



EUROPEAN CENTRAL BANK

EUROSYSTEM

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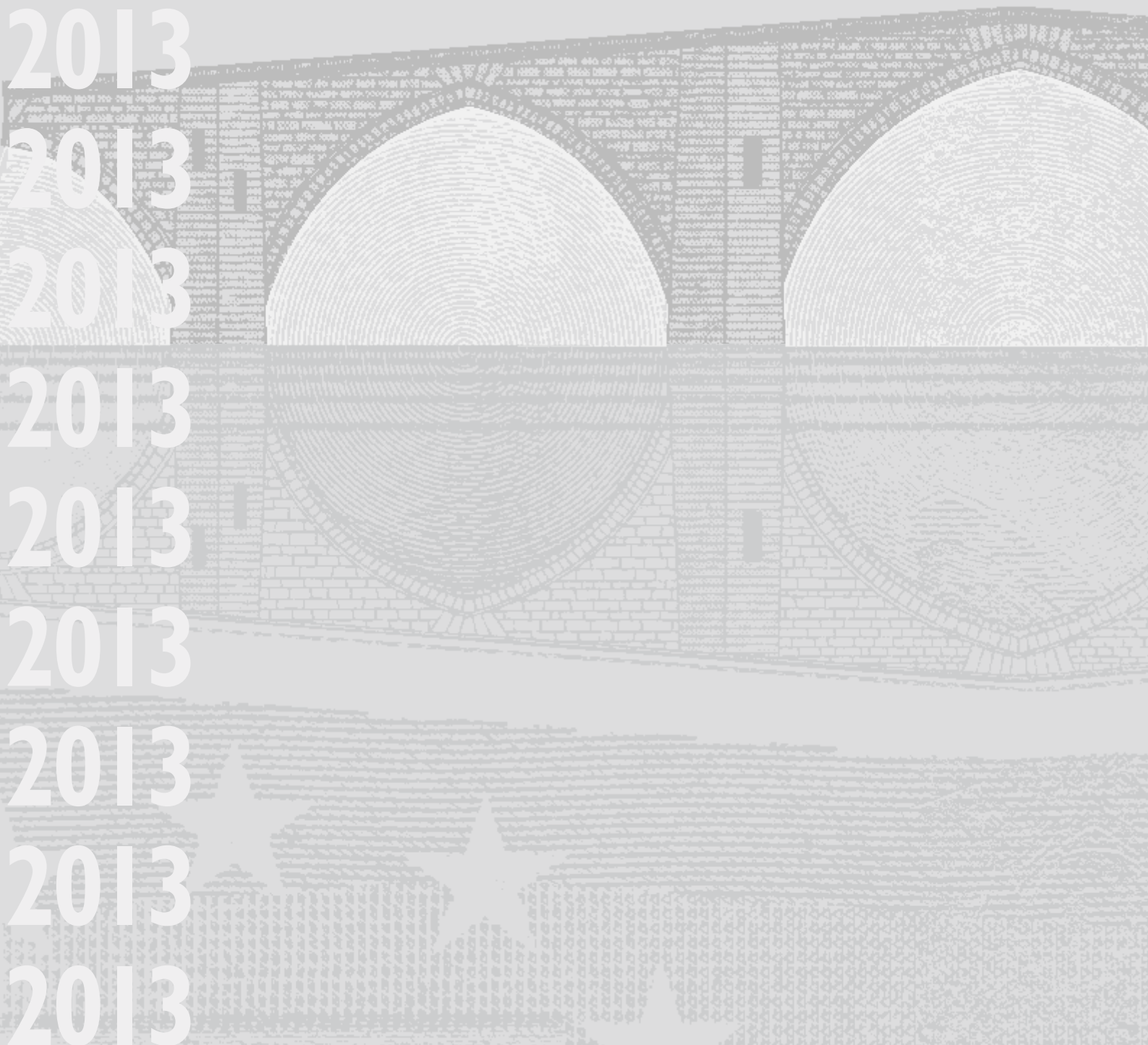
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ABBREVIATIONS

COUNTRIES

BE	Belgium
BG	Bulgaria
CZ	Czech Republic
DK	Denmark
DE	Germany
EE	Estonia
IE	Ireland
GR	Greece
ES	Spain
FR	France
HR	Croatia
IT	Italy
CY	Cyprus
LV	Latvia
LT	Lithuania
LU	Luxembourg
HU	Hungary
MT	Malta
NL	Netherlands
AT	Austria
PL	Poland
PT	Portugal
RO	Romania
SI	Slovenia
SK	Slovakia
FI	Finland
SE	Sweden
UK	United Kingdom
JP	Japan
US	United States

OTHERS

BIS	Bank for International Settlements
CPI	Consumer Price Index
EBA	European Banking Authority
ECB	European Central Bank
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pensions Authority
EMU	Economic and Monetary Union
ESA 95	European System of Accounts 1995
ESCB	European System of Central Banks
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
EUR	euro
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
ILO	International Labour Organization
IMF	International Monetary Fund
MFI	monetary financial institution
NCB	national central bank
OECD	Organisation for Economic Co-operation and Development
PPI	Producer Price Index
SSM	Single Supervisory Mechanism

In accordance with EU practice, the EU Member States are listed in this report using the alphabetical order of the country names in the national languages.

Unless stated otherwise, all references in this report to Treaty article numbers reflect the numbering in effect since the Treaty of Lisbon entered into force on 1 December 2009.

FOREWORD



In 2013 monetary policy continued to operate in a challenging environment characterised by ongoing, albeit moderating, financial fragmentation in the euro area. Underlying price pressures receded further amid broad-based economic weakness and continued subdued monetary dynamics. At the same time, medium to longer-term inflation expectations remained firmly anchored in line with the Governing Council's aim of keeping inflation rates below, but close to, 2% over the medium term, confirming the credibility of the ECB's monetary policy strategy.

Over the course of 2013 the euro area economy emerged from recession as a result of a gradual revival in domestic demand – supported by an accommodative monetary policy stance as well as by improving economic and financial market sentiment – and stronger foreign demand. However, the ongoing process of balance sheet adjustment in the public and private sector and high unemployment continued to dampen economic activity. Inflation declined perceptibly throughout 2013, reflecting, in

particular, receding contributions from energy and food prices, as well as weaker underlying price pressures. On average, inflation stood at 1.4% in 2013, after 2.5% in 2012. The underlying pace of monetary growth remained subdued and loan growth continued to decline, mainly on account of weak credit demand, although adverse factors weighing on credit supply also played a role. In the light of a weaker inflation outlook extending into the medium term, the Governing Council lowered key ECB interest rates in May and again in November, reducing the rate on the main refinancing operations to 0.25%.

Throughout the first half of 2013 euro area money market interest rates displayed significant volatility. Money market interest rates, in particular at the longer end of the term structure, rose markedly towards mid-2013, reflecting shifting expectations regarding future monetary policy and spillovers from developments outside the euro area. In order to anchor market expectations of interest rates more firmly around a path warranted by the outlook for price stability over the medium term, the Governing Council provided forward guidance in July, announcing that it expected the key ECB interest rates to remain at their prevailing or lower levels for an extended period of time. This message was confirmed over the remainder of the year, notably in the context of the November interest rate cut. In November the Governing Council decided that the Eurosystem would continue to provide liquidity to banks through fixed rate tender procedures with full allotment until at least mid-2015.

Financing conditions improved in 2013 amid an abating sovereign debt crisis on account of further fiscal consolidation, a reduction of macroeconomic imbalances particularly in vulnerable euro area countries, improved EMU governance and progress towards banking union. However, financial fragmentation along national borders persisted, particularly in credit markets. To ensure that monetary policy decisions are adequately transmitted to the real economy in euro area countries, it

is essential that the fragmentation of euro area credit markets declines further and that the resilience of banks is strengthened where needed. This confidence-building process will be enhanced by the comprehensive balance sheet assessment conducted by the ECB before it adopts its supervisory role under the Single Supervisory Mechanism. Further decisive steps by governments to establish banking union will help to restore confidence in the financial system.

Euro area countries continued to make progress with fiscal consolidation in 2013. The average government deficit is expected to have declined to around 3% of GDP, after 3.7% in 2012. With the entry into force of the “two-pack” regulations in May 2013, the euro area governance framework was strengthened further. Euro area governments are now required to submit their draft budgetary plans to the European Commission each autumn for a review of their compliance with the EU fiscal rules. This obligation greatly enhances transparency and aligns the European surveillance calendar more closely with national budgetary procedures. In its review of the submitted draft budgetary plans in October, the Commission found most plans to be at least broadly compliant with the fiscal rules. However, it identified a risk of non-compliance for some countries and invited the respective authorities to adopt additional measures to ensure full compliance.

Looking ahead, it will be important not to unravel past efforts but to sustain fiscal consolidation over the medium term, not least because general government debt-to-GDP ratios remain at high levels. Fiscal strategies should be in line with the fiscal compact. They should ensure growth-friendly consolidation which combines improving the quality and efficiency of public services with minimising distortionary effects of taxation. Governments also need to push ahead with product and labour market reforms, in order to improve competitiveness, raise potential growth, generate employment opportunities and foster the adaptability of the euro area.

Market tensions continued to recede in the course of 2013, in an environment of improved investor confidence and easing funding conditions for euro area banks and sovereigns. In particular, excess liquidity in the banking system declined owing to repayments by various Eurosystem monetary policy counterparties of part or all of the amounts that they had borrowed in the three-year longer-term refinancing operations (LTROs) conducted in late 2011 and early 2012. The option of early repayment was first made available to the banks in January 2013, and they made extensive use of this possibility over the course of the year. These early repayments marked a shift in the banking system’s demand for liquidity buffers, which by the end of 2013 had returned to levels last seen in autumn 2011, before the allotment of the first three-year LTRO. The Eurosystem’s stock of securities held for monetary policy purposes declined during the year owing to redemptions and to the absence of additional purchases. Moreover, in 2013 the Governing Council took various decisions related to the collateral which is eligible for use in monetary policy operations. In particular, the eligibility criteria were adjusted and the risk control framework was further strengthened.

Turning to financial stability developments, against the background of a challenging but improving macroeconomic environment, euro area financial sector stress remained moderate in 2013. Advances made on the regulatory front contributed to the building-up of higher capital and liquidity buffers in the banking sector, enhancing the banking system’s shock-absorption capacity and weakening the adverse feedback loops between banks and sovereigns.

The financial performance of large banking groups in the euro area remained subdued in the first three quarters of 2013, hampered by sluggish revenue growth and still elevated loan loss provisioning charges, which appear to be closely linked to the economic cycle and have been

particularly pronounced for banks in stressed countries. Despite relatively weak profitability, euro area banks have continued to steadily strengthen their capital positions. These improvements by euro area banks have been achieved through a combination of capital increases and reductions in risk-weighted assets, with the relative contribution of these two factors varying greatly across banking groups.

Conditions in bank funding markets improved, but fragmentation remains. Euro area banks' issuance of both senior unsecured and covered bonds remained below 2012 levels, even though average bank funding costs reached their lowest level for more than three years across all major debt instruments in early October. The funding situation of banks benefited from continued deposit inflows in most countries, including some reversal of the fragmentation that had previously exerted a negative effect on deposits in some countries under stress. Moreover, banks in most stressed countries continued to reduce their dependence on central bank funding.

Notwithstanding these advances, ongoing efforts are needed to remove the risk of further negative interactions, at the country level, among stressed sovereigns, diverging economic growth prospects and bank fragility. Further progress towards establishing banking union will make an important contribution to overcoming these hurdles.

A major step towards enhancing the resilience of the financial system in the EU was taken in 2013 with the implementation of the new international standards of the Basel Committee on Banking Supervision on capital and liquidity (Basel III) in the EU through the Capital Requirements Regulation and Directive (CRR/CRD IV). The provisions of the Regulation are directly applicable in all Member States as of 1 January 2014. They form a "single rulebook" for financial regulation and supervision across the EU, thus ensuring equal regulatory treatment of institutions providing financial services in the Single Market and enhancing financial integration in Europe. The Single Supervisory Mechanism (SSM) will also rely on the single rulebook, which will ensure the harmonised application of rules within the euro area and in other Member States participating in the SSM. The SSM will become operational in November 2014.

The Single Resolution Mechanism (SRM) will be the next step towards banking union. The European Commission proposed legislation in July 2013 which foresees a single European authority and a single bank resolution fund for all EU Member States that participate in banking union. The entry into force of the regulation is envisaged in mid-2014, and the SRM should become fully operational from 2015.

The SSM together with the SRM will help to break the link between banks and sovereigns in participating Member States and reverse the current process of financial market fragmentation.

An effective SRM also requires a comprehensive set of enforceable tools and powers, as provided for in the Bank Recovery and Resolution Directive (BRRD), on which agreement was reached between the European Parliament, EU Member States and the European Commission on 12 December 2013. The BRRD is expected to enter into force in 2015, and the bail-in tool will be effective as of 1 January 2016 at the latest.

In 2013 the European Systemic Risk Board (ESRB), the EU body responsible for the macro-prudential oversight of the EU financial system, devoted significant resources to further developing the macro-prudential policy framework, resulting in particular in the ESRB Recommendation on intermediate objectives and instruments of macro-prudential policy of

4 April 2013. The introduction of the CRR/CRD IV regulatory package for the EU banking sector also called for a series of preparatory and implementing measures by the ESRB, which were carried out in cooperation with ESRB members. In July 2013 the ESRB published a handbook on the follow-up to its recommendations, which was first used to assess the implementation of the ESRB Recommendation on lending in foreign currencies. The results of the assessment showed that Member States had complied well with the Recommendation. Furthermore, the review of the European System of Financial Supervision (which includes the ESRB) is ongoing.

In the area of payment systems and financial market infrastructures, the ECB continued to contribute to the key policy and regulatory initiatives aimed at enhancing the stability of market infrastructures, including legislative initiatives at the EU level. The ECB also contributed to the work of the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions, in particular with respect to the Principles for Financial Market Infrastructures and the resolution and recovery of such infrastructures, as well as to work in the field of over-the-counter derivatives market infrastructures. Furthermore, in the area of retail payments oversight, the Eurosystem defined oversight expectations for links between retail payment systems, and the Forum on the Security of Retail Payments developed security requirements for payments over the internet.

