shall use confidential statistical information transmitted to it exclusively for the exercise of the tasks of the ESCB, except:

(a) if the reporting agent or the other legal person, natural person, entity or branch concerned has unambiguously given its consent to the use for other purposes;

(b) for the production of specific aggregate statistics required by the Commission, following an agreement between the Commission and the ECB;

(c) for granting to scientific research bodies access to confidential statistical information which does not allow direct identification, without prejudice to national legislation and with the previous unambiguous consent of the national authority which provided the information.

4 The NCBs shall use the confidential statistical information collected to fulfil the ECB's statistical reporting requirements exclusively for the exercise of the tasks of the ESCB unless:

(a) the reporting agent or the other legal person, natural person, entity or branch concerned has unambiguously given its consent to the use for other purposes;

(b) it is used at national level for statistical purposes;

(c) it is used in the field of prudential supervision or for the exercise in accordance with Article 14.4 of the Statute of the ESCB of functions other than those specified in this Statute.

5 This Article shall not prevent confidential statistical information collected for purposes other than, or in addition to, meeting the ECB's statistical reporting requirements from being used to meet those other purposes.

6 This Article shall apply only to confidential statistical information transmitted to the ECB; it shall not affect special national or Community provisions relating to the transmission of other types of information to the ECB.

7 No reporting agent will be entitled, to the extent that it has to report data under the present Regulation, to invoke the provisions of Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data for not providing the requested data.

8 The ECB and the NCBs shall take all the necessary regulatory, administrative, technical and organisational measures to ensure the physical and logical protection of confidential statistical information. The ECB shall define common rules and minimum standards to prevent unlawful disclosure and unauthorised use. The protection measures shall apply to all confidential statistical information as defined in paragraph 1.

9 Member States shall adopt all the necessary measures to ensure the physical and logical protection of confidential statistical information, including the imposition of the appropriate sanctions in the event of violations.

ARTICLE 9

Final provision

This Regulation shall enter into force on 1 January 1999.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Annex 12

The EMI's proposal for a draft EU Council Regulation concerning the power of the ECB to impose sanctions

The legal framework for the ECB's power to impose sanctions will have to be laid down in secondary Community legislation in accordance with Article 34.3 of the Statute of the ESCB. The ECB will submit a recommendation to the EU Council to this effect following its establishment. In view of lead-time considerations, the EMI has already prepared the text of a draft EU Council Regulation which is reproduced hereafter.

PREAMBLE

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular to Article 108a (3) and Article 106 (6) thereof,

Having regard to the recommendation from the European Central Bank,

Having regard to the opinion of the European Parliament,

Having regard to the opinion of the Commission,

(1) Whereas Article 42 of the Statute of the ESCB, in accordance with Article 106 (6) of the Treaty, provides for the Council to adopt, inter alia, provisions referred to in Article 34.3 of the said Statute;

(2) Whereas this Regulation according to Article 34.3 of the Statute of the ESCB only applies to participating Member States;

(3) Whereas Article 34.3 of the Statute of the ESCB requires the Council to specify the limits and conditions under which the ECB shall be entitled to impose fines or periodic penalty payments on undertakings for failure to comply with obligations under its regulations and decisions;

(4) Whereas violations of the obligations arising from ECB regulations and decisions can arise in various fields of competence of the ECB;

(5) Whereas it is appropriate, to ensure a uniform approach towards the imposition of sanctions in various fields of competence of the ECB, that all generic and procedural provisions for the imposition of such sanctions are contained in a single EU Council Regulation; whereas other EU Council Regulations provide for specific sanctions in specific fields but leave the administration and mechanics relating to the imposition of such sanctions for the present Regulation; whereas the application of provisions of the present Regulation is subsidiary to the one of provisions contained in regulations providing for sanctions in specific areas;

(6) Whereas to provide an effective regime for the administration of sanctions this Regulation must leave a certain discretion to the ECB, both in relation to the relevant procedures and in relation to their implementation within the limits and conditions laid down in this Regulation;

(7) Whereas the ECB shall have recourse to the NCBs to carry out the tasks of the ESCB to the extent deemed possible and appropriate;

(8) Whereas a simplified procedure to impose sanctions for certain kinds of infringements has to be set out;

(9) Whereas decisions under this Regulation imposing pecuniary obligations

shall be enforceable in accordance with Article 192 of the Treaty;

HAS ADOPTED THIS REGULATION

ARTICLE 1

Definitions

For the purposes of this Regulation:

1 *participating Member State* shall mean a Member State which has adopted the single currency in accordance with the Treaty;

2 *national central bank* shall mean the central bank of a participating Member State;

3 *infringement* shall mean failure by an undertaking to comply with an obligation established in an ECB regulation or decision;

4 *sanctions* shall mean fines, periodic penalty payments, penalty interest and other sanctions with comparable effect imposed as a consequence of an infringement;

5 *fine* shall mean a single amount of money which an undertaking is obliged to pay as a sanction;

6 *periodic penalty payments* shall mean repetitive amounts of money which, in the case of a continued infringement, an undertaking is obliged to pay as a sanction, which shall be calculated for each day of continued infringement following the notification to the undertaking of a decision, in accordance with Article 3.1, second paragraph, of this Regulation, requiring the termination of such an infringement;

7 *undertakings* shall mean those natural or legal persons, private or public, which are the subject of obligations arising from ECB regulations and decisions with the exception of public national authorities; when such persons have their head office or registered office outside a participating Member State, the term refers to the branches or other permanent establishments of such undertakings in a participating Member State.

ARTICLE 2

Sanctions

1 The limits for the ECB to impose fines and periodic penalty payments on undertakings shall be, unless otherwise provided in specific Council Regulations, the following:

(a) Fines: the upper limit shall be EURO [500,000].

(b) Periodic penalty payments: the upper limit shall be EURO [10,000] per day of infringement. Periodic penalty payments may be imposed in respect of a maximum period of six months following the notification to the undertaking of the decision in accordance with Article 3.1, fourth paragraph, of this Regulation.[25]

2 In determining whether to impose a sanction and in determining the appropriate sanction, the ECB shall be guided by the principle of proportionality. To that effect, it shall, where relevant, take into consideration the circumstances of the specific case, such as:

(a) on the one hand, the good faith and the degree of openness of the undertaking in the interpretation and application of the

[25] *The maximum figures in square brackets are indicative and may be changed in the light of policy considerations. However, it is important that the figures which are included are proportional and that the sanctioning regime has internal coherence.*

obligation arising from an ECB regulation or decision as well as the degree of diligence and co-operation shown by the undertaking or, on the other hand, any evidence of wilful deceit on the part of officials of the undertaking;

(b) the seriousness of the effects of the infringement;

(c) the repetition, frequency or duration of the infringement by that undertaking;

(d) the profits obtained by the undertaking by reason of the infringement;

(e) the economic size of the undertaking;

(f) prior sanctions imposed by other authorities on the same undertaking and based on the same facts.