The ECB also continued to facilitate the creation of an integrated European retail payments market, and a significant proportion of euro direct debits and credit transfers are now SEPA-compliant. An important milestone in the TARGET2-Securities (T2S) project was reached in 2013, as the work on developing the software for T2S was completed. A testing phase is now under way to ensure that the T2S platform starts operating in June 2015 as scheduled. Agreement was also reached on the dates for the migration of central securities depositories (CSDs) and their users to T2S, which will take place in four waves between June 2015 and February 2017. The total number of CSDs participating in T2S increased to 24, as two further CSDs signed the T2S Framework Agreement. The continual growth of the T2S community demonstrates the significant impact that T2S will have on the post-trade infrastructure in Europe.

Turning to organisational issues, the ECB had 1,907 full-time equivalent permanent positions at the end of 2013, compared with 1,450.5 positions at the end of 2012. The increase is mainly due to positions approved in 2013 in relation to the establishment of the SSM. In accordance with the ECB's mobility policy, 308 members of staff moved internally to other positions in 2013, while 12 members of staff were seconded to other organisations for external work experience and 62 were granted unpaid leave to study or take up employment with another organisation, or for personal reasons. In 2013 the ECB's human resources strategy focused on working culture, gender diversity, recruitment, professional development and employment conditions. One of the main developments in the area of HR policies was the implementation of a gender diversity action plan designed with the aim of doubling the share of women in high-ranking positions at the ECB in the medium term.

Work on the new ECB premises neared completion in 2013, with the double office tower reaching its final height of 185 m in March. By the end of the year, good progress had been made on the technical infrastructure and fit-out of the standard office floors. The entrance building took shape and now clearly marks the main entrance to the ECB. Restoration works on the Grossmarkthalle roof and west wing progressed. The relocation of ECB staff is planned for the second half of 2014.

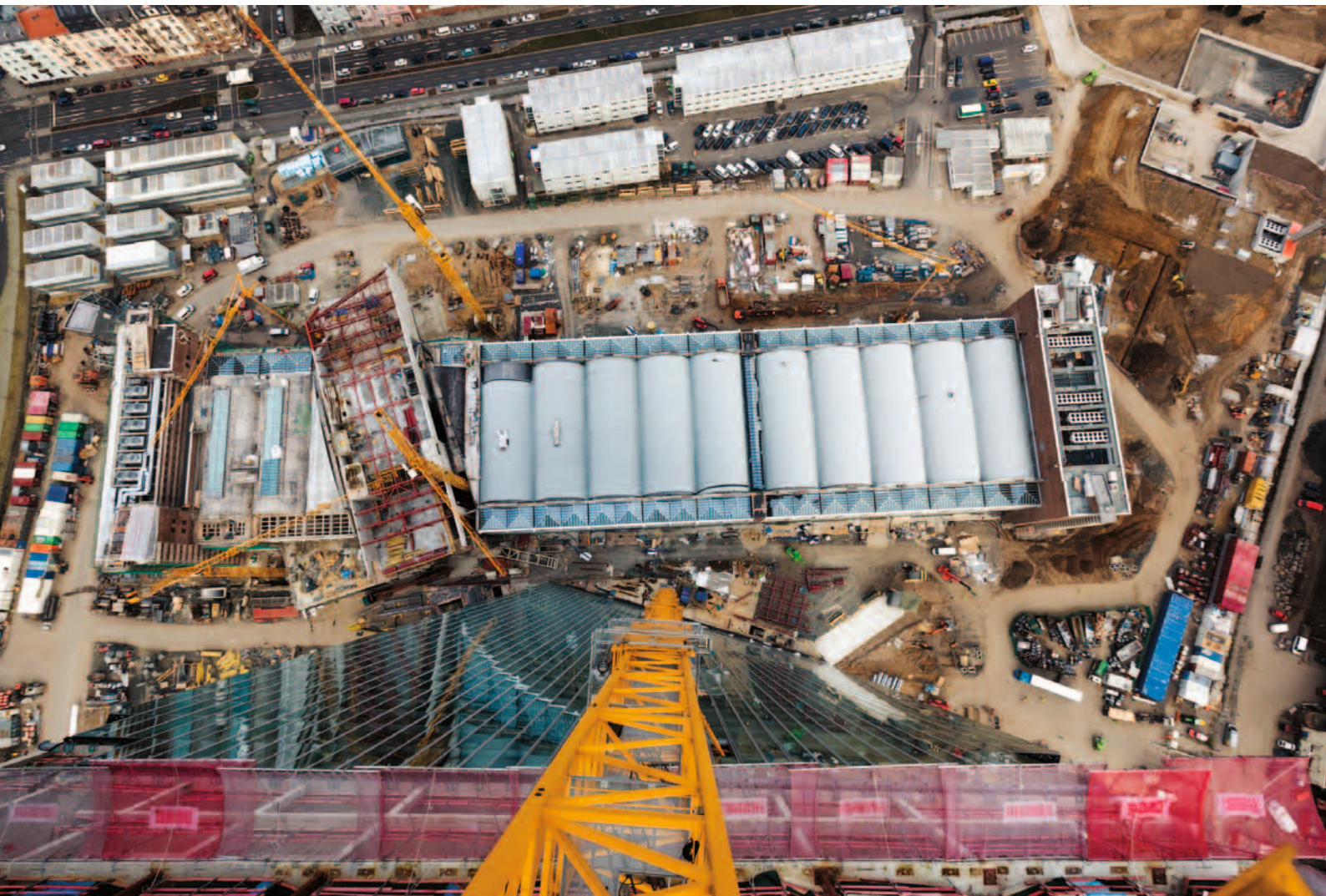
Regarding its financial accounts, the ECB earned a surplus of €1,440.2 million in 2013, compared with a surplus of €2,161 million¹ in 2012. The Governing Council decided to transfer, as at 31 December 2013, an amount of €0.4 million to the provision for foreign exchange rate, interest rate, credit and gold price risks, thereby increasing it to its ceiling of €7,529.7 million, which was the value of the ECB's capital paid up by the euro area NCBs as at that date. The size of this provision is reviewed annually. The ECB's net profit for 2013, following the transfer to the provision, was €1,439.8 million. The remaining amount of €1,430.3 million was distributed to the euro area NCBs in proportion to their paid-up shares in the ECB's capital.

Frankfurt am Main, March 2014



Mario Draghi

¹ As restated owing to a change in accounting policies.



In 2013 visible progress was made on the construction of the new ECB premises. The structural works for all of the new building elements were completed in the spring and the concrete shells of the Grossmarkthalle's roof had been fully restored by the end of the year. The interior of the large market hall has now also taken on a new splendour.

CHAPTER I

ECONOMIC DEVELOPMENTS AND MONETARY POLICY

I MONETARY POLICY DECISIONS

THE MONETARY POLICY ENVIRONMENT IMPROVED BUT REMAINED CHALLENGING

In 2013 the Eurosystem conducted its monetary policy in an environment which remained challenging, despite improvements in economic confidence, financial market sentiment and financing conditions. The level of stress in financial markets had been easing since the summer of 2012 on the back of the non-standard monetary policy measures undertaken by the ECB, the reform efforts made in several euro area countries, and progress towards a stronger euro area economic governance framework. Funding constraints for euro area banks continued to ease over the course of 2013, including for financial institutions in stressed countries. At the same time, a substantial degree of financial market segmentation along national borders persisted. Overall, while financial fragmentation continued to recede in the course of 2013, it remained elevated, resulting in significant heterogeneity in financing conditions for households and firms across euro area countries.

The ongoing process of balance sheet adjustment in the financial and non-financial sectors, combined with high unemployment and ongoing fiscal consolidation, continued to dampen economic activity in the euro area in 2013. At the same time, receding financial market tensions, improving economic confidence and a pick-up in foreign demand allowed output to stabilise in the second quarter after six quarters of contraction. The recovery, which gradually took hold over the second half of the year, also encompassed domestic demand. For the year as a whole, real GDP nonetheless declined by 0.4%.

Average annual HICP inflation stood at 1.4% in 2013 – with inflation declining perceptibly over the course of the year from 2.2% in December 2012 to 0.8% in December 2013 – as compared with the annual average of 2.5% in 2012. Low euro area inflation rates mainly reflected a strong decline in energy and food price inflation. The outlook for inflation was also revised downwards during the year in a context of weak economic activity. At the same time, medium and long-term inflation expectations remained firmly anchored at levels consistent with the Governing Council's aim of keeping inflation rates below, but close to, 2% in the medium term.

Monetary and, in particular, credit dynamics remained subdued throughout 2013. M3 growth overall weakened in the course of the year, reaching an annual average rate of 2.4%, as compared with 3.1% in 2012. Loans to the private sector contracted again during 2013, reflecting in particular net redemptions of loans to non-financial corporations. To a large extent, subdued loan dynamics reflected the weak economic situation and outlook, heightened risk aversion and the ongoing adjustment in the balance sheets of households and enterprises, all of which continued to weigh on credit demand. Furthermore, in a number of euro area countries, pressure on banks to further deleverage remained high. Despite substantial improvements in the funding situation of banks since the summer of 2012 and an increase in economic confidence, credit supply continued to be restricted by capital constraints, the segmentation of financial markets and risk perception.

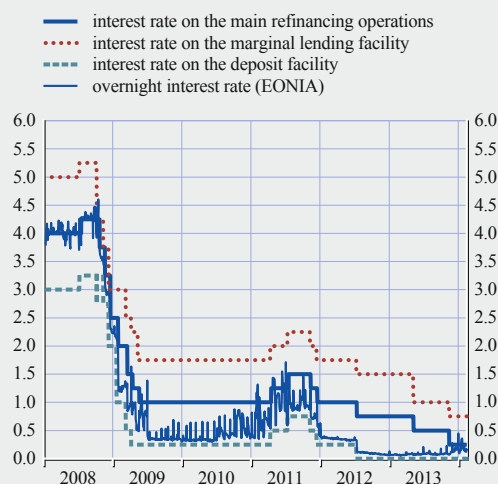
DIMINISHED INFLATIONARY PRESSURES LED TO TWO FURTHER CUTS IN KEY ECB INTEREST RATES

To ensure price stability in an environment of low underlying price pressures over the medium term, and to support the gradual economic recovery, the Governing Council cut key ECB interest rates twice in the course of 2013. In May it cut the interest rate on the main refinancing operations

by 25 basis points and the interest rate on the marginal lending facility by 50 basis points. In November, given the overall subdued outlook for inflation extending into the medium term, the Governing Council cut both the interest rate on the main refinancing operations and the interest rate on the marginal lending facility by a further 25 basis points. Policy rates were then kept at their historically low level of 0.25% for the main refinancing rate, 0.00% for the rate on the deposit facility and 0.75% for the rate on the marginal lending facility for the remainder of the year (see Chart 1). The Governing Council confirmed that the ECB's monetary policy stance would remain accommodative for as long as necessary, given its expectations of a prolonged period of low inflation, to be followed by a gradual upward movement towards inflation rates below, but close to, 2% later on.

Chart 1 ECB interest rates and the overnight interest rate

(percentages per annum; daily data)



Sources: ECB and Thomson Reuters.

In order to anchor market expectations of future policy interest rates more firmly around a path warranted by its assessment of the outlook for price stability over the medium term, the Governing Council decided in July 2013 to provide forward guidance, stating that it expected the key ECB interest rates to remain at their prevailing or lower levels for an extended period of time (see Box 1). It confirmed this message over the remaining months of the year. The Governing Council's expectations continued to be based on an overall subdued outlook for inflation extending into the medium term, given the broad-based weakness of the economy and subdued monetary dynamics.

Box 1

THE ECB'S FORWARD GUIDANCE

On 4 July 2013 the Governing Council of the ECB announced that it expected the key ECB interest rates to remain at present or lower levels for an extended period of time. The expectation of the Governing Council was based on an overall subdued outlook for inflation extending into the medium term, given the broad-based weakness of the economy and subdued monetary dynamics. This communication provided a form of forward guidance on the monetary policy orientation of the Governing Council, conditional on the assessment of risks to price stability. Following the initial announcement, the forward guidance provided in July was confirmed in its original formulation throughout the second half of the year. Notably, forward guidance was reasserted after the monetary policy decisions of 7 November 2013, which were taken in full consistency and continuity with that formulation. This box reviews the objectives, the design and the market impact of forward guidance.

Objectives

The Governing Council's decision to provide forward guidance was motivated by the need to align more firmly market expectations concerning the future evolution of the key ECB interest rates with the Governing Council's conditional policy orientation. The decision taken by the Governing Council on 4 July came after a period in which euro money market interest rates had been rising consistently and had become more volatile. This market trend had led to a situation in which the accommodation introduced earlier through policy action had effectively been reduced. Moreover, the increased volatility in money market rates had made expectations of the effective stance overly sensitive to shocks that were disconnected from the underlying economic and monetary conditions of the euro area. In addition to shifting market expectations regarding future monetary policy decisions and changes in the expected future path of excess liquidity, spillovers from developments originating outside the euro area were a key factor driving money market rates at that time. In these circumstances, more precise communication about the monetary policy orientation of the Governing Council was aimed at promoting steadier money market conditions and anchoring market expectations about future policy rates more firmly around a path warranted by the Governing Council's assessment of the outlook for price stability over the medium term.

Design

The Governing Council's forward guidance, in full accordance with the ECB's mandate and its monetary policy strategy, was designed around three main elements.

First, the Governing Council's expected path for the key ECB interest rates was based on the medium-term outlook for inflation, in line with the ECB's primary objective to maintain price stability. Second, the extended period of time referred to by the Governing Council was a flexible horizon which did not pre-specify an end-date but was conditional on the Governing Council's assessment of the economic and monetary developments that determine the outlook for price stability. Third, the underlying conditions upon which the expectations regarding the key ECB interest rates were based reflected the ECB's approach to organising, evaluating and cross-checking the information relevant for assessing risks to price stability. In particular, this approach comprises the analysis of both economic and monetary developments, which provides a robust assessment of the medium-term outlook for price stability.

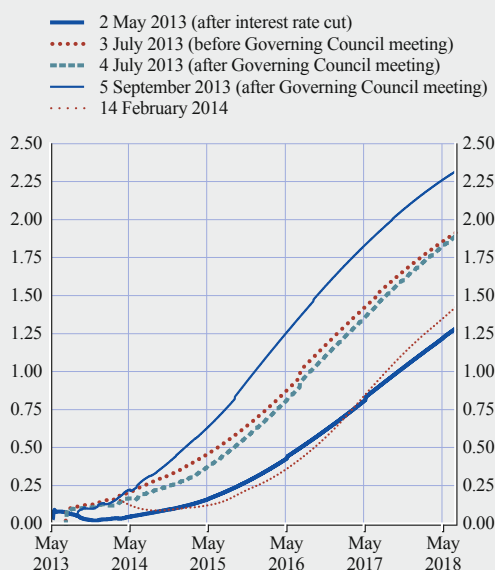
Notably, the Governing Council decided to provide forward guidance before having exhausted the potential for further reductions in key ECB interest rates. By reducing uncertainty around the expected path of future interest rates, forward guidance can provide a firmer control over market expectations independently of the prevailing stance of monetary policy. In fact, the ECB's forward guidance entailed the possibility to reduce key ECB interest rates further if warranted by the evolving outlook for price stability. The Governing Council's decision of 7 November 2013 to lower the interest rate on the main refinancing operations of the Eurosystem and the rate on the marginal lending facility, while leaving the deposit facility rate unchanged, was thus consistent with the conditionality of the 4 July statement. The confirmation of forward guidance after the November monetary policy decisions contributed to amplifying the accommodative impact of the interest rate reduction by facilitating its transmission to longer-term money market rates and to a broad set of financial market conditions.

Market impact

The announcement of forward guidance on 4 July 2013 led to an immediate flattening of the money market curve (see Chart A), with forward rates declining by around 5 basis points at maturities of more than six months. In the months following the introduction of forward guidance, however, the forward curve started to steepen, reflecting positive economic news and data releases within and outside the euro area. The slope of the forward curve reached a new high in September, before flattening in a sustained manner, notably as a consequence of the November monetary policy decisions.

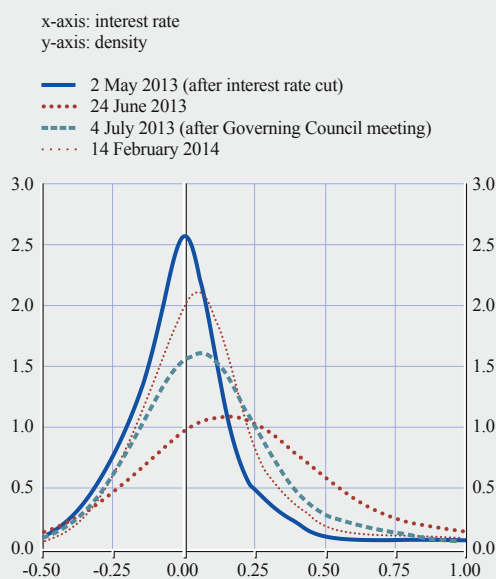
In parallel, forward guidance has led to a lasting decline in market uncertainty about the path of future short-term interest rates. Implied densities extracted from EURIBOR options show that the dispersion of short-term rate expectations has declined visibly from the elevated levels observed in June to a level closer to that observed in early May 2013 (see Chart B). On 2 May, after the Governing Council had reduced key ECB interest rates, market expectations of future interest rates one year ahead were concentrated around low levels. Thereafter uncertainty about future money market rates increased. With greater probability attached to higher levels, the mean expectation also increased, reaching its peak on 24 June. The forward guidance announcement subsequently led to a renewed narrowing of the dispersion of market expectations towards lower interest rate levels, accompanied by a downward shift in the mean expectation.

Chart A EONIA forward rates



Sources: Thomson Reuters and ECB calculations.
Note: Data as at end of day.

Chart B Uncertainty about future short-term money market rates



Sources: NYSE Liffe, Thomson Reuters and ECB calculations.
Note: Option-implied density of three-month EURIBOR in 12 months' time applied to three-month overnight index swap rate in 12 months' time.

Overall, the evidence suggests that forward guidance has helped to provide greater clarity and transparency with regard to the Governing Council's policy intentions, conditional on the evolving outlook for price stability. It also appears to have contributed to more stable money market conditions and to have anchored expectations more firmly. Therefore, forward guidance has successfully supported the ECB in the pursuit of its mandate to maintain price stability in the euro area over the medium term.

Against the background of the monetary policy measures adopted throughout the year, the Governing Council considered that price developments remained in line with price stability over the policy-relevant horizon in an environment of weak economic growth, well-anchored medium-term inflation expectations and subdued monetary dynamics. Risks to the outlook for price stability were seen to be broadly balanced.

NON-STANDARD MONETARY POLICY MEASURES ADOPTED IN 2013

Substantial early repayments of the three-year longer-term refinancing operations (LTROs) conducted in late 2011 and early 2012 meant a reduction in excess liquidity which, given remaining tensions in funding markets for banks, exerted some upward pressure on money market rates. To continue to ensure that solvent banks would not face liquidity constraints, especially once the three-year LTROs matured, the Governing Council announced in November 2013 that the Eurosystem would continue to provide liquidity to banks through fixed rate tender procedures with full allotment in all refinancing operations until at least 7 July 2015.

MONETARY POLICY TRANSMISSION IMPROVED BUT REMAINED UNEVEN ACROSS COUNTRIES

The effects of the two cuts in key ECB interest rates in 2013 as well as of forward guidance worked directly through term money market rates as there was little scope for a further reduction in overnight rates: for most of 2013 excess liquidity kept very short-term rates close to the rate on the deposit facility (which had been reduced to 0.00% in July 2012).

The non-standard monetary policy measures adopted in 2011 and 2012 continued to contribute to a more effective transmission of the ECB's interest rate measures in 2013. These non-standard measures included the two three-year LTROs conducted in late 2011 and early 2012, and the announcement by the Governing Council in the summer of 2012 of its readiness to undertake Outright Monetary Transactions (OMTs) in secondary markets with regard to sovereign bonds in the euro area.¹ The measures helped to alleviate tensions in financial markets and reduced tail risks and uncertainty. They thereby contributed to a sustained improvement in financing conditions, evidenced, for example, by a continued decline in the government bond yields of countries under stress and the issuance of new bonds by banks, companies and sovereigns which for some time had not had access to markets.

¹ In order to address severe distortions in the pricing of sovereign debt in some euro area countries, in particular related to unfounded concerns on the part of investors about the reversibility of the euro, the Governing Council announced in August 2012 its readiness to undertake OMTs in secondary markets with regard to sovereign bonds in the euro area. OMTs had not been activated by the end of 2013, but the Eurosystem remains ready to undertake them under certain conditions (outlined in detail in Section 1.1 of Chapter 2 of the ECB's Annual Report 2012). The Governing Council will independently consider conducting OMTs to the extent that they are warranted from a monetary policy perspective in the event of market fragmentation (subject to the aforementioned conditions). OMTs are aimed at supporting the transmission mechanism in all euro area countries and the singleness of the monetary policy. They provide a fully effective backstop to avoid destructive scenarios with potentially severe challenges for price stability in the euro area.

Although bank lending rates for households and non-financial corporations generally decreased at the euro area level in 2013, reflecting the pass-through of the cuts in key ECB interest rates as well as the improvement in financial market conditions, cross-country heterogeneity remained high. The lingering fragmentation of financial markets along national borders continued to hinder an even transmission of monetary policy in the euro area. As a result, the cuts in policy rates were largely passed on in some countries, but the interest rates charged on bank loans to the real economy decreased only slightly in other countries.

In order to ensure the adequate transmission of monetary policy to the financing conditions in euro area countries, it is essential that the fragmentation of euro area credit markets declines further and that the resilience of banks is strengthened where needed. The ECB's comprehensive assessment of banks' balance sheets before it adopts its supervisory role under the Single Supervisory Mechanism will further support this confidence-building process. It will enhance the quality of information available on the condition of banks and result in the identification and implementation of necessary corrective actions. Further decisive steps to establish banking union will help to restore confidence in the financial system. However, the root causes of the crisis are still to be fully addressed. In this context, governments should maintain their efforts to reduce deficits and sustain fiscal adjustment over the medium term. They should also decisively strengthen efforts to implement the needed structural reforms in product and labour markets to make their economies more competitive, and continue to improve the institutional setting of EMU.

2 MONETARY, FINANCIAL AND ECONOMIC DEVELOPMENTS

2.1 THE GLOBAL MACROECONOMIC ENVIRONMENT

GLOBAL RECOVERY CONTINUED AT A SLOW PACE IN 2013

The global economy continued to grow at a modest pace in 2013, with the recovery slowly gaining some traction yet remaining fragile and heterogeneous across countries as the year progressed. In the early part of the year, survey indicators signalled sustained momentum in global economic growth, with the Purchasing Managers' Index (PMI) for global all-industry output hovering slightly above 52.9, the average in the final quarter of 2012. The continuous strengthening of business sentiment, albeit from low levels, along with improved global financial conditions, pointed to a gradual recovery in advanced economies and more solid growth in emerging market economies. The data releases for the final quarter of 2012 and the first half of 2013 largely confirmed the pattern of continuing global recovery, which, however, remained muted and uneven. In advanced economies, growth stabilised in the first half of 2013, while in emerging market economies, contrary to expectations of gathering momentum, economic activity slowed again after rebounding at the end of 2012.

As the year unfolded, a number of negative surprises in both sentiment and hard data underscored the fragility of the recovery and the uncertainty surrounding the global outlook. In May the suggestion by the Chairman of the US Federal Open Market Committee of the likelihood that the Federal Reserve System would be tapering its asset purchase programme triggered a period of heightened uncertainty and renewed volatility in global financial markets. These developments resulted in tighter financing conditions, particularly for some emerging market economies, and a

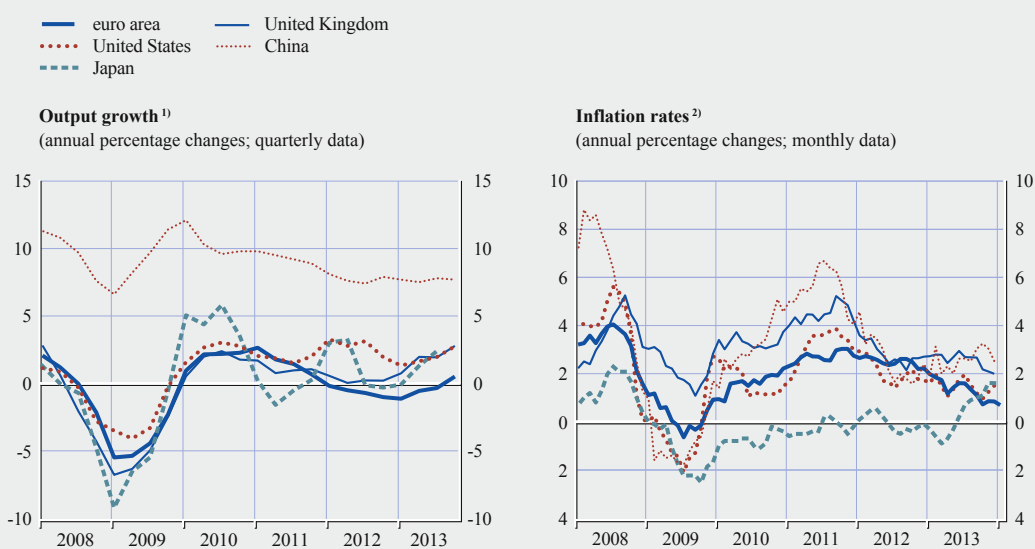
significant sell-off in global financial assets. Box 2 discusses the role of country vulnerabilities in the repricing of risk in emerging market economies and reviews the euro area's exposure to these economies. The tightening of global financial conditions during the summer, coupled with weaker domestic demand and a still subdued external environment, weighed on activity in emerging market economies, weakening their short-term growth prospects.

In the second half of 2013 a gradual shift in growth dynamics in favour of advanced economies was observed. The pace of growth steadily firmed in most major advanced economies, although their medium-term prospects continued to be restrained by ongoing balance sheet repair, fiscal consolidation, relatively tight credit conditions and weak labour markets. Meanwhile, growth in a number of large emerging market economies lost some vigour, also owing to structural impediments, but remained robust compared with that in advanced economies and contributed significantly to global economic activity. Social unrest and geopolitical tensions in a number of Middle Eastern and North African countries also stifled growth.

Overall, global growth momentum remained slow, wavering and persistently divergent across countries. By the end of the year, however, data releases and survey indicators were both showing tentative signs of a gradual firming of global economic activity. The normalisation of global financing conditions in the second half of the year, after the adoption of forward guidance policies by the ECB and the Bank of England and the US Federal Open Market Committee's decision to taper its asset purchases at a measured pace, seems to have removed some market uncertainty and supported global growth dynamics (see Chart 2).

World trade picked up from the very low levels recorded during the second half of 2012 but continued to be characterised by moderate and volatile quarterly growth. Following several months of solid readings in the first half of 2013, short-term trade indicators weakened again at the end

Chart 2 GDP growth and inflation in major economies



Sources: National data, BIS, Eurostat and ECB calculations.

1) Eurostat data are used for the euro area and the United Kingdom; national data are used for the United States, China and Japan. GDP figures have been seasonally adjusted.

2) HICP for the euro area and the United Kingdom; CPI for the United States, China and Japan.

of the summer, before recovering in the last months of the year. Overall, the volume of world imports of goods grew by an average of 0.8% quarter on quarter in the first three quarters of 2013, compared with 0.4% in 2012, gaining more vigour from September onwards, according to data from the CPB Netherlands Bureau of Economic Policy Analysis. At the end of 2013 all available short-term trade indicators pointed to a more sustained recovery in global trade, with the PMI new export order index recording its highest values since March 2011. Nevertheless, trade momentum is expected to remain subdued and below its pre-crisis levels in the near term.

Regarding price developments, the slowdown in global inflation that has been observed since 2011 continued in 2013, although it masked mixed developments across countries. A number of factors, including muted commodity price dynamics and weak global economic activity, as reflected in still ample global spare capacity and high unemployment, ensured that inflationary pressures remained contained. In the OECD area, average headline consumer price inflation fell to 1.6% in 2013, from 2.2% in 2012, largely driven by lower energy and food prices. The decline was broadly based across advanced economies, with the exception of Japan, where inflation rose (see Chart 2). Average OECD consumer price inflation excluding food and energy fell to 1.5% from 1.8% in 2012. Rates of inflation varied more among emerging market economies over the course of the year. Annual inflation rates were relatively modest in China but remained elevated in some other large emerging market economies. The weak global and domestic environment, coupled with moderations in food and energy prices, helped to dampen price increases, although currency depreciation from the middle of the year increased inflationary pressures in some emerging market economies.

Box 2

IMPLICATIONS FOR THE EURO AREA OF CHANGING FINANCIAL CONDITIONS IN EMERGING MARKET ECONOMIES

In 2013 significant changes in financing conditions were witnessed across a number of countries. Emerging markets were particularly affected, as an episode of risk repricing that had already been observed in some of these countries in early 2013 was amplified by the US Federal Reserve System signalling in May that it might taper its asset purchase programme later in the year. The vulnerability of some emerging economies to changes in global investor sentiment became exposed when their asset markets and currencies underwent considerable corrections, resulting in a tangible tightening of the financing environment with negative repercussions on their growth dynamics.