3 Whenever the infringement consists of a failure to perform a duty, the application of a sanction shall not exempt the undertaking from its performance unless the decision adopted in accordance with Article 3.4 of this Regulation explicitly states the contrary.

ARTICLE 3

Procedural rules

1 The decision whether or not to initiate an infringement procedure shall be taken by the Executive Board of the ECB, acting on its own initiative or on the basis of a motion to that effect addressed to it by the NCB in whose jurisdiction the infringement has occurred. The same decision can also be taken, on its own initiative or on the basis of a motion to that effect addressed to it by the ECB, by the national central bank in whose jurisdiction the infringement has occurred.

The decision to initiate an infringement procedure shall include the appointment of an official, either from the ECB or from a national central bank, to carry out the examination of the case (hereinafter referred to as the "Rapporteur").

It shall be notified in writing to the undertaking concerned, to the relevant supervisory authority and to the national central bank in whose jurisdiction the infringement has occurred or to the ECB. It shall disclose to the undertaking the details of the allegations against it and the evidence on which such allegations are founded. Where appropriate, the decision shall give notice to the undertaking concerned that periodic penalty payments may be imposed, the calculation of which, in particular, shall depend on the period of maintenance of the alleged infringement.

2 The Rapporteur, or the persons appointed by him/her, may:

(a) require submission of documents;

(b) examine the books and records of the undertaking;

(c) take copies or extracts from such books and records;

(d) ask for written or oral explanations;

(e) enter the premises of undertakings in pursuance of the objectives in (a) to (d) above.

The Rapporteur may address communications or requests for information to supervisory authorities.

The Rapporteur may ask the authority which appointed him/her to adopt procedural decisions to facilitate his/her tasks.

When an undertaking obstructs the examination carried out by the Rapporteur, the Member State where the relevant premises are located shall afford the necessary assistance to enable him/her to perform his/her task.

The appointing authority may replace the Rapporteur for any cause stated at any time by another individual who shall subsequently assume the role of Rapporteur. The undertaking concerned shall be provided with a written notice of such replacement.

The undertaking concerned shall have the right to be heard by the Rapporteur. He/she shall give the undertaking a period of not less than 30 days to present its defences.

3 The Rapporteur shall submit to the ECB and to the NCB in whose jurisdiction the infringement has occurred a report with a description of the facts, copy of the allegations and defences, if any, of the undertaking concerned, and a proposal for a decision.

4 The Executive Board of the ECB shall, within 30 days of receiving the submission from the Rapporteur under 3 above and after having consulted the NCB in whose jurisdiction the infringement has occurred, adopt a reasoned decision on the proposal together with the sanction, if any, to be imposed. Such decision shall be notified in writing to the undertaking concerned, and such notice shall inform the undertaking of its right for review to which the following paragraph refers. Such decision shall also be notified to relevant supervisory authorities and to the national central bank in whose jurisdiction the infringement has occurred.

5 The undertaking concerned shall have the right to request a review by the Governing Council of the decision to impose a sanction. Such request must be made within 30 days of the receipt of the notice of such decision and shall include all supporting information and allegations. Such request shall be addressed in writing to the Governing Council of the ECB.

6 A decision by the Governing Council in response to a request submitted under paragraph 5 above shall include the reasons for such decision and shall be notified in writing to the undertaking concerned, to the relevant supervisory authority of that undertaking and to the national central bank of the jurisdiction where the infringement occurred. The notice shall inform of the right for judicial review as stated in this Regulation. If no decision has been taken by the Governing Council within two months from the request, the undertaking concerned may request a review of the decision in accordance with the provisions laid down in Article 6.

7 No sanction shall be enforced against the undertaking until the decision becomes final through either:

(a) the period of 30 days referred to in paragraph 5 having elapsed without the undertaking making a request for review to the Governing Council; or,

(b) the Governing Council notifying the undertaking of its decision, or the period referred to in paragraph 6 having elapsed without the Governing Council having taken a decision.

8 The proceeds from fines, periodic penalty payments, penalty interest and other sanctions with comparable effect imposed under this Regulation shall pertain to the ECB.

9 If an infringement relates exclusively to a task entrusted to the ESCB under the Treaty and the Statute of the ESCB an infringement procedure may only be initiated on the basis of this Regulation, irrespective of the existence of any national law or regulation which may provide for a separate procedure. If an infringement also relates to one or more areas outside the competences of the

ESCB, the right to initiate an infringement procedure on the basis of this Regulation shall be independent of any right of a competent national authority to initiate separate procedures in relation to such areas outside the competences of the ESCB. This provision is without prejudice to the application of the criminal law and to prudential supervisory competences in participating Member States.

10 Participating Member States shall adopt all the necessary measures to ensure that the provisions of this Article can be fully applied.

ARTICLE 4

Time limits

1 The right to take the decision to initiate the procedure on infringements provided for by this Regulation shall expire one year after the existence of such infringements first became known either to the ECB or the national central bank in whose jurisdiction the infringement occurred and in any case five years after the infringement occurred (in the case of a continued infringement, five years after the infringement ceased).

2 The right to take the decision to impose sanctions on infringements provided for by this Regulation shall expire one year after the decision to initiate the procedure as described in Article 3 (1) was taken.

3 The right to start an enforcement procedure shall expire six months after the decision has become enforceable pursuant to Article 3 (7).

ARTICLE 5

Simplified procedure

Whenever a sanction is imposed in accordance with Article 6.1 of the EU Council Regulation [... *on minimum reserves, a draft of which is reproduced in Annex 8*]:

(a) the ECB shall notify in writing the undertaking concerned;

(b) Articles 2.1, 2.2, 3.1, 3.2, 3.3, 3.4 of the present Regulation shall not be applicable, and the period referred to in paragraphs 5, 6 and 7 of Article 3 shall be reduced to fifteen days.

ARTICLE 6

Judicial review

The Court of First Instance shall have a competence of full jurisdiction in reviewing final decisions adopted under this Regulation.

ARTICLE 7

General provisions

1 This Regulation shall supplement, and be subsidiary to, other Council Regulations establishing a right for the ECB to impose sanctions for infringements to ECB regulations or decisions.

2 Subject to the limits and conditions laid down in this Regulation, the ECB may adopt regulations in order to specify further the arrangements whereby sanctions may be imposed in accordance herewith and guidelines to co-ordinate and harmonise the procedures in relation to the examination of the case and the enforcement of the sanctions.

3 This Regulation shall enter into force on 1 January 1999.

Annex 13

Models for the cross-border use of collateral

1 General observations

The EMI and the NCBs have agreed that there are a number of grounds for enabling ESCB counterparties to use collateral in a cross-border context, in respect of both monetary policy and payment system operations. First, the principle of "equal treatment", included in the Treaty pleads for the need to include securities in the list of eligible paper for mobilisation and pledging independently of their geographical location. In particular, because the list of eligible assets[26] for monetary policy operations in Stage Three is expected to be rather wide, counterparties may hold eligible assets in several countries. They may wish to use them to collateralise monetary policy operations and the ESCB will have to ensure that this is technically possible. Second, if no form of link is established, markets in assets may continue to be fragmented since banks would have an incentive to hold specific securities (traded at a domestic level) to cover their possible liquidity needs. Third, solutions for the cross-border use of collateral which do not meet adequate safety standards would not be adequate for monetary policy and payment systems needs and would be more difficult to change in the longer term if consolidated market practices were to be established.

The EMI and the NCBs have considered a set of different models for the settlement of cross-border transactions. Implementing linkages between central securities depositories (CSDs) can meet: (i) both the need of central banks for effective collateral management, both in the conduct of monetary policy and in safeguarding the smooth functioning of payment systems; and (ii) the needs of financial intermediaries and investors in terms of flexibility, possibility of access to several markets, economies of scale, etc.

However, the implementation of direct linkages between domestic and/or international CSDs at an EU-wide level could require considerable lead times. By contrast, the need for central banks to allow the cross-border use of collateral for monetary policy and payment systems operations calls for solutions which would at least provide a framework within which to settle central banks' operations safely from the start of Stage Three.

In this respect, two different models for the cross-border use of collateral are being prepared: the correspondent central banking model (CCBM) and the guarantee model (GM). The two models have been constructed on the basis of the existing procedures in securities administration and the current communication infrastructures. As a consequence, the number of cross-border securities transactions that the two models can process would depend on the technical links between the procedures for the cross-border exchange of information and the internal systems for securities administration. For the start of Stage Three no new automatic procedures are envisaged.

The two models can be used for all kinds of eligible assets and all kinds of monetary policy and payment systems operations. Preparatory work on the two models does not prejudge in any way the implementation of other solutions at a later stage.

2 The correspondent central banking model

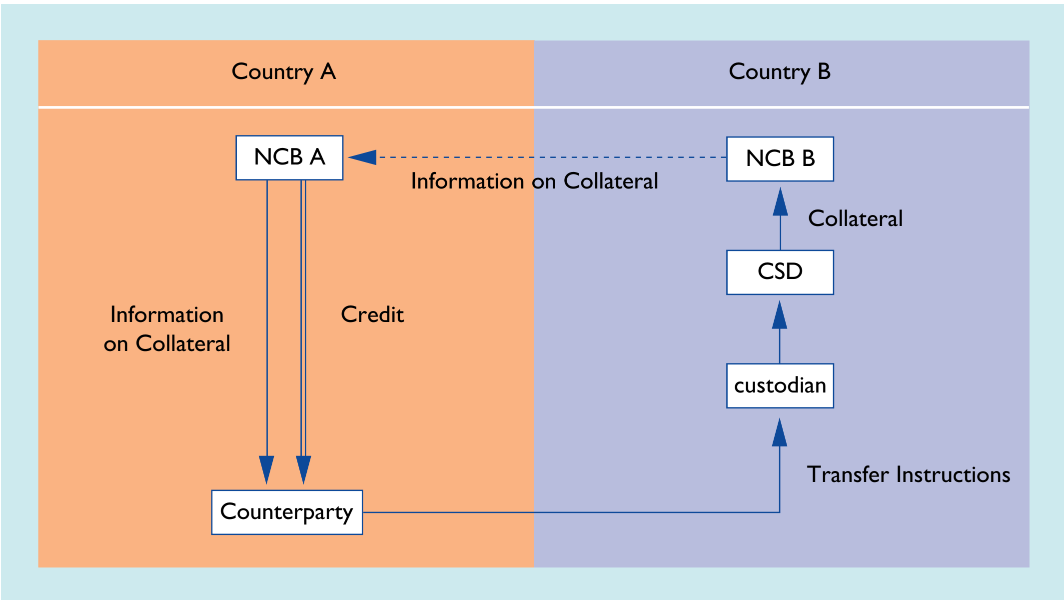
In the correspondent central banking model (CCBM), NCBs open securities accounts with one another and act as custodians for other NCBs. This implies that each NCB

[26] *Eligibility of assets for monetary policy operations is defined in Chapter II, Section 4.2 of this report.*

will have a securities account in its securities administration for each of the other NCBs and for the ECB in which the amount of securities deposited will be registered together with their accompanying characteristics. Counterparties of the ESCB will be able to approach their "home" NCB to obtain credit against eligible paper delivered at a "foreign" NCB, which acts as a (securities) correspondent for the home NCB. On the basis of this information, the home NCB will have collateral relations (and in the event of a pledge or pre-deposit, also be involved in securities account administration) with the counterparty. This model requires the use of an agreed set of services under a standardised custody agreement to be used between any two NCBs.[27] In the CCBM, counterparties may concentrate and centralise their credit operations with their home NCB, even when they have remote access to other countries' payment systems as they may transfer intraday liquidity to other RTGS systems through TARGET.

Chart 2

Correspondent Central Banking Model



In the CCBM, the home NCB does not transfer funds until its correspondent NCB has confirmed the existence and its receipt of the securities with finality.

The CCBM makes use of the existing S.W.I.F.T. communication lines and working methods at NCBs.

Example: Use of euro-denominated paper deposited in country B by an ESCB counterparty in country A in order to obtain credit at NCB A (Chart 2).