Against this background, this box attempts to gauge potential negative implications for the euro area of the deterioration in economic and financial conditions in emerging markets. It finds that the emerging markets most susceptible to the risk reassessment that took place during 2013 are characterised by significant domestic and external vulnerabilities. The euro area's exposure to these latter countries via various transmission channels is relatively limited.

The role of vulnerabilities in the repricing of emerging market risk

Following a global sell-off of emerging market assets immediately after the Federal Reserve System's announcement in May 2013, investors adopted a more nuanced stance over the

remainder of the year. Their focus shifted to countries that were perceived to be particularly vulnerable to possible further disruptions to capital flows, which resulted in additional declines in the latter's equity, bond and currency markets. Countries with significant domestic and/or external imbalances, such as Brazil, India, Indonesia, South Africa and Turkey, therefore generally saw the largest deterioration in their financing environment.

Investor perceptions of domestic or external vulnerabilities of this group of countries are substantiated by a range of indicators. These economies stood out at the end of 2012 as being potentially susceptible to a worsening of global funding conditions (see the table). Turkey exhibited domestic vulnerabilities, such as very strong credit growth, and external imbalances, above all a substantial current account deficit largely financed by short-term portfolio flows and an unfavourable ratio of short-term external debt to foreign exchange reserves. India, South Africa and – to a lesser extent – Brazil and Indonesia had twin (fiscal and current account) deficits. These were combined in the latter three countries with a dependence on volatile portfolio investment (South Africa) or excessive credit growth (Brazil and Indonesia). However, some economies that seem to have been equally vulnerable on the basis of the same metrics were generally less affected by global market volatility. This points to the relevance of other factors shaping investors' views on emerging economies, such as exposure to a slowdown in Chinese output, the capacity to benefit from the gradual recovery of economic activity in the euro area or the vigour with which governments have addressed existing imbalances, for example by implementing fiscal consolidation or structural reforms.

Selected indicators of external and domestic vulnerabilities

	External indicators				Domestic indicators	
	Current account balance	Portfolio inflows ¹⁾	Short-term external debt	Total external debt	Fiscal balance	Credit-to-GDP gap ²⁾
	(as a percentage of GDP)	(as a percentage of total capital inflows)	(as a percentage of foreign reserves)	(as a percentage of GDP)	(as a percentage of GDP)	(percentage points)
	2012	2010-12	2012	2012	2012	2012
Czech Republic (CZ)	-2.4	36.0	58.3	50.5	-4.4	n. a.
Hungary (HU)	1.7	-48.3	83.0	130.3	-2.0	-16.5
Poland (PL)	-3.5	53.4	97.6	74.4	-3.9	1.0
Romania (RO)	-4.4	45.7	121.8	75.7	-2.5	n. a.
Russia (RU)	3.7	6.2	32.7	28.6	0.4	-2.7
Turkey (TR)	-6.1	41.8	147.7	42.8	-1.6	11.7
China (CN)	2.3	7.3	17.6	9.0	-2.2	13.4
India (IN)	-4.8	22.9	44.3	21.2	-8.0	3.4
Indonesia (ID)	-2.7	34.2	50.7	29.4	-1.7	12.8
Malaysia (MY)	6.1	63.8	39.1	27.1	-4.5	5.5
South Korea (KR)	3.8	88.7	39.4	36.2	1.9	3.4
Taiwan (TW)	10.5	n. a.	28.8	27.5	-4.3	n. a.
Thailand (TH)	0.0	29.6	41.6	36.4	-1.7	26.2
Argentina (AR)	0.0	14.0	272.9	32.0	-4.3	2.9
Brazil (BR)	-2.4	24.8	21.3	14.1	-2.7	10.2
Mexico (MX)	-1.2	66.0	67.3	29.2	-3.7	3.4
South Africa (ZA)	-6.3	54.6	79.6	35.8	-4.8	-4.9

Sources: IMF, BIS, national sources, Haver Analytics and ECB calculations.

1) Portfolio investment liabilities incurred in the period 2010-12 as a percentage of all (foreign direct, portfolio and other) investment liabilities incurred.

2) Deviation of the credit-to-GDP ratio from its one-sided (real-time) long-term trend. Data for Argentina, Mexico and South Africa refer to the first half of 2012.

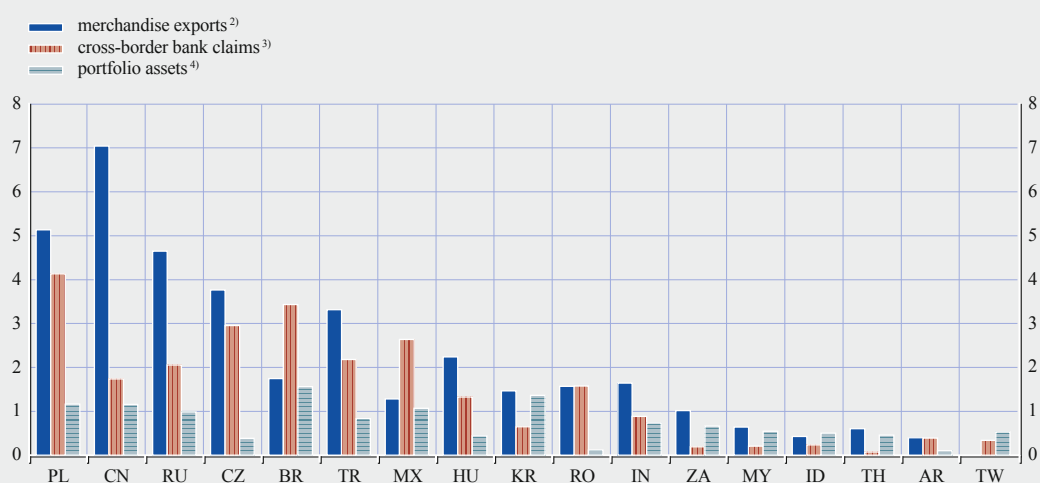
Euro area exposure to vulnerable emerging markets

The direct transmission to the euro area of deteriorating economic and financial conditions in emerging markets is likely to be relatively contained. The euro area's trade and financial ties with most emerging economies are fairly limited, a few noteworthy exceptions notwithstanding (see the chart). Moreover, its exposure to individual emerging markets is generally highest for countries which seem to have been least affected by global financial developments in 2013. However, besides direct implications for the euro area of slower growth in emerging markets, indirect effects may also play a role. For example, a fall in commodity prices as a result of lower demand from emerging economies could improve the euro area's terms of trade, although it might also put additional downward pressure on inflation. Furthermore, euro area foreign demand might be affected via indirect trade linkages if a slowdown in output growth in emerging markets were to affect economic activity in the euro area's major trading partners among the advanced economies.

Looking at financial linkages in more detail, euro area portfolio investment in emerging economies is negligible. According to data from the IMF's Coordinated Portfolio Investment Survey, Brazil, China, Poland and South Korea are the only countries where the euro area's share of total portfolio assets held abroad is over 1.0%. Cross-border bank claims, while mostly more significant than portfolio flows, predominantly involve certain countries in central and eastern Europe (such as Poland with 4.0% of total claims and the Czech Republic with 3.0%) and Latin America (particularly Brazil with 3.6% and Mexico with 2.8%). As regards trade linkages, emerging market countries in close proximity to the euro area generally feature most prominently, with merchandise exports to Poland (5.1%), Russia (4.7%), the Czech Republic

Euro area exposure to emerging market economies¹⁾

(percentages of total exposure)



Sources: IMF, BIS and ECB calculations.

Notes: Merchandise export data are unavailable for Taiwan. For country abbreviations, see the table above. Countries in the chart are ranked according to the sum of euro area exposure via merchandise exports, cross-border bank claims and portfolio assets.

1) Net of intra-euro area exposure.

2) As a percentage of total merchandise exports in 2012.

3) As a percentage of total cross-border bank claims as at the third quarter of 2013; data for the euro area include Belgium, Germany, Greece, Spain, France, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland.

4) As a percentage of global assets in 2012.

(3.8%) and Turkey (3.3%) constituting a large share of the total. An outlier in this respect is China, which takes 7.0% of euro area merchandise exports.

Among the countries that were considered most vulnerable by investors during 2013 and that consequently witnessed a substantial deterioration in their economic and financial conditions, only Turkey and Brazil account for significant shares in the euro area's exposure to emerging markets, via trade (Turkey) and cross-border bank flows (Brazil and Turkey). The shares of India, Indonesia and South Africa are very small.

UNITED STATES

The recovery in the US economy continued in 2013, although at a slower pace than in the previous year. Real GDP growth stood at 1.9%, compared with 2.8% in 2012. Growth in 2013 was supported by a strengthening in private domestic demand, reflecting continued improvements in the housing and labour markets, supportive financial conditions resulting in positive wealth effects from rising stock and house prices, and accommodative monetary policy. In addition, inventory accumulation and, to a lesser extent, net trade also contributed positively to real GDP growth. The current account deficit narrowed to 2.4% of GDP in the first three quarters of the year, from 2.7% in 2012. By contrast, higher taxes, as enshrined in the fiscal agreement of January 2013, and the automatic across-the-board spending cuts (the “sequester”) enacted in March, remained a drag on economic activity throughout the year.

In the first half of the year economic activity remained sluggish, against the backdrop of continued declines in government consumption related to the aforementioned government spending cuts, subdued private non-residential investment and weak exports. Nevertheless, private consumption expenditure was resilient during the same period, with higher taxes and sluggish income growth being more than offset by an improvement in the labour market and substantial positive wealth effects owing to rising stock and house prices. Private residential investment also remained quite robust on the back of a resilient recovery in the housing sector. Real GDP accelerated in the second half of 2013, with particularly strong growth in the third quarter. Economic activity, however, lost some momentum towards the end of the year on account of two main factors. The increase in long-term interest rates, starting in May, when the Federal Reserve suggested it might slow the pace of asset purchases later in the year, resulted in a tightening of financial conditions, which dampened somewhat the housing market recovery. In addition, the government shutdown following the political brinkmanship over the debt limit extension in October, with the associated rise in uncertainty, weighed on domestic demand. Meanwhile, labour market momentum remained quite resilient in the second half of 2013, although the year ended with a substantial deceleration in the pace of job creation, partly reflecting severe weather conditions in December. The unemployment rate continued to trend down in the course of the year, owing partly to continued declines in the labour force participation rate.

Average annual CPI inflation declined to 1.5% in 2013, from 2.1% in 2012, owing to lower energy prices and considerable spare capacity, which kept underlying price pressures contained. In the first half of 2013 CPI inflation hovered between 1.1% and 2%, affected by substantial volatility in the energy component, while food prices exhibited a slightly downward trend. Through most of the second half of 2013, annual CPI inflation declined as the strong positive base effects of energy prices waned. Excluding food and energy, CPI inflation stood at 1.8% in 2013, after 2.1% in 2012.

The US Federal Open Market Committee (FOMC) of the Federal Reserve System kept its target for the federal funds rate unchanged within a range of 0% to 0.25% throughout 2013, in an environment of moderate economic and employment growth and inflation running below the Committee's longer-term objective. The FOMC announced that exceptionally low levels for the federal funds rate would be appropriate at least as long as the unemployment rate remained above 6.5%, inflation between one and two years ahead was not projected to be above 2.5% and longer-term inflation expectations continued to be well anchored. The FOMC decided to continue purchasing additional agency mortgage-backed securities at a rate of USD 40 billion per month and longer-term Treasury securities at a rate of USD 45 billion per month. Furthermore, the Committee maintained its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities. With these actions, the FOMC expected to maintain downward pressure on longer-term interest rates with a view to supporting mortgage markets and to help make broader financial conditions more accommodative. In June the FOMC reaffirmed Chairman Bernanke's remarks before the US Congress Joint Economic Committee in May that, later in the year, the FOMC could slow the pace of asset purchases should the economy continue to improve as expected. It stated that it expected its asset purchase programme to end in mid-2014. Nevertheless, taking into account the extent of federal fiscal retrenchment in the period to September and the prevailing fiscal policy uncertainty, the Committee announced in September that it would wait for more evidence of sustained progress in economic activity and labour market conditions before adjusting the pace of its asset purchases. On 18 December the Committee decided to ease the pace of its asset purchases slightly, given the cumulative progress towards maximum employment and the improvement in the outlook for labour market conditions. The FOMC announced that, from January 2014 onwards, it would add to its holdings of agency mortgage-backed securities at a rate of USD 35 billion per month, rather than USD 40 billion, and to its holdings of longer-term Treasury securities at a rate of USD 40 billion per month, instead of USD 45 billion. The Committee stated that it would likely reduce its asset purchases in further measured steps at future meetings, conditional on the FOMC's assessment of economic developments.

As regards fiscal policy, the federal budget deficit declined significantly to 4.1% of GDP in fiscal year 2013, from 6.8% in the previous year.² Federal debt held by the public increased to stand at 72.1% of GDP at the end of 2013, compared with 70.1% at the end of 2012. A large part of the reduction in the fiscal deficit in 2013 was due to a political agreement on tax and spending reforms (the American Taxpayer Relief Act) in early January, which mainly included revenue-raising measures, and to the across-the-board spending cuts enacted in March. However, political uncertainty over the most appropriate fiscal path persisted throughout the year. Political and fiscal uncertainty reached a peak in October, stemming from the partial shutdown of non-essential government services, coupled with political brinkmanship over the extension of the debt limit. Although a political deal was reached to keep the government funded and the debt limit suspended to avoid a government default, fiscal uncertainty continued to cloud the short-term economic outlook. On 26 December 2013 President Obama signed into law a bipartisan budget deal to end some of the spending cuts under the sequester by raising the caps on discretionary spending for the next two fiscal years, replacing them with other sources of saving spread over ten years.

JAPAN

In Japan, economic activity rebounded during 2013, mainly driven by robust domestic demand. While growth was vibrant in the first half of the year, it lost momentum thereafter as net exports weighed on growth and private consumption slowed. In 2013 economic growth was supported by a

² Fiscal years in the United States run from October of the previous year to September of the reference year.

more accommodative monetary and fiscal policy as part of the government's new growth strategy. This strategy is intended to move Japan away from persistent deflation and to boost the country's trend growth through three distinct pillars: (i) Quantitative and Qualitative Monetary Easing (QQE) by the Bank of Japan, (ii) a fiscal stimulus implemented at the start of 2013, followed by a commitment to fiscal consolidation over the medium term, and (iii) structural reform to boost productivity and labour force growth.