[27] *Services between NCBs should include: 1) confirmation of incoming receipts and outgoing deliveries of securities; 2) early notification of corporate actions on securities held on securities accounts; and 3) periodical reporting of account statements for reconciliation purposes.*

4 The guarantee model

In the guarantee model (GM), the procedures are the same as for the CCBM except that the correspondent NCB issues a guarantee against eligible paper to the home NCB in favour of the ESCB counterparty, which has delivered the collateral to the correspondent NCB. The home NCB will not transfer funds unless it has received a guarantee from its correspondent NCB. The guarantee would take the form of full compensation, meaning that all risks (credit risk, market risk of collateral and legal risks) would be transferred to the correspondent NCB. The guarantor NCB would need to have the power to liquidate the collateral when the lending NCB calls on the guarantee. In some situations the guarantee model may be more secure from a legal point of view, because in some countries it may be an advantage to have the realiser of the collateral (i.e. the guarantor) located in the same jurisdiction as the one in which the collateral is situated so that, in event of a failure, it would be able to execute the collateral underlying the credit operation on its own behalf.

The GM may be designed in different ways depending on the features of the eligible assets which are to be used on a cross-border basis. Further details about the operational characteristics of the model will be provided at a later stage.

The GM (like the CCBM) can make use of the existing S.W.I.F.T. communication lines and working methods at NCBs.

Annex 14

Operational design of the TARGET system

This annex describes the overall structure of the TARGET System, the execution of cross-border payments in TARGET, and the mechanism to provide settlement services to other systems.

1 Overall structure of the TARGET system

TARGET will only process euros. The domestic RTGS systems will be interconnected through common infrastructures and procedures (the Interlinking system), to allow payment orders denominated in euro to move from one system to another. RTGS systems of EU Member States that are not yet part of the euro area will be allowed to be connected to TARGET provided that they are able to process the euro as a foreign currency.

The structure of the TARGET system will mirror that of the ESCB. It will be a decentralised system with some common functions undertaken by the ECB.

Within TARGET, the Interlinking system will be composed of a telecommunications network, linked in each country to a local interface, called the national Interlinking component. These components will consist of infrastructures and procedures which will be used, within or in addition to each national RTGS system, to process cross-border payments. The role of the Interlinking components will consist, in particular, in transforming the presentation of payment data from the national standard into the Interlinking standard, and vice versa.

TARGET will operate basically as an RTGS system, with payment orders being processed one by one on a continuous basis. It will provide for immediate and final settlement of all payments, on condition that there are sufficient funds (i.e. credit institutions' working balances or central bank intraday credit) available on the sending institution's account with its central bank. This will imply that the account of the receiving institution will never be credited before the account of the ordering (sending) credit institution has been debited. As a result, there will always be certainty for the receiving institution that funds received through TARGET are unconditional and irrevocable. Thus, the receiving institution will not be exposed to credit or liquidity risk originating from such payment orders received.

Participants in national RTGS systems should, in principle, be able to send cross-border payments through TARGET as easily as they can send domestic payments through the national RTGS system. For a cross-border TARGET payment, the delay between the debiting of the account of the sending credit institution by the sending RTGS system and the crediting of the account of the beneficiary credit institution at the receiving RTGS is expected, under optimal circumstances, to be a matter of seconds.[28]

[28] *Since the execution of cross-border payments will involve settlement at two distinct NCBs, it may happen that a payment cannot be processed by the receiving NCB although it has already been settled at the first sending NCB (for instance, if the beneficiary credit institution indicated in the payment order is no longer a participant in the receiving RTGS system). Therefore, in order not to withhold liquidity from the payment system, a procedure will be implemented by which, after having been informed by the receiving NCB that the payment cannot be processed successfully, the sending NCB will be able to re-credit the amount originally debited from the account of the sending credit institution.*

2 The execution of cross-border TARGET payments

2.1 Procedures involved

To initiate a cross-border TARGET payment, the ordering credit institution will send a payment order to the local NCB through the national RTGS system (see 1) in Chart 3). The first instructed central bank, the sending NCB, will check the validity of the payment (the sending NCB may, in accordance with the functioning rules of the national RTGS or Interlinking system, leave this responsibility to a private operator). To be successfully processed by the sending NCB, a payment order will need to be presented according to the agreed standards,[29] to contain the information needed, and the amount of the payment will not be able to exceed the balance of the account of the sending bank, or the amount of the credit lines available to it. The sending NCB will also check that the receiving RTGS system is operational (see 2) in Chart 3).

Once the sending NCB has declared the payment valid, the amount of the payment will be immediately and irrevocably debited from the RTGS account of the sending credit institution and credited to the Interlinking account of the receiving NCB (see 3) in Chart 3). The sending NCB will then be entrusted with the task of: (i) converting, if necessary, the payment order into the message standards which are used by the Interlinking; (ii) including the additional security features used during the communication between NCBs; and (iii) sending the message, through the Interlinking network, to the receiving NCB.

Once the receiving NCB has received the payment message it will check the security features and verify that the beneficiary bank, as specified in the payment order, is a participant in the national RTGS system. If this is the case, the receiving NCB will convert, where appropriate, the message from Interlinking standards into domestic standards, debit the Interlinking account of the sending NCB and credit the beneficiary's RTGS account (see 4) in Chart 3). Finally, the receiving NCB will send the payment order, through the national RTGS system, to the beneficiary credit institution (see 5) in Chart 3). If the receiving bank is not a member of the RTGS system, the receiving NCB will reject the payment and ask the sending NCB to re-credit the amount to the sending bank's account. However, if the payment can be automatically processed the central bank will accept the payment and process it appropriately.

Finally, a procedure will be adopted for TARGET whereby the receiving RTGS system will send a settlement acknowledgement to the sending NCB after having successful credited funds. This procedure will enable the sending NCBs to ensure that all payments they have sent to other NCBs are successfully settled. If a sending NCB does not receive the expected acknowledgement within 30 minutes, it must investigate the status of the payment, i.e. start an error detection procedure.

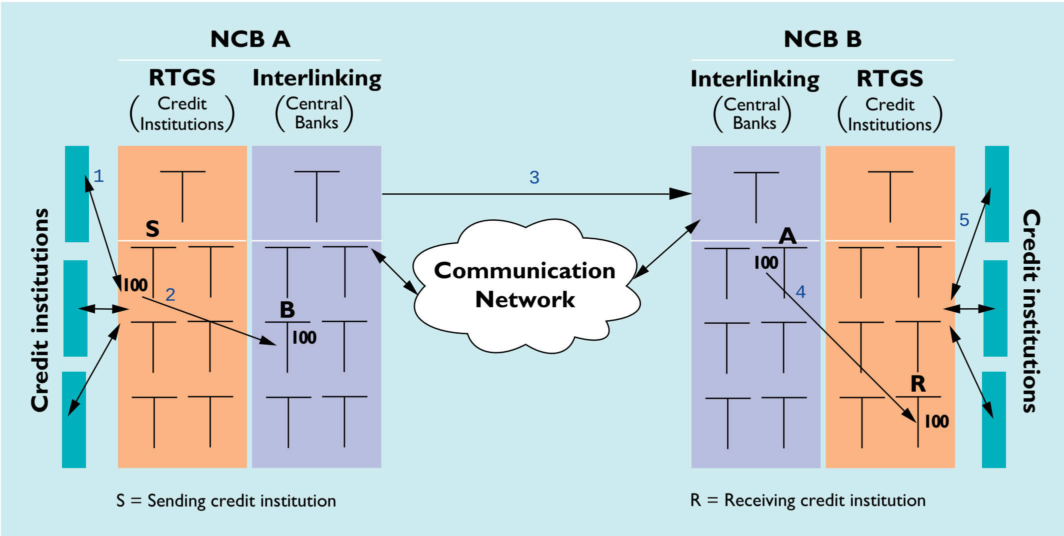
2.2 Interlinking communication and message formats

In order to meet the requirements of TARGET, the transmission of payment orders between the national Interlinking components will be made via telecommunications lines. Besides speed and availability requirements, the communications network will meet strict requirements regarding security and also

[29] *National RTGS systems will continue to operate according to the domestic standards. The technical standards of the Interlinking have been defined in the "Technical Annexes to the first progress report on the TARGET project", published in August 1996.*

Chart 3

Cross-border TARGET payment



provide flexibility with regard to processing capacity.

In TARGET, there needs to exist "a common language" - standardised data formats - for communication between NCBs. Interlinking message types have been developed on the basis of the S.W.I.F.T. message MT 100 and 202.[30]

2.3 End-of-day procedures

TARGET will be a decentralised system where the exchange of information is organised according to the "correspondent central banking model", by which payment messages will be exchanged on a bilateral basis. In order to keep the system as simple as possible, no information on inter-NCB exchanges of payment orders will be sent during the day to the ECB. However, the ECB will provide end-of-day procedures ensuring the completion of the business day in a final and irrevocable position before the start of the next business day. In this respect, specific control operations will be performed by the ECB at the end of the day in order to ensure the correctness of the processing of cross-border payments exchanged within the system during the business day and of the inter-NCB balance positions resulting from this activity. These operations will include a check that all bilateral messages sent by one NCB to another NCB have been received and that the total values of cross-border payments sent and received by the NCBs during the day match.

No Interlinking component may close before it has finalised its positions with all bilateral partners.

3 Relations with other transfer systems

TARGET will offer a solution to facilitate the settlement of cross-border large-value net settlement systems (NSSs) operating within the euro area, in order for them to be able to settle their final net balances in central bank money.

[30] *S.W.I.F.T. message types are public standards which are widely used in the financial industry.*

The settlement procedure for providing settlement services to cross-border NSSs (so-called TARGET transfer method) will enable participant credit institutions to carry out these settlements by sending normal TARGET transfers between their ordinary accounts and a special account. The special account ("central account") will be held at a single NCB or at the ECB, for the Clearing House or on behalf of all the participants. This account will have a zero balance at the beginning and at the end of the day and will be used only for settlement purposes. Credit institutions will transfer the settlement funds to the central account, in most cases through TARGET. By using this method no active role of the ECB or NCB as settlement agent (i.e. institution responsible for settlement) will be necessary.

With this method, the responsibility for the successful finalisation of the settlement process will lie with the system operator or the participants. This method will also be preferable from a purely technical point of view as it could be provided without the addition of new features to the national RTGS systems or to the Interlinking system.

In addition to the TARGET transfer method, settlement services to domestic NSSs may be provided at the domestic level by means of other methods, provided that the solution does not entail risks for the other members of the ESCB.

Annex 15

Glossary

Actual/360: the **day-count convention** applied for the calculation of interest on a credit, implying that the interest is calculated over the actual number of calendar days over which the credit is extended, on the basis of a 360-day year. This day-count convention will be applied in ESCB monetary policy operations.

American auction: see **multiple-rate auction.**

Averaging provision: a provision allowing **counterparties** to fulfil their **reserve requirements** on the basis of their average **reserve holdings** over the **maintenance period**. The averaging provision contributes to the stabilisation of money market interest rates by giving institutions an incentive to smooth the effects of temporary liquidity fluctuations.

Batch: the transmission or processing of a group of payment orders and/or securities transfer instructions as a set at discrete intervals of time.

Bilateral procedure: a procedure whereby the central bank deals directly with only one or a few **counterparties**, without making use of tender procedures. Bilateral procedures include operations executed through stock exchanges or market agents.

Book-entry system: an accounting system that permits the transfer of claims (e.g. securities and other financial assets) without the physical movement of paper documents or certificates. See also **dematerialisation**.

Business day: any day other than a Saturday or Sunday on which the **TARGET system** is defined as being operational to effect payments.

Capital risk: see **principal risk.**

Caps: a risk management arrangement whereby limits are placed on the positions that participants in an interbank funds transfer system can incur during the business day; they may be set by each individual participant or by the body governing the transfer system; they can be set in multilateral net, bilateral net or (less commonly) gross terms and can be either a credit cap or a debit cap; for example, bilateral net credit caps, set by an individual participant, will constitute a limit on the credit exposure that that participant will accept vis-à-vis each other participant; in contrast, sender net debit caps, which may for example be set by the governing body of the clearing system based on a particular formula, limit the aggregate value of transfers that an individual participant may send to all other participants over and above its incoming transfers.

Central securities depository (CSD): a facility for holding securities which enables securities transactions to be processed by **book entry**. Physical securities may be immobilised by the depository or securities may be **dematerialised** (i.e. so that they exist only as electronic records). In addition to safekeeping, a CSD may incorporate comparison, clearing and settlement functions.

Chaining: a method used in certain transfer systems (mostly for securities) for processing instructions. It involves the manipulation of the sequence in which transfer instructions are processed to increase the number or value of transfers that may be settled with available funds and/or securities balances (or available credit or securities lending lines).

Clearing/Clearance: clearing is the process of transmitting, reconciling and in some cases confirming payment orders or securities transfer instructions prior to settlement, possibly including the netting of instructions and the establishment of final positions for settlement. In the context of securities markets this process is often referred to as clearance.