On 4 April 2013 the Bank of Japan unveiled the details of the QQE, while it discontinued the Asset Purchase Program announced earlier in January. In the context of the QQE, the price stability target of 2% in terms of the year-on-year rate of change in the CPI by 2015 was reaffirmed by the central bank through a doubling, by the end of 2014, of the monetary base, which will rise at an annual rate of JPY 60-70 trillion. Year-on-year CPI inflation turned positive in June, before climbing to 1.6% in December, the highest level since 2008. In addition, year-on-year CPI inflation excluding food, beverages and energy also increased, rising to 0.7% in December from -0.7% in January.

Regarding fiscal policy, an economic stimulus package announced at the start of 2013 was followed by commitments to halve the primary deficit – estimated at 7% for 2013 – by 2015 and to achieve a primary surplus by 2020. Meanwhile, the third pillar of the government's new growth strategy – structural reform – involves a series of initiatives to boost Japan's long-term growth rate through increased competition and the elimination of inefficiencies in the product market, as well as increased participation in the labour force. In addition to labour market reforms, an increase in private sector wages, scheduled for 2014, should help to reinforce higher prices, thus helping the Bank of Japan to reach its 2% inflation target.

EMERGING ASIA

The pace of economic activity in emerging Asia remained broadly steady in 2013, still below its long-term average. Although export growth rose somewhat amid the gradual recovery in advanced economies, stronger import growth led to a weaker contribution of net exports. Domestic demand remained resilient, supported by favourable credit and policy conditions, but lost vigour in the course of the year mainly owing to a tightening of monetary and fiscal policies in countries with structural problems (e.g. India and Indonesia). On account of stable commodity prices and a modest economic recovery, inflation was contained in 2013, with the exception of India and Indonesia, where weakening currencies led to increased inflationary pressures. With the US Federal Reserve System signalling its intention to taper its asset purchases, and against the backdrop of weak fundamentals, the currencies of both countries depreciated abruptly between May and August 2013, with significant capital outflows. In view of increasing inflationary pressures, India and Indonesia raised their policy rates, while most other central banks in emerging Asia maintained or cut their policy rates.

In China, real GDP growth was 7.7% in 2013, unchanged from the previous year. Although economic activity was relatively weak in the first half of 2013, it gained strength in the second half of the year supported by, among other factors and policy measures, the introduction of a small fiscal stimulus package. Investment was the main driver of growth, followed closely by consumption, while net exports made a small negative contribution. Residential housing sales grew solidly during the year but construction activity was more subdued, depleting the stock of unsold housing and leading to sustained price increases. A weak international environment continued to weigh on the economy. Growth in trade in goods remained moderate, with exports growing by 7.8% and imports

by 7.3% year on year, far below the growth rates seen prior to the crisis. As a result, the current account surplus stood at 2.1% of GDP. In mid-November economic policy priorities for the next ten years were unveiled. The priorities aim to increase the role of market forces in the economy, which should help reduce domestic imbalances and set economic growth on a more sustainable path.

Annual consumer price inflation was unchanged from 2012 at 2.6%. However, producer price inflation remained negative, declining further to -1.9% compared with -1.7% in 2012. Monetary policy rates and reserve requirements remained unchanged in 2013. Credit expansion continued to be strong, with the growth of bank loans declining only marginally, while total social financing decreased more markedly especially towards the end of the year.

The renminbi continued to appreciate during 2013, although the pace of appreciation declined towards the end of the year. China's foreign exchange reserves grew, amounting to 41% of GDP at the end of the year. On 8 October 2013 the ECB and the People's Bank of China established a bilateral currency swap arrangement (see also Section 1.2 of Chapter 2).

LATIN AMERICA

Economic activity in Latin America continued to recover overall in 2013, albeit at a rather subdued pace and unevenly across major economies. Domestic demand continued to be the main driver of growth in the region, while external demand acted as a drag on activity especially at the beginning of the year owing to the slowdown in the world economy and, in particular, in the euro area and the United States. For the region as a whole, year-on-year real GDP growth stood at 2.9% in the first half of 2013, slightly below the average of 3.1% in 2012. In the second half of the year economic growth lost momentum owing to constraints on the domestic side, although foreign demand showed signs of improvement.

In Brazil, the largest economy in Latin America, the recovery continued at a slow pace. Private consumption remained subdued amid high inflation, moderating consumer credit growth and somewhat less favourable labour market conditions, while external demand contributed negatively to growth. Year-on-year real GDP growth rose to 2.4% on average in the first three quarters of 2013, compared with 0.8% in the first three quarters of 2012. In Mexico, the economy slowed significantly in 2013, reflecting weakness in public and private investment and in external demand. In Argentina, the economic indicators released later in the year suggested activity had weakened after the unexpectedly strong growth in the first half of the year.

Financial market instability, together with persistent inflationary pressures, prompted the Banco Central do Brasil to increase interest rates by 275 basis points to 10% between April and November, partially reversing the previous cycle of interest rate cuts. Against this background and owing to a moderation in food prices, annual consumer price inflation eased to 5.9% in December, after standing at 6.7% in June, above the upper bound of the central bank's inflation target. Overall in the region, average annual consumer price inflation increased from 6.1% in 2012 to 7.5% in 2013, mainly owing to high inflationary pressures in Venezuela. After the US Federal Reserve System's announcement of a possible gradual withdrawal of monetary stimulus, financial markets went through a period of significant volatility between May and August, as reflected in exchange rate depreciations, capital outflows and a decline in equity prices.

MODERATE DYNAMICS IN COMMODITY PRICES IN 2013

Brent crude oil prices were broadly stable in the course of 2013, fluctuating around USD 110 per barrel (see Chart 3). This marks a third consecutive year of record high Brent oil prices, at an annual average above USD 100 per barrel. In euro terms, oil prices declined by 3% in the course of 2013 owing to the appreciation of the euro.

Both demand and supply factors explain the relative stability of Brent oil prices. The economic slowdown in emerging market economies coupled with a muted recovery in advanced economies dampened growth in the demand for oil. Meanwhile, oil supplies were boosted by a rapid increase in US shale oil production, which pushed growth in non-OPEC supply to its highest annual rate since 2002. However, a large part of this supply remained concentrated in the United States, contributing to a build-up in oil inventories and pushing the US oil price benchmark (West Texas Intermediate) lower. By contrast, Brent oil prices remained high, especially in the second half of the year, owing to a number of severe supply interruptions in several OPEC countries (such as Libya, Iraq and Nigeria), which could not be offset by increased production by Saudi Arabia. In addition, renewed geopolitical tensions in the Middle East and North Africa added upward pressure on oil prices.

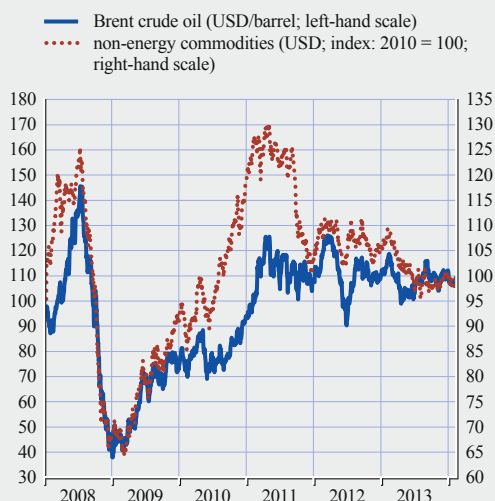
The prices of non-energy commodities, in aggregate terms, declined in 2013 (see Chart 3). Among the sub-components, cereal prices showed significant declines, owing to a strong rise in supply stimulated by the price peaks in the summer of 2012 and less adverse weather conditions in major exporting countries than during the previous year. Non-ferrous metal prices also declined, especially in the first half of the year, driven mainly by a slowdown in emerging market economies, particularly China. In aggregate terms, non-energy commodity prices (denominated in US dollars) were 4.9% lower at the end of 2013 than at the beginning of the year.

THE EFFECTIVE EXCHANGE RATE OF THE EURO STRENGTHENED OVER THE YEAR

Euro exchange rate developments in 2013 largely reflected evolving market expectations regarding the monetary policy stance in the euro area relative to other major economies. This was particularly evident in the first quarter of 2013, which was characterised by relatively pronounced fluctuations in the nominal effective exchange rate of the euro. Specifically, the euro appreciated by almost 4% in January 2013, stabilised in February and depreciated in March to the level observed at the start of the year (see Chart 4). Thereafter, the euro was temporarily broadly stable in an environment of low volatility in global foreign exchange markets. This trend came to a halt in mid-May, when markets began to consider that the US Federal Reserve System might start tapering its quantitative easing programme in the near future. Amid heightened tensions in global financial markets, coupled with pronounced capital outflows from some emerging market economies, the euro gradually appreciated until mid-September. Largely on account of better than expected data on economic activity in the

Chart 3 Main developments in commodity prices

(daily frequency)



Sources: Bloomberg and Hamburg Institute of International Economics.

Chart 4 Patterns in exchange rates and implied volatilities

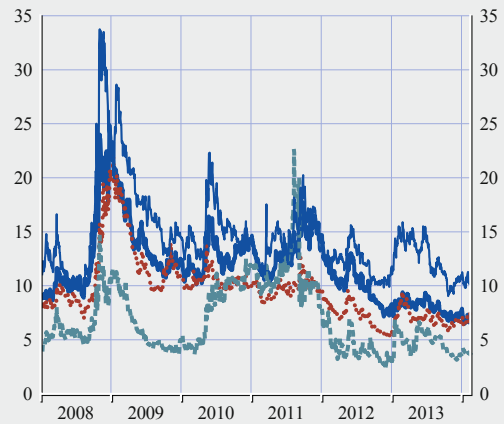
(daily data)

- USD/EUR (left-hand scale)
- GBP/EUR (left-hand scale)
- - - CHF/EUR (left-hand scale)
- JPY/EUR (right-hand scale)

Exchange rates



Implied exchange rate volatilities (three-month)



Sources: Bloomberg and ECB.
Note: The last observation is for 14 February 2014.

euro area, the euro exchange rate continued its upward trend in the latter part of 2013, while volatility in foreign exchange markets gradually abated (see Chart 4).

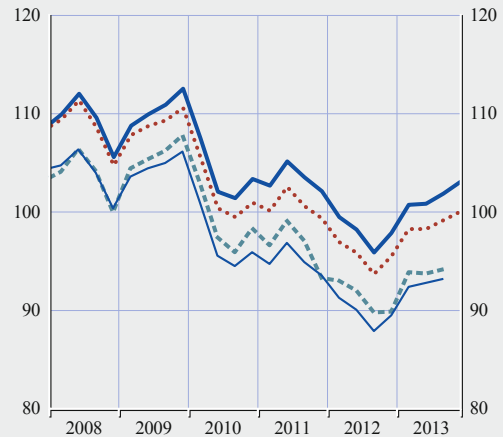
The nominal effective exchange rate of the euro, as measured against the currencies of 20 of the euro area's most important trading partners, appreciated markedly over the year (see Chart 5). By the end of 2013, in nominal effective terms, the euro stood 5.1% above its level at the end of 2012 and 3.9% higher than its average level since 1999. Against the US dollar, on 31 December 2013 the euro traded at USD 1.38, which was around 4.5% higher than at the end of 2012 and 7.3% above its average for 2012.

Regarding the currencies of the euro area's other major trading partners, the euro appreciated strongly against the Japanese yen and the currencies of large commodity-exporting economies. The strengthening of the euro against the yen occurred mainly in the first half of 2013, with the gradual build-up of expectations of a

Chart 5 Euro nominal and real effective exchange rates (EER-20)¹⁾

(quarterly data; index: Q1 1999 = 100)

- nominal
- real, CPI-deflated
- - - real, ULCT-deflated
- real, GDP-deflated



Source: ECB.

1) An upward movement of the EER-20 indices represents an appreciation of the euro. The latest observations are for the fourth quarter of 2013 for "nominal" and "real, CPI-deflated" and the third quarter of 2013 for "real, GDP-deflated" and "real, ULCT-deflated". ULCT stands for unit labour costs of the total economy.

shift in the Bank of Japan's monetary policy stance – eventually announced in April 2013 – towards fighting deflation and providing support to domestic demand. On 31 December 2013 the euro stood at JPY 145, 27% higher than at the end of 2012 and 41% above its 2012 average. Regarding the currencies of large commodity-exporting economies, the euro appreciated over the course of 2013 by 21% against the Australian dollar, by 12% against the Canadian dollar and by 14% against the Norwegian krone.

Against the pound sterling, the euro strengthened modestly, trading at GBP 0.83 at the end of 2013, around 2% above its level at the beginning of the year and 3% higher than its average level in 2012. Similarly, the euro appreciated modestly against the Asian currencies that are linked to the US dollar, including the Chinese renminbi (by 1.6%) and the Hong Kong dollar (by 4.6%). Against the Swiss franc, the euro appreciated but continued to trade close to the minimum exchange rate of CHF 1.20, which was unilaterally announced by the Swiss National Bank in September 2011. On 31 December 2013 the euro stood at CHF 1.23, 2% above its level at the end of 2012.

The real effective exchange rates of the euro based on different cost and price measures increased over the year. In the second half of 2013 they stood at levels above those prevailing at the end of 2012 (see Chart 5).

2.2 MONETARY AND FINANCIAL DEVELOPMENTS

SUBDUED UNDERLYING MONEY AND CREDIT GROWTH DURING 2013

Broad money growth declined over the course of 2013, thereby remaining at subdued levels. The annual growth rate of M3, which had stood at 3.5% in December 2012, decreased for most of the year. In December 2013 it was 1.0%. From a general perspective, monetary developments in the euro area were influenced by a number of factors. On the one hand, a reduced risk aversion and a search for yield by the money-holding sector led to considerable outflows from less liquid instruments included in M3 into riskier and longer-term assets. On the other hand, a strong preference for the most liquid instruments within M3 was observed in an environment of low interest rates, leading to robust growth in M1. This was also driven by a reduction in financial fragmentation and a return of confidence among international investors in the euro and euro area as well as by improvements in current account balances. In addition, it may have reflected other factors, such as regulatory changes that encourage banks to increase their reliance on retail deposit-based funding. The positive developments were supported by signs of an ongoing recovery in real activity, the low interest rate environment, in particular following the further reductions in key ECB interest rates in May and November, and reductions in risk premia on government bonds for a number of euro area countries. The Governing Council's announcements of its readiness to undertake Outright Monetary Transactions, changes in collateral rules for Eurosystem credit operations and forward guidance on the key ECB interest rates also contributed.