Clearing system: a set of procedures whereby financial institutions present to and exchange with other financial institutions data and/or documents relating to funds or securities transfers . The procedures often also include a mechanism for the calculation of participants' bilateral and/or multilateral net positions with a view to facilitating the settlement of their obligations on a net or net net basis.

Close-out netting: a special form of netting which occurs following some predefined event such as default. Close-out netting is intended to reduce exposures on open contracts if one party meets certain conditions specified by the contract (e.g. becomes subject to insolvency procedures) before the settlement date (also referred to as default netting, open contract netting or replacement contract netting).

Collateral: assets pledged as a guarantee for the repayment of the short-term liquidity loans which credit institutions receive from central banks, as well as assets received by central banks from credit institutions as part of repo operations.

Collection of fixed-term deposits: a monetary policy instrument that may be used by the ESCB for fine-tuning purposes where the ESCB offers remuneration on counterparties' fixed-term deposits on accounts with the national central banks in order to absorb liquidity from the market.

Confirmation: a particular connotation of this widely used term is the process whereby a market participant notifies its counterparties or customers of the details of a trade and, typically, allows them time to affirm or to question the trade.

Correspondent banking: an arrangement under which one bank provides payment and other services to another bank. Payments through correspondents are often executed through reciprocal accounts (so-called nostro and loro accounts), to which standing credit lines may be attached. Correspondent banking services are primarily provided across international boundaries.

Correspondent central banking model: a model whereby NCBs would open securities accounts with one another. As a result, central banks would be able to act as local custodians (or sub-custodians) for one another.

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

Custodian: an institution that safekeeps and takes care of the administration of securities and other financial assets on behalf of others.

Custody: the safekeeping and administration of securities and other financial assets on behalf of others.

Day-count convention: the convention regulating the number of days included in the calculation of interest on credits. The ESCB will apply the day-count convention **"actual/360"** in its monetary policy operations.

Daylight credit (daylight overdraft, daylight exposure, see also intraday credit): a credit extended for a period of less than one business day. In a credit transfer system with end-of-day final settlement, daylight credit is tacitly extended by a receiving institution if it accepts and acts on a payment order even though it will not receive final funds until the end of the business day.

Default: the failure to complete a funds or securities transfer according to its terms for reasons that are not technical or temporary. Default is usually distinguished from a "failed transaction".

Delivery: final transfer of a security or financial asset.

Delivery versus payment system (DVP): a mechanism in an exchange-for-value settlement system that ensures that the final transfer of an asset occurs if and only if the final transfer of another (other) asset(s) occurs.

Dematerialisation: the elimination of physical certificates or documents of title which represent ownership of financial assets so that the financial assets exist only as accounting records.

Deposit facility: an ESCB **standing facility** which counterparties may use to make overnight deposits remunerated at a pre-specified interest rate.

Depository: an agent with the primary role of recording securities either physically or electronically and keeping records of the ownership of the securities.

Dutch auction: *see* **single-rate auction.**

DVP link: a link (either unilateral or bilateral) between **CSDs**, which allows for the transfer of securities and funds on a **delivery versus payment** (DVP) basis. In such a link, from the participant's perspective, securities and funds are passed simultaneously between counterparties. From the perspective of the linked CSDs, given current operational constraints, the transfer of funds and securities is likely to be neither simultaneous nor linked owing to timing constraints related to data transfers through the link and dependency on the underlying national payment systems.

EEA (Economic European Area) countries: the EU Member States and Iceland, Liechtenstein and Norway.

End-of-day: the time of the **business day** (after the closing of the TARGET system) at which the payments processed in the TARGET system have been finalised for the day.

End-of-day gross settlement systems: funds transfer systems in which payment orders are received one by one by the settlement agent during the business day, but in which the final settlement takes place at the end of the day on a one-by-one or an aggregate gross basis. This definition also applies to gross settlement systems in which payments are settled in real time but remain revocable until the end of the day.

Euro area: the area covering those EU Member States which have adopted the euro as the single currency in accordance with the Treaty.

Equity price risk: the risk of loss due to movements in equity prices. The ESCB will be exposed to equity price risk in its monetary policy operations to the extent that equities are considered to be eligible as underlying assets.

Exchange-for-value settlement system: a system which involves the exchange of assets, such as money, foreign exchange, securities or other financial assets, in order to discharge settlement obligations. These systems may use one or more funds transfer systems in order to satisfy the payment obligations that are generated. The links between the exchange of assets and the payment system(s) may be manual or electronic. See **delivery versus payment system**.

Final (finality): irrevocable and unconditional.

Final settlement: a settlement which is irrevocable and unconditional.

Final transfer: an irrevocable and unconditional transfer which effects a discharge of the obligation to make the transfer.

Fine-tuning operation: a non-regular open market operation executed by the central bank mainly in order to deal with unexpected liquidity fluctuations in the market.

Fixed-rate tender: a tender procedure where the interest rate is specified in advance by the central bank and participating counterparties bid the amount of money they want to transact at the fixed interest rate.

Foreign exchange rate risk: the risk of loss due to movements in exchange rates. The ESCB will be exposed to foreign exchange rate risk in its monetary policy operations to the extent that assets denominated in foreign currencies are considered to be eligible as underlying assets.

Foreign exchange swap: simultaneous spot and forward transactions of one currency against another. The ESCB will execute open market monetary policy operations in the form of foreign exchange swaps where the NCBs (or the ECB) buy (or sell) euro spot against a foreign currency and at the same time sell (or buy) it back forward.

Funds transfer system (FTS): a formal arrangement, based on private contract or statute law, with multiple membership, common rules and standardised arrangements, for the transmission and settlement of money obligations arising between the members.

Fungibility: a concept that characterises the method of holding securities by a CSD or another financial intermediary in which each of a number of issues of physical or dematerialised securities are held in separate fungible pools. No owner has the right to any particular physical or dematerialised security in a particular pool, but has a right to a given amount of physical or dematerialised securities as shown in its account with a CSD or another financial intermediary.

Gross settlement system: a transfer system in which the settlement of funds or securities transfers occurs individually on an order-by-order basis according to the rules and procedures of the system, i.e. without netting debits against credits. See real-time gross settlement.

Guarantee model: a model whereby NCBs would open securities accounts with one another and exchange guarantees with one another to cover credits extended by the domestic NCB on the basis of collateral deposited with another NCB in the euro area.

Haircut: the difference between the market value of a security and its collateral value. Haircuts are taken by a lender of funds in order to protect the lender, should the need arise to liquidate the collateral, from losses owing to declines in the market value of the security.

Initial margin: a risk control measure applied to underlying assets used in reverse monetary policy operations implying that the central bank provides liquidity only up to a limit set by the value of the underlying asset after deduction of the initial margin. The initial margin is expressed in relation to the value of the underlying assets provided by the **counterparty**. The ESCB will apply initial margins to assets underlying its monetary policy operations.

Interest rate risk: the risk of loss due to movements in interest rates. The ESCB will be exposed to interest rate risk in relation to its holdings of financial assets.

International CSD: a **central securities depository** that clears and settles international securities or cross-border transactions in domestic securities.

Intraday credit: credit extended and reimbursed within a period of less than one business day. The ESCB will extend intraday credit (based on underlying assets) to eligible **counterparties** for payment systems purposes.

Irrevocable and unconditional transfer: a transfer which cannot be revoked by the transferor and which is unconditional.

Issuer: the entity which is obligated on a security or other financial instrument.

Legal risk: the risk of loss due to the unenforceability of contractual arrangements, lawsuits or adverse judgements (including in proceedings relating to the insolvency of a **counterparty**). Such a loss may be caused either by errors, omissions or faults in legal procedures or operations, or by substantive legal difficulties or problems arising from the legal system of a country or group of countries relevant to the operation.

Liquidity risk: the risk that a **counterparty** (or a participant in a settlement system) will not settle an obligation for full value when due. Liquidity risk does not imply that a counterparty or participant is insolvent since he may be able to settle the required obligation some time thereafter.

Longer-term refinancing operation: a regular **open market operation** to be executed by the ESCB in the form of a reverse transaction. Longer-term refinancing operations are executed through monthly **standard tenders** and have a maturity of three months.

Main refinancing operation: a regular **open market operation** executed by the ESCB in the form of a **reverse transaction**. Main refinancing operations are executed through weekly **standard tenders** and have a maturity of two weeks.

Maintenance period: the period over which compliance with reserve requirements is calculated. The maintenance period for ESCB minimum reserves would be one month, starting on a fixed day of each month (e.g. the maintenance period may start on the 24th of each month and end on the 23rd of the following month).

Marginal interest rate: the interest rate at which the total tender allotment was exhausted.

Marginal lending facility: *ESCB* standing facility *which* **counterparties** *may use to receive overnight credit against a pre-specified interest rate.*

Marginal swap point quotation: the **swap point** quotation at which the total tender allotment was exhausted.

Marketable assets: assets, at least listed or quoted on a regulated market as defined according to the Investment Services Directive, or listed, quoted or traded on certain non-regulated markets (to be specified by the ECB).

Marking-to-market: *see* **variation margin.**

Master Foreign Exchange Swap Agreement: the agreement regulating the obligations of the ESCB and its counterparties in relation to ESCB **foreign exchange swap** operations.

Master Repurchase Agreement: the agreement regulating the obligations of the ESCB and its **counterparties** in relation to ESCB operations based on repurchase agreements.

Maturity date: the date on which a monetary policy operation expires. In the case of a **repurchase agreement** or swap, the maturity date corresponds to the **repurchase date**.

Maximum bid limit: the limit to the highest acceptable bid from an individual **counterparty** in a tender operation. The ESCB may impose maximum bid limits in order to avoid disproportionately large bids from individual counterparties.

Member State: refers in this document to a Member State of the European Union.

Minimum allotment: the limit to the lowest amount to be allotted to **counterparties** in a tender operation. The ESCB may decide to allot a minimum amount to each counterparty in its tender operations.

Monetary Financial Institution (MFI): a credit institution or other financial institution whose business is to receive deposits and/or close substitutes for deposits from the public and that, for its own account (at least in economic terms), grants credit and/or makes investments in securities.

Multiple-rate auction: an auction where the allotment interest rate (or price/swap point) equals the interest rate offered in each individual bid.

National central bank (NCB): refers in this document to the central bank of a Member State of the European Union which, after the start of Stage Three, will participate in the European System of Central Banks (ESCB).

Non-transferable assets: assets which for legal or administrative reasons are or can be neither deposited with a CSD nor held in an operational safe custody account with the central bank.

Obligation: a duty imposed by contract or law. It is also used to describe a security or other financial asset, such as a bond or promissory note, which contains the issuer's undertaking to pay the owner.

Open market operation: an operation executed at the initiative of the central bank in the financial markets involving either of the following transactions: 1) buying or selling assets outright (spot and forward); 2) buying or selling assets under a repurchase agreement; or 3) lending or borrowing against underlying assets as collateral.

Outright transaction: a transaction where the central bank buys or sells (spot and forward) assets outright in the market.

Principal risk: the credit risk that a party will lose the full value involved in a transaction. In the settlement process, this term is typically associated with exchange-for-value transactions when there is a lag between the final settlement of the various legs of a transaction (i.e. the absence of delivery versus payment). Principal risk that arises from the settlement of foreign exchange transactions is sometimes called cross-currency settlement risk.

Provisional transfer: a provisional or conditional transfer in which one or more parties retain the right by law or agreement to rescind the transfer.

Purchase date: the date on which the sale of purchased assets by the seller to the buyer becomes effective.

Purchase price: the price at which purchased assets are sold or are to be sold by the seller to the buyer.

Queuing: a risk management arrangement whereby transfer orders are held pending by the originator/deliverer or by the system until sufficient cover is available on the originator's/deliverer's clearing account or under the limits set against the payer; in some cases, cover may include unused credit lines or available collateral. See **caps**.

Quick tender: tender procedure used by the ESCB mainly for **fine-tuning operations** when it is deemed desirable to have a rapid impact on the liquidity situation in the market. Quick tenders are executed within a time frame of one hour and are restricted to a limited set of **counterparties**.

Real-time gross settlement (RTGS) system: a **gross settlement system** in which processing and settlement take place in real time (continuously).

Registration: the listing of ownership of securities in the records of the issuer or its transfer agent/registrar.

Remote access: the facility for a financial actor in his home country to become a direct participant in the financial system in another country without having a physical presence in that country (e.g. to an interbank **FTS** or a **CSD** established in another country or to the NCB's monetary policy operations in another country).

Remote payment: a payment performed by means of the sending of payment orders or payment instruments (e.g. by mail).

Repo operation: a liquidity-providing **reverse transaction** based on a **repurchase agreement.**

Repurchase agreement: an arrangement whereby an asset is sold while the seller simultaneously obtains the right and obligation to repurchase it at a specific price on a future date or on demand. Such an agreement is similar to collateralised borrowing, except that ownership of the securities is not retained. The ESCB will use repurchase agreements with a fixed maturity in its **reverse transactions.**

Repurchase date: the date on which the buyer is obliged to sell back assets to the seller in relation to a transaction under a **repurchase agreement**.