Improvements in financial markets and bank funding have not yet led to an increase in loans to the non-financial sector. The annual rate of change in loans to the private sector (adjusted for the impact of loan sales and securitisation activity) declined steadily in 2013, stabilising towards the end of the year and standing at -2.0% in December, compared with -0.2% in December 2012. In line with this development, the divergence observed since early 2012 in the annual growth rates of money and credit to the private sector persisted during 2013 (see Chart 6). At the same time, some of the funding pressures faced by MFIs have been alleviated by the non-standard measures adopted by the Governing Council over the past few years. These measures provided important backstops

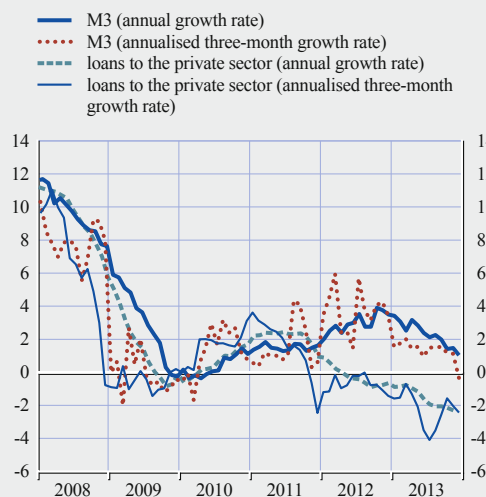
that limited a further strengthening of negative feedback loops between financial markets and the real economy. Taken together, developments in broad money and credit indicate that the pace of underlying monetary expansion declined in 2013. These developments reflect ongoing deleveraging.

PORTFOLIO CONSIDERATIONS REMAINED THE KEY DRIVER OF DEVELOPMENTS IN COMPONENTS OF M3

As regards the developments in the main components of M3, the uncertainties prevailing in financial markets and the accompanying preference for highly liquid deposits – against the background of very low policy and money market interest rates – manifested themselves mainly in a marked increase in the annual growth rate of M1. It rose to 8.6% in April 2013, from 6.4% in December 2012, before declining but remaining at an elevated level (5.7% in December 2013; see Chart 7). These portfolio reallocations took place amid a decline in the remuneration of other monetary assets contained in M3, with the effect of a reduction in the opportunity costs of holding highly liquid instruments (see Chart 8). This preference for liquidity points to a continued build-up of cash buffers by the money-holding sector.

Chart 6 M3 and loans to the private sector

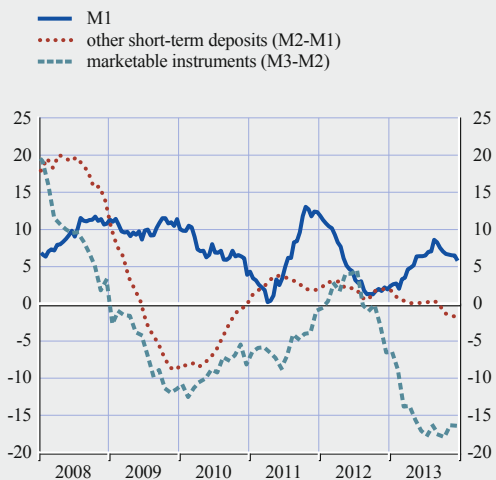
(annual percentage changes; adjusted for seasonal and calendar effects)



Source: ECB.

Chart 7 Main components of M3

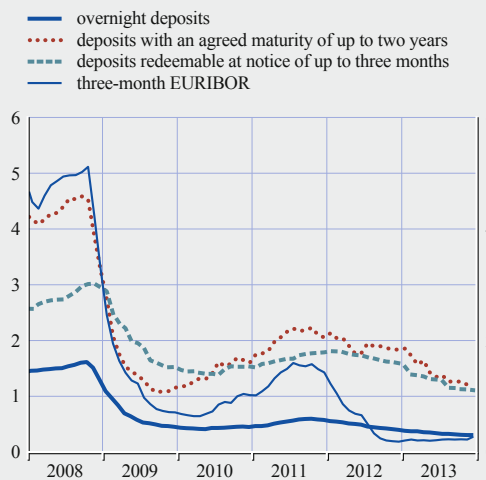
(annual percentage changes; adjusted for seasonal and calendar effects)



Source: ECB.

Chart 8 MFI interest rates on short-term deposits and the three-month EURIBOR

(percentages per annum)



Source: ECB.

The annual rate of change in marketable instruments declined further over the course of 2013, standing at -16.2% in December compared with -6.5% in December 2012. All three sub-components of marketable instruments registered a persistent decline, partly owing to regulatory changes that reduce banks' incentives to use market-based funding.

Repurchase agreements have in the past often been used by investors to temporarily park liquidity, but may have lost attractiveness in the light of an ongoing search for yield in instruments outside M3 (such as equity and mixed funds). 2013 also saw a sizeable reduction in the money-holding sector's holdings of short-term MFI debt securities (i.e. debt securities with an original maturity of up to two years), the annual rate of change of which declined substantially over the course of the year and stood at a negative double-digit level in December. Money market fund shares/units displayed a continuous decline over the course of 2013. This behaviour was related to remuneration considerations: in an environment of very low short-term interest rates, money market funds have not been in a position to generate significant returns for investors and have therefore experienced an ongoing reallocation of funds to other types of investment. The weak issuance of MFI debt securities and money market fund shares/units may also reflect regulatory changes encouraging banks to use deposit-based rather than market-based funding.

DEPOSIT HOLDINGS OF NON-FINANCIAL CORPORATIONS INCREASED

The annual growth rate of M3 deposits – which comprise short-term deposits and repurchase agreements and represent the broadest monetary aggregate for which reliable information is available at the sectoral level – decreased from 4.4% in December 2012 to 2.0% in December 2013.

As in the past, households were the largest contributor to this development. The annual growth rate of M3 deposits held by households declined over the course of 2013 from 4.4% in December 2012 to 2.0% in December 2013, notwithstanding the efforts of banks to increase deposit funding against the background of regulatory requirements and the considerable increase in deposit holdings in 2013 in a number of stressed countries, reflecting the return of confidence on the part of international investors as well as of domestic money-holding sectors in financial investment in the euro area. By contrast, the annual growth rate of M3 deposits held by non-financial corporations accelerated from 4.6% in December 2012 to 6.1% in December 2013. This may reflect a build-up of liquidity buffers, which are typically used as a first funding source at the start of a recovery. However, at least in some countries, it may also reflect an increased need for internal funding in the context of supply-side restrictions. Capital inflows from abroad, in part related to renewed interest in euro area assets on the part of international investors, supported this process.

Developments in M3 deposits also reflected the contribution made by non-monetary financial intermediaries other than insurance corporations and pension funds (referred to as “other financial intermediaries” or OFIs). The annual rate of change in M3 deposits held by OFIs decreased to -2.0% in December 2013 from 2.1% in December 2012, albeit with considerable fluctuations. From an economic perspective, the money demand behaviour of OFIs (which include investment funds and securitisation vehicles) can sometimes be very erratic, so its short-term dynamics should not be over-interpreted. Indeed, the money holdings of OFIs are often significantly affected by volatile conditions in financial markets and shifts in relative yields across a broad range of assets. At the same time, the behaviour of these investors endows their money holdings with early signalling properties for incipient trends in portfolio allocation which will only emerge with a lag in the money holdings of other sectors, such as households. The rate of change in deposits placed by general

government other than the central government declined markedly, from 9.0% in December 2012 to -3.0% in December 2013.

CONTRACTION IN CREDIT TO THE PRIVATE SECTOR

As regards the counterparts of M3, the annual rate of change in MFI credit to euro area residents declined to -2.0% in December 2013 from 0.5% in December 2012. This development was driven by a decrease in the annual rate of change in credit to both the general government and the private sector. The decrease in the annual rate of change in credit to general government, which stood at -0.7% in December 2013, reflected a decline in loans to general government, while demand for government debt securities remained positive. Overall, MFIs increased their holdings of government debt securities against a background of strong government issuance, subdued private sector dynamics and accommodative monetary conditions. Towards the end of the year, MFI holdings of government debt securities were affected by increased year-end deleveraging by some institutions positioning themselves ahead of the ECB's comprehensive assessment, which is based on the 31 December 2013 balance sheet.

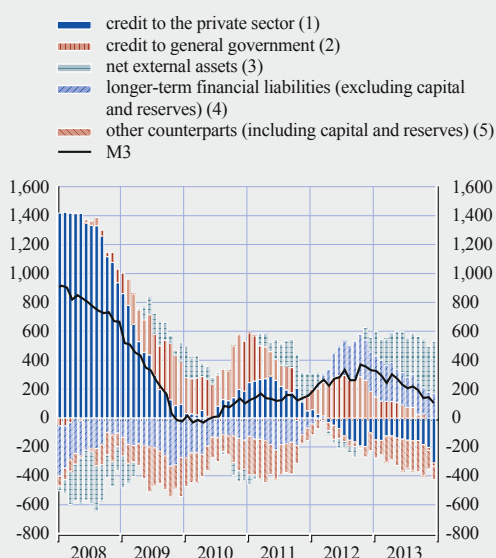
The growth profile of credit to the private sector generally mirrors that of loans, which are the main component of this aggregate. Credit to the private sector moved further into negative territory in 2013, with an annual rate of change of -2.4% in December, compared with -0.8% in December 2012. The annual rate of change in MFI loans to the private sector (adjusted for sales and securitisation) also declined over the year, standing at -2.0% in December 2013, compared with -0.2% in December 2012 (see Chart 9).

This pattern is broadly consistent with developments in economic activity and financial markets over the course of 2013, in particular as regards loans to non-financial corporations, which normally lag economic developments by about one year. Developments in loans to the non-financial private sector reflected those in its main components. While the annual rate of change in loans to households (adjusted for sales and securitisation) remained broadly unchanged throughout the year, the rate of change in loans to non-financial corporations (adjusted for sales and securitisation) declined further, but showed signs of stabilisation in late 2013. Loans to OFIs also declined, albeit with considerable volatility.

The annual growth rate of loans to households (adjusted for sales and securitisation), which stood at 0.7% in December 2012, remained broadly stable during 2013, standing at 0.3% in December. Factors behind the low growth include the weakness of economic activity, the prospects for the housing market and the need to deleverage (for more details on lending to households, see the section on household

Chart 9 Counterparts of M3

(annual flows; EUR billions; adjusted for seasonal and calendar effects)



Source: ECB.

Notes: M3 is shown for reference only ($M3 = 1+2+3-4+5$). Longer-term financial liabilities (excluding capital and reserves) are shown with an inverted sign, since they are liabilities of the MFI sector.

borrowing later in this chapter). At the end of the year, however, a pick-up in demand was reported in the euro area bank lending survey. The annual rate of change in loans to non-financial corporations (adjusted for sales and securitisation) stood at -2.9% in December 2013, having stabilised after following a declining path until late summer.

The weakness of bank lending reflects not only cyclical but also structural supply and demand factors, with some differences from country to country. The weak loan dynamics for non-financial corporations continue to reflect primarily their lagging relationship with the business cycle, credit risk and the ongoing adjustment of financial and non-financial sector balance sheets. This adjustment was visible in 2013, especially in certain countries, in strong issuance of securities by non-financial corporations. From a medium-term perspective, the need to reduce corporate indebtedness in a number of countries can be expected to continue to exert a negative influence on the demand for loans.

On the supply side, capital shortfalls and the continued (albeit receding) financial market fragmentation limited the supply of MFI credit to the economy. Overall, supply constraints seem to have lessened over the course of 2013 but remain present in a number of countries. The various non-standard monetary policy measures taken by the Governing Council have contributed to averting a disorderly deleveraging of the banking sector by alleviating the funding pressures on euro area credit institutions. The results of the December 2013 euro area bank lending survey tentatively signalled a stabilisation in credit conditions for firms and households.

Regarding the other counterparts of M3, the annual rate of change in MFI longer-term financial liabilities (excluding capital and reserves) held by the money-holding sector remained in negative territory in 2013, standing at -3.3% in December after -5.0% in December 2012. This development was driven by sizeable declines in the rates of change in longer-term deposits and longer-term debt securities, the latter reflecting banks' deleveraging and increased recourse to deposit funding relative to market funding. The outflows from longer-term deposits largely reflected a reversal of past securitisation activities.

Finally, the net external asset position of euro area MFIs – which captures the capital flows of the money-holding sector when routed via MFIs and the transfer of assets issued by the money-holding sector – increased strongly, by €361 billion, over the 12 months to December 2013, the largest inflow since the euro's inception. These flows reflect an improvement in the current account balances of a number of countries, as well as a renewed interest among international investors in euro area assets.

MONEY MARKET CONDITIONS IMPROVED IN 2013

Conditions in euro area money markets improved over the course of 2013. With the sovereign debt crisis abating, cross-border interbank markets started to reopen, although a substantial degree of market segmentation persisted.

Perceived credit and country risk continued to decline in 2013, reflecting a further increase in financial market confidence, reform efforts made in several euro area countries, progress towards a stronger euro area economic governance framework, and some improvement in the euro area macroeconomic outlook. The continued decline in perceived credit and country risk led to a gradual reduction in market segmentation, including in interbank markets. Furthermore, the normalisation of financial market conditions reduced the need for banks to hold precautionary liquidity buffers.