Repurchase price: the price at which the buyer is obliged to sell back assets to the seller in relation to a transaction under a **repurchase agreement**. The repurchase price equals the sum of the purchase price and the price differential corresponding to the interest of the extended liquidity over the maturity of the operation.

Reserve account: an account with the central bank on which a counterparty's **reserve holdings** are maintained. The **counterparties**' settlement accounts with central banks may be used as reserve accounts.

Reserve base: the sum of the eligible balance sheet items (in particular liabilities) which constitutes the basis for calculating the **reserve requirement** of an institution.

Reserve holdings: counterparties' holdings on their reserve accounts which serve to fulfil reserve requirements.

Reserve ratio: the ratio defined by the central bank for each category of eligible balance sheet items included in the reserve base. The ratios are used to calculate **reserve requirements.**

Reserve requirement: the requirement for institutions to hold minimum reserves with the central bank. The reserve requirement of an institution is calculated by multiplying the reserve ratio for each category of items in the reserve base by the amount of those items in the institution's balance sheets.

Reverse repo operation: a liquidity-absorbing **reverse transaction** based on a **repurchase agreement.**

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 system.**

Safe custody account: a securities account managed by the central bank on which credit institutions can place securities deemed suitable for the backing of central bank operations.

Same-day funds: money balances that the recipient has a right to transfer or withdraw from an account on the day of receipt.

Settlement account: an account held by a direct participant in the national **RTGS system** with the central bank for the purpose of processing payments.

Settlement institution(s): the institution(s) across whose books transfers between participants take place in order to achieve the settlement of transfers of funds or financial assets.

Settlement risk: the general term used to designate the risk that settlement in a transfer system will not take place as expected. This risk may comprise both credit and liquidity risk.

Single-rate auction: an auction at which the allotment interest rate (or price/swap point) applied for all satisfied bids is equal to the **marginal interest rate**.

Solvency risk: the risk of loss due to the failure (bankruptcy) of an issuer of a financial asset or due to the insolvency of the **counterparty**.

Standard tender: a tender procedure to be used by the ESCB in its regular open market operations. Standard tenders are carried out within a time frame of 24 hours. All **counterparties** fulfilling the general eligibility criteria are entitled to submit bids in standard tenders.

Standing facility: a central bank facility available to **counterparties** at their own initiative. The ESCB will offer two overnight standing facilities, the **marginal lending facility** and the **deposit facility.**

Start date: the date on which the first leg of a monetary policy operation is settled. The start date corresponds to the **purchase date** for operations based on **repurchase agreements** and **foreign exchange swaps.**

Structural operation: an **open market operation** to be executed by the ESCB mainly in order to adjust the structural liquidity position of the banking system vis-à-vis the ESCB.

Swap point: the difference between the exchange rate of the forward transaction and the exchange rate of the spot transaction in a **foreign exchange swap**.

Systemic risk: the risk that the failure of one participant in a transfer system, or in financial markets generally, to meet its required obligations will cause other participants or financial institutions to be unable to meet their obligations (including settlement obligations in a transfer system) when due. Such a failure may cause significant liquidity or credit problems and, as a result, might threaten the stability of financial markets.

TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) system: a payment system consisting of one **real-time gross settlement (RTGS)** system in each of the Member States participating in the **euro area** at the start of Stage Three of Economic and Monetary Union. The national RTGS systems will be interconnected through the Interlinking mechanism so as to allow same-day cross-border transfers throughout the euro area. RTGS systems of non-euro area Member States may also be connected to TARGET, provided that they are able to process euro.

Tier one asset: a marketable asset fulfilling certain uniform **euro area**-wide eligibility criteria specified by the ECB. Among these criteria are the requirement to be denominated in euro, to be issued (or guaranteed) by entities located in the **EEA**, and to be located in an **NCB** or **CSD** of the euro area.

Tier two asset: a marketable or non-marketable asset (of particular importance for a national financial market) for which eligibility criteria are established by **NCB**s, subject to ECB guidelines. Among the common minimum eligibility criteria are the requirement to be denominated in **EEA** currencies or other widely-traded currencies, to be issued (or guaranteed) by entities located in the EEA, and to be located within the EEA.

Trade date (T): the date on which a trade (i.e. an agreement on a financial transaction between two **counterparties**) is struck. The trade date might coincide with the value date for the transaction (same-day settlement) or precede the **value date** by a specified number of **business days** (the value date is specified as T + the settlement lag).

Trade netting: a consolidation and offsetting of individual trades into net amounts of securities and money due between trading partners or among members of a clearing system. A netting of trades which is not legally enforceable is known as a position netting.

Treaty: the Treaty establishing the European Community (or EC Treaty). It comprises the original EEC Treaty (Treaties of Rome) as amended by the Treaty on European Union (signed in Maastricht on 7 February 1992).

Unwinding (or settlement unwind): a procedure followed in certain **clearing and settlement systems** in which transfers of securities or funds are settled on a net basis, at the end of the processing cycle, with all transfers provisional until all participants have discharged their settlement obligations. If a participant fails to settle, some or all of the provisional transfers involving that participant are deleted from the system and the settlement obligations from the remaining transfers are then recalculated. Such a procedure has the effect of transferring liquidity pressures and possibly losses from the failure to settle to other participants, and may, in an extreme case, result in significant and unpredictable **systemic risks.**

Value date: the date on which a transaction is settled. The settlement might take place on the same day as the trade (same-day settlement) or can occur one or several days after the trade (the value date is specified as T + the settlement lag).

Variable-rate tender: a tender procedure whereby the **counterparties** bid both the amount of money they want to transact with the central bank and the interest rate at which they want to enter into the transaction.

Variation margin (or marking-to-market): the margin to be maintained over time for an underlying asset used in a reverse transaction. Variation margins are applied in order to reduce replacement cost exposures resulting from changes in market prices. This implies that if the market value of the underlying assets, following their revaluation, falls below the variation margin, counterparties have to supply additional assets to the central bank. The ESCB may apply variation margins to underlying assets used in its monetary policy operations.

Volume tender: see **fixed-rate tender**.

Zero-hour clause: a provision in the bankruptcy laws of some countries which may retroactively render transactions of a closed institution ineffective after 0.00 a.m. on the date on which the institution is ordered to be closed.