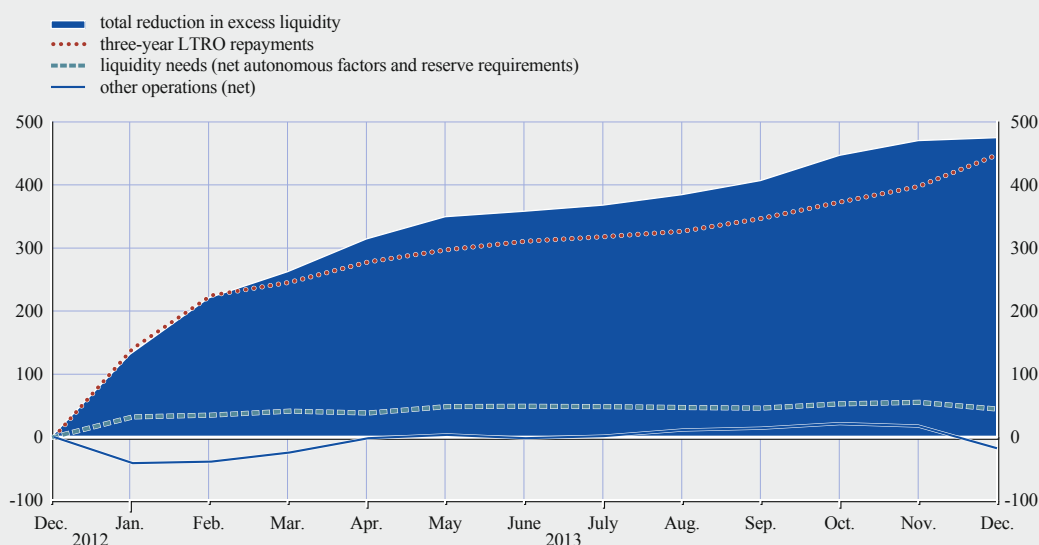
In this context of gradually receding financial and interbank market fragmentation, excess liquidity (defined as the liquidity provided in excess of the banking sector's liquidity needs, which are given by the sum of autonomous factors and reserve requirements) declined. Between 31 December 2012 and 30 December 2013, excess liquidity fell from €621 billion to €275 billion, a decline of €346 billion. A large part of this decline, €323 billion, was due to a reduced net recourse to Eurosystem refinancing operations. The remainder was due to an increase in autonomous liquidity factors, which was partially offset by a marginal decrease in reserve requirements resulting from a decline in the reserve base of credit institutions (see Chart 10).

The marked decline in net recourse to Eurosystem refinancing operations in the course of 2013 encompassed the following developments. From January 2013 counterparties began making use of the early repayment option embedded in the two three-year longer-term refinancing operations (LTROs) of December 2011 and February 2012. By the end of December 2013 counterparties had repaid 37% of the gross liquidity – or 85% of the €523 billion net liquidity – injected by the two three-year LTROs, with accelerated repayments occurring at the beginning and the end of 2013 (see Chart 10). Counterparties also substituted main refinancing operation (MRO) for LTRO funding. In particular, the acceleration of early LTRO repayments observed around the end of 2013 was associated with an increased recourse to other liquidity-providing operations – the MROs in particular – as well as with a reduced total value of bids in the Eurosystem's liquidity-absorbing fine-tuning operations. As a result, between November and December 2013 excess liquidity actually increased by €110 billion. However, large parts of that increase turned out to be only of a temporary nature, related as they were to the particularly tight money market conditions prevailing during the last maintenance periods of 2013.

The reductions in the MRO rate in May and November 2013 lowered the cost of Eurosystem funding and narrowed the gap between the MRO rate and the deposit rate. While this reduced incentives

Chart 10 Breakdown of excess liquidity absorption

(EUR billions; cumulative changes since December 2012)



Source: ECB.

Notes: All observations are averages over the respective maintenance periods. The 12th maintenance period of 2013 ended on 14 January 2014.

to repay, it did not affect the downward trend in excess liquidity. In this context, recourse to the deposit facility fell from an average of €238 billion in the last maintenance period of 2012 to an average of €60 billion in the last maintenance period of 2013. At the same time, the counterparties' current account holdings in excess of reserve requirements decreased from €384 billion to €145 billion.

Throughout most of 2013 the level of excess liquidity remained sufficiently high to keep very short-term money market rates close to the 0.00% deposit facility rate (see also Box 3). Nevertheless, the EONIA increased from 0.07% in December 2012 to 0.18% in December 2013 in maintenance period average terms. More generally, money market rates in 2013 were affected by a variety of factors. Shorter-term money market rates were driven by uncertainty about the future path of excess liquidity, particularly around the end of January 2013, when initial repayments of the first three-year

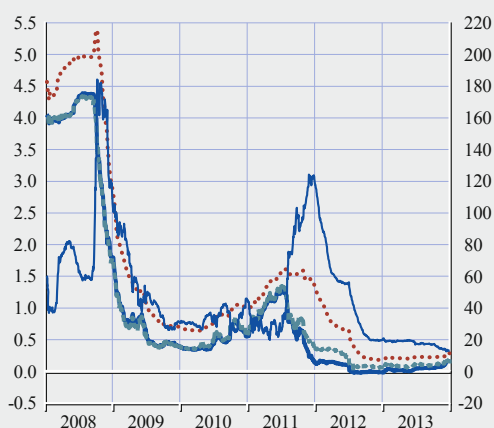
LTRO were very high. This factor became less important as repayments soon declined sharply from their very high initial levels. Longer-term money market rates fluctuated considerably owing to shifting expectations regarding future monetary policy and to spillovers from developments outside the euro area. Against this backdrop, the Governing Council introduced forward guidance in July 2013 to provide greater clarity on its monetary policy orientation (see Box 1). With the introduction of forward guidance, which was reinforced by the November 2013 Governing Council decision to lower the main refinancing rate to 0.25% and thereby narrow the effective corridor, volatility in longer-term money market rates declined.

Chart 11 shows the development of three-month unsecured interest rates (the three-month EURIBOR), three-month secured interest rates (the three-month EUREPO), and the three-month overnight index swap rate over the course of 2013. After their strong decline during the second half of 2012, all of these money market interest rates fluctuated in a relatively narrow range close to zero during 2013. Secured interest rates actually increased by a few basis points in the course of the year, with the three-month EUREPO quotes re-entering positive territory in January after having been in marginally negative territory for most of the second half of 2012. This development was consistent with the general trend of gradually receding financial market tensions which started in mid-2012 and continued throughout 2013.

Chart 11 Three-month EUREPO, EURIBOR and overnight index swap rates

(percentages per annum; spread in basis points; daily data)

— three-month EUREPO (left-hand scale)
 three-month EURIBOR (left-hand scale)
 - - - three-month overnight index swap rate (left-hand scale)
 — spread between the three-month EURIBOR and the three-month EUREPO (right-hand scale)



Sources: ECB and Thomson Reuters.

Box 3

DEVELOPMENTS IN THE EUROSISTEM'S BALANCE SHEET

This box reviews how the Eurosystem's balance sheet and money market rates developed in the course of 2013. It also touches upon issues related to the Eurosystem's risk exposure.

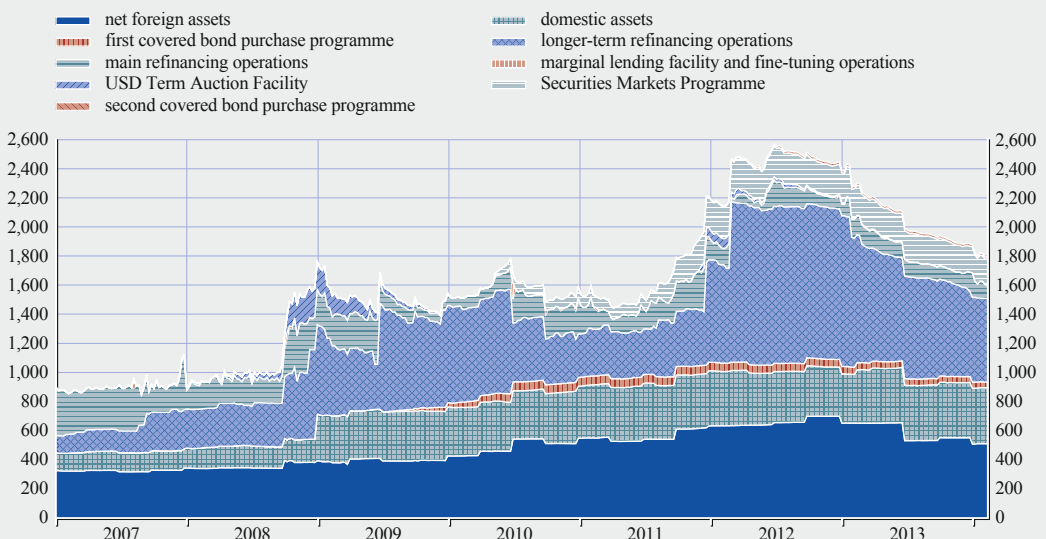
The balance sheet of a central bank largely reflects the implementation of its monetary policy. As a consequence of adopting non-standard measures to support the transmission of monetary policy in an environment of severe financial market stress, the Eurosystem's balance sheet expanded in an unprecedented way, overall more than doubling in size between 2008 and mid-2012, before starting to recede in the second half of 2012 (see Charts A and B).

The fixed rate full allotment tender procedure that has been in place for essentially all refinancing operations since October 2008 implies that the demand for liquidity of euro area banks that are counterparties of the Eurosystem is met in full, provided counterparties can pledge adequate collateral to secure their borrowing. As a result, the size and composition of the Eurosystem's balance sheet is determined, for a large part, by the euro area banking system's aggregate demand for liquidity (see Charts A and B).

Since its peak in summer 2012, the size of the Eurosystem's balance sheet has declined steadily, reflecting receding financial fragmentation. Improved market funding was one of the important factors behind the reduced demand for central bank liquidity. This improvement was itself a result of the non-standard monetary policy measures adopted by the ECB, but also of structural reform efforts undertaken in several euro area countries and the progress made in strengthening the euro area's framework for economic governance.

Chart A Simplified Eurosystem balance sheet: assets

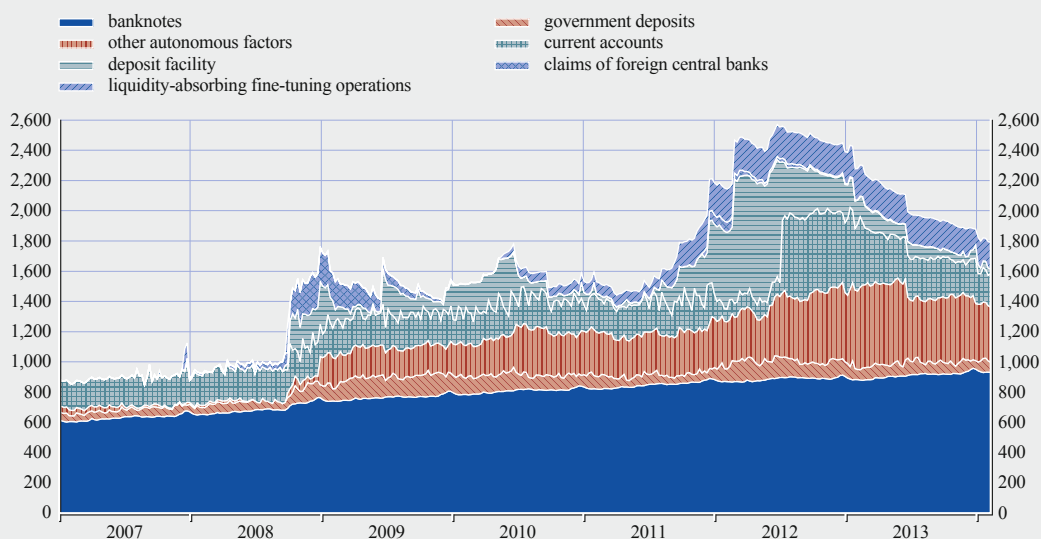
(EUR billions)



Source: ECB.
Note: Data up to 14 February 2014.

Chart B Simplified Eurosystem balance sheet: liabilities

(EUR billions)



Source: ECB.
Note: Data up to 14 February 2014.

On the assets side of the balance sheet, the outstanding volume of refinancing operations has declined, as banks used the option for an earlier repayment of funds received via the three-year longer-term refinancing operations (LTROs) conducted in December 2011 and February 2012.¹ Around 37% of the liquidity provided in the three-year LTROs had been repaid by 20 December 2013, which corresponds to 85% of the net liquidity injected at the time these operations were conducted. The provision of central bank refinancing through the weekly main refinancing operations (with a one-week maturity), which had decreased substantially to around €90 billion at the end of December 2012, largely remained in a range of €90-130 billion throughout 2013.

The balance sheet also includes holdings of assets acquired in the context of asset purchase programmes for monetary policy purposes conducted prior to 2013. These acquisitions are related to the first and second covered bond purchase programmes (July 2009 to June 2010 and November 2011 to October 2012 respectively) and the Securities Markets Programme (May 2010 to September 2012). All these are classified as held-to-maturity portfolios, and are consequently valued at amortised cost subject to impairment. Their outstanding amount decreased slightly in 2013, on account of assets reaching maturity. The combined portfolio of assets held outright provided liquidity of, on average, €257 billion in the period under review (i.e. from end-December 2012 to end-December 2013).

Moreover, the Eurosystem continued to hold, in net terms, sizeable amounts of foreign reserves (i.e. foreign currency-denominated assets held outright for foreign exchange intervention or

¹ In the two three-year LTROs conducted on 21 December 2011 and 29 February 2012, a total amount of €1,018.7 billion was allotted. However, taking into account operations that matured in mid-December 2011, as well as shifts in demand in refinancing operations ahead of the two three-year operations, the net increase in liquidity as a result of the two three-year LTROs amounted to around €520 billion.

investment purposes) and domestic assets (investment portfolios), which are held outright by NCBs and are, de facto, not related to the implementation of monetary policy.²

On the liabilities side of the Eurosystem's balance sheet, items reflecting excess liquidity declined, given the ongoing repayment of funds borrowed through the three-year LTROs. Excess liquidity (defined as the liquidity provided in excess of the banking sector's liquidity needs, as determined by autonomous factors and reserve requirements) hovered around €150-200 billion towards the end of 2013, down from the peak of €827.5 billion reached in the wake of those three-year LTROs on 5 March 2012. Banks kept the excess liquidity either in the deposit facility or in their current accounts: after the deposit rate was cut to zero in July 2012, banks became largely indifferent as to whether to transfer their excess liquidity to the deposit facility overnight or to leave it unremunerated as excess reserves on their current accounts – although a moderate bias in favour of the latter was observed within the overall trend of declining excess liquidity.

In 2013 the Eurosystem continued to sterilise the liquidity injected via the Securities Markets Programme, which was terminated in September 2012. Banknotes in circulation maintained their shallow trend and, partly affected by seasonal factors, reached a new record high level of above €950 billion at the end of 2013. At the same time, government deposits (i.e. treasury departments' deposits with NCBs) decreased by €35 billion. One reason for this decline in government deposits is that treasuries placed more funds with the banking system than in 2012. Finally, the impact of autonomous factors other than banknotes in circulation and government deposits declined, largely on account of lower claims on euro area residents denominated in euro (reflecting the provision of liquidity outside Eurosystem operations).

Overall, between the peak recorded on 29 June 2012 and 27 December 2013, the Eurosystem's balance sheet declined by around 26%, reaching around €2,300 billion. Taking a simplified presentation of the balance sheet,³ this translates into a level slightly below €1,900 billion (see Charts A and B).

The Eurosystem balance sheet and the money market

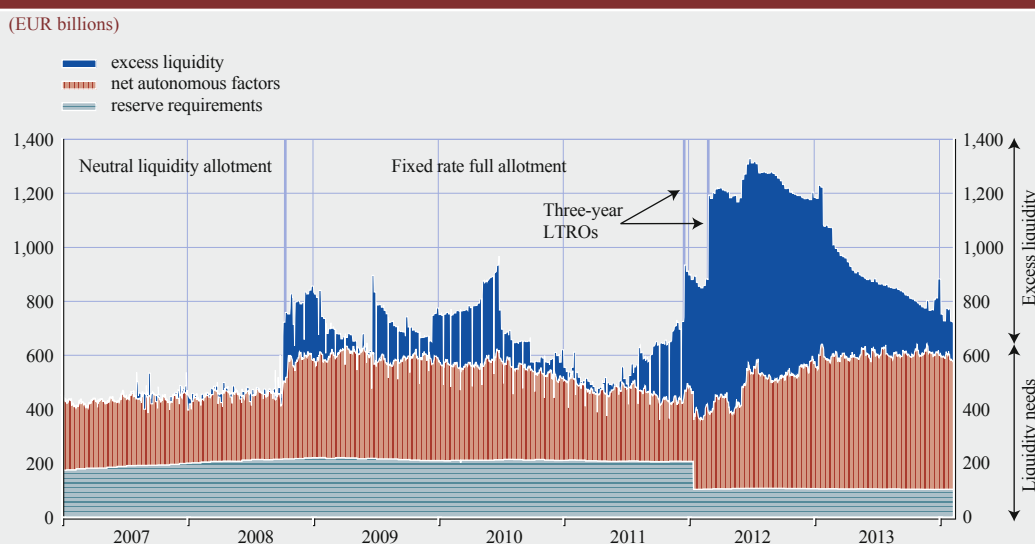
In the money market, the introduction of fixed rate full allotment tenders in October 2008 was accompanied by a transition from a regime of neutral liquidity to one of excess liquidity (see the area shaded in blue in Chart C). Under neutral liquidity conditions, i.e. in the case of near-zero excess liquidity, very short-term money market rates, in particular the EONIA, are anchored to the minimum bid rate of the main refinancing operation. In situations marked by ample excess liquidity, by contrast, the EONIA is anchored to the ECB's deposit facility rate.⁴

2 In addition, the Eurosystem gold reserves, which are revalued at market prices at the end of every quarter, have increased in value since the beginning of 2007 (also implying a corresponding increase in the revaluation accounts of the Eurosystem on the liabilities side). Those elements are not reflected in the simplified balance sheet in Charts A and B.

3 The balance sheet presentation in Charts A and B differs from that of the consolidated balance sheet of the Eurosystem as at 31 December 2013, as presented in more detail in this Annual Report. In the simplified presentation of Charts A and B, a number of items are consolidated; for the underlying methodology, see the box entitled "Simplified balance sheets: methodology" in the article entitled "Recent developments in the balance sheets of the Eurosystem, the Federal Reserve System and the Bank of Japan", *Monthly Bulletin*, ECB, October 2009.

4 The deposit rate provides a lower bound for the EONIA, as banks with access to the deposit facility are unlikely to lend on the money market at a less favourable rate than the deposit facility rate. See also the article entitled "Recent developments in excess liquidity and money market rates", *Monthly Bulletin*, ECB, January 2014.

Chart C Aggregate liquidity needs and excess liquidity since 2007



Source: ECB.
Note: Data up to 14 February 2014.

Notwithstanding the sizeable decline in excess liquidity – and hence in the size of the Eurosystem’s balance sheet – that occurred in 2013, the EONIA remained close to the deposit rate for most of the year, although it registered occasional small upward drifts in the last quarter of 2013. This increase in the EONIA, and its volatility, was related partly to seasonal or irregular factors, as well as to market liquidity developments, since money market fragmentation receded in parallel with the decline in excess liquidity. As a result, the EONIA started exhibiting a consistently higher responsiveness to market developments, while the overall impact of the decline in excess liquidity on very short-term interest rates can be deemed fairly limited. On occasions over 2013, however, expectations of a continued decline in excess liquidity shifted the expected path of the EONIA upwards. As a consequence of the reduction of the outstanding liquidity provided through monetary policy operations, the Eurosystem’s risk exposure also declined in 2013.

Assessing the Eurosystem’s risk exposure

It is worth recalling that central banks always take on some financial risk when implementing monetary policy decisions. Monetary policy operations are associated with potential financial risk even in normal times, because they involve the provision of central bank money against assets or collateral originating from various economic agents. Depending on the magnitude of shocks and risks to the monetary policy transmission mechanism, central banks may consider taking measures in pursuit of, and within the limits of, their respective mandates that increase their financial risk exposure in times of crisis. In the case of the Eurosystem, the risk profile in normal times is dominated mainly by risks associated with holdings of foreign exchange reserves and gold, while in times of tension its increased intermediation in euro area financial markets implies larger risk-taking associated with monetary policy operations.

However, central banks in general, and the Eurosystem in particular, have certain mechanisms in place which aim to protect their balance sheet against those risks.⁵ Two elements contribute to ensuring this. First, the central bank manages the financial risks. For instance, the Eurosystem only provides credit through refinancing operations to counterparties that are considered financially sound and that are required to pledge adequate collateral assets, subject to haircuts commensurate with their risk, thereby ensuring two layers of protection against losses.⁶ The risk management framework is evaluated and reviewed on an ongoing basis. For example, on 18 July 2013 the ECB announced several measures aimed at maintaining adequate risk protection and improving the overall consistency of the framework.⁷ Second, central banks create or build up financial buffers over time, which serve the purpose of making their balance sheet more resilient to the materialisation of potential losses (e.g. those incurred in the event of a counterparty defaulting on its central bank credit, the value of which would not be recovered in full).

Financial buffers may be created by setting up provisions against risk, the size of which is determined by a risk assessment, or by retaining part of the annual profit for assignment to the central bank's reserves. In addition to the financial buffers on their balance sheets, there are institutional arrangements supporting the integrity of the central bank's balance sheet with the aim of ensuring that it will have sufficient financial resources available for the conduct of monetary policy in an independent manner, and will thus deliver on the policy objective. They relate to the concept of "financial strength", which – as defined by the BIS in a recent report – also includes the "risk transfer or insurance arrangements and, importantly, institutional design features that help maintain financial resources over time".⁸ Governments can contribute to the financial strength of the central bank by guaranteeing to cover any losses it may make and, eventually, to recapitalise it when necessary (i.e. what is known as "fiscal backing") and by stipulating in law that the central bank will have sufficient resources to perform its tasks in the fulfilment of its mandate (financial independence and a prohibition on performing tasks not covered by its mandate).

In the case of the Eurosystem, the institutional setting and the integrity of the Eurosystem's balance sheet are reinforced in specific Treaty provisions; for example, Article 130 of the Treaty on the Functioning of the European Union states that the Eurosystem independently exercises its powers and carries out its tasks and duties. The principle of financial independence implies that a central bank must have sufficient means to perform its tasks, including the financing of its administration and operations.⁹ In addition, Article 123(1) prohibits monetary financing (see Section 6.1 of Chapter 2). These provisions together preclude the monetisation of sovereign debt, for instance by providing Member States with financial contributions in excess of their shares in the central bank's profits realised in the respective financial year. In addition to these Treaty provisions, some Eurosystem central banks enjoy financial guarantees from their shareholders as part of their institutional arrangements.

5 See also the box entitled "Central bank financial strength during the crisis: the case of the Eurosystem", *Monthly Bulletin*, ECB, September 2013.

6 The incurrance of losses requires the inability to recover outstanding credit either from the counterparty directly or through the realisation of the collateral held.

7 See also the box entitled "Review of the risk control framework", *Monthly Bulletin*, ECB, October 2013.

8 According to this report, such arrangements may, among other things, take the form of fiscal backing or stand-alone financial strength. See Archer, D. and Moser-Boehm, P., "Central bank finances", *BIS Papers*, No 71, BIS, April 2013.

9 This would also entail the separation of budgets; for example, the ECB's budget is not part of the EU's annual budget under Article 314 of the Treaty. See also Case C-11/00, *Commission v ECB*, paragraph 132.

Because (non-inflationary) financial resources are by definition limited in practice,¹⁰ the only way of ensuring the availability of the necessary and sufficient financial resources for delivering price stability in all circumstances is to preserve the financial strength of the central bank in the long run. This helps eventually to entrench expectations among both the general public and financial market participants that the central bank will not be unduly constrained in the pursuit of its price stability objective by concerns about financial resources.

10 See the discussion in Reis, R., “The mystique surrounding the central bank’s balance sheet, applied to the European crisis”, *American Economic Review: Papers & Proceedings* 2013, Vol. 103(3), pp. 135-140.

HIGHLY RATED GOVERNMENT BOND YIELDS INCREASED IN THE EURO AREA, BUT LESS MARKEDLY THAN IN THE UNITED STATES

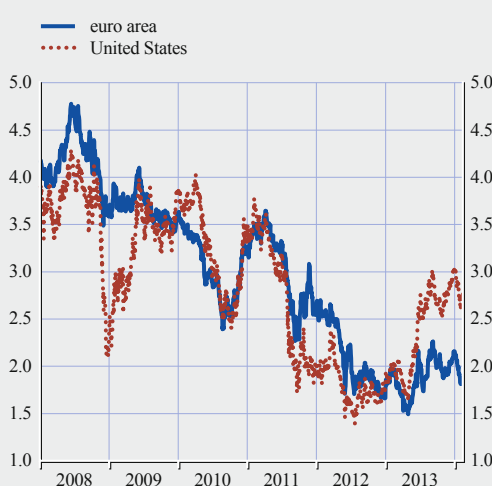
AAA-rated long-term government bond yields³ in the euro area increased from around 1.7% at the beginning of January 2013 to 2.2% at the end of December (see Chart 12). In the United States, yields on long-term government bonds rose more sharply over the same period, from around 1.8% to around 3.1%. The development of government bond yields in 2013 can be broken down into two periods.

In the first phase, from January to early May, a weak macroeconomic outlook in the euro area, as suggested by business surveys and data releases on employment and manufacturing activity, weighed on AAA-rated euro area long-term government bond yields. Also, the conclusion of a financial assistance package for Cyprus and perceived domestic uncertainties in some euro area countries triggered renewed flight-to-safety flows in favour of highly rated government bonds. As a result, AAA-rated euro area long-term government bond yields fell to historic lows of close to 1.5% on 2 May. Over the same period in the United States, ten-year government bond yields declined slightly less markedly in the light of more balanced macroeconomic data releases.

During the second phase from early May to the end of the year, interest rates in the market for AAA-rated long-term government bonds rose sharply in the euro area and in the United States, by 70 and 140 basis points respectively. In May and June alone, those interest rates increased in an almost synchronous manner by 60 and 80 basis points respectively, despite clear differences both in the cyclical positions of the two regions and in the prospects for monetary policy. The increases largely reflected some statements by the US Federal Reserve that it would be appropriate, if the economy were to progress broadly as forecast, to moderate the pace of

Chart 12 Long-term government bond yields

(percentages per annum; daily data)



Sources: Bloomberg, EuroMTS and ECB.

Notes: The euro area ten-year government bond yield is represented by the ten-year par yield derived from the yield curve of AAA-rated euro area government bonds, as estimated by the ECB. For the United States, yields on ten-year government bonds are shown.

³ After the downgrade of France by Fitch Ratings in July 2013, the group of AAA-rated euro area countries consists of Austria, Finland, Germany, Luxembourg and the Netherlands.

bond purchases under its quantitative easing programme later in the year. This apparently led to a reassessment by markets of the future course of monetary policy not only in the United States, but also in other advanced economies. Generally, there was a marked spillover of the changing bond market conditions in the United States to the euro area. Accordingly, the resulting tightening of financial conditions was not warranted by underlying economic developments in the euro area.

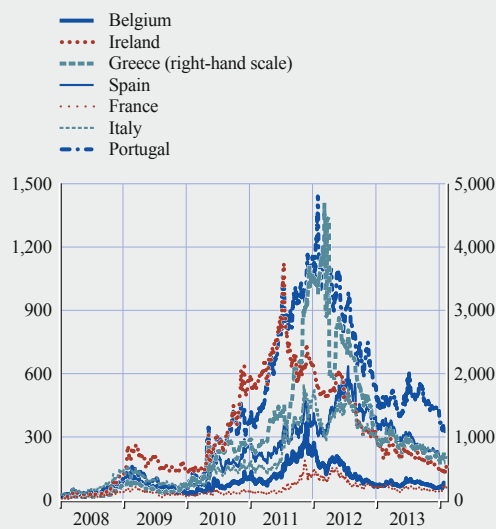
In July the ECB stated in its forward guidance that it expected key interest rates to remain at current or lower levels for an extended period of time. This forward guidance reduced the direct spillover from the United States. In August euro area long-term government bond yields increased again, but this time against the background of a gradual and broad-based improvement in the outlook for the euro area economy, as suggested especially by survey-based measures. In the United States, yields continued to rise perceptibly in July and August, against the background of broadly positive economic data releases and intensifying expectations of an imminent tapering of the Federal Reserve's bond purchase programme.

Since September, however, the movement of euro area long-term government bond yields has reversed somewhat, partly as a result of mixed macroeconomic data and the ECB's decision in November to lower key monetary policy rates and reiterate its forward guidance. Overall, a change in market participants' expectations of an imminent tapering of the Federal Reserve's bond purchases may have contributed to a decline in yields until late autumn. That was a result of, among other things, some clarification by the Federal Reserve regarding what would influence its eventual decision to begin tapering and releases of US economic data that did not point conclusively to a firm and self-sustaining recovery of the US economy. In December US economic data again surprised on the positive side, and eventually the Federal Reserve announced that it would start to modestly reduce the pace of purchases as from January 2014. This announcement only had a small impact on long-term government bond yields, since it reduced uncertainty about the pace of reductions in bond purchases, and was accompanied by reinforced forward guidance on monetary policy rates. In the United States, yields have been fairly volatile in the period since September and were influenced both by increased uncertainty with respect to the future course of monetary policy and by the political tensions surrounding the negotiations over the federal debt limit. Owing to mostly strong economic data towards the end of the year and the announcement by the Federal Reserve that it would taper its bond purchase programme, long-term government bond yields ended the year at the highest level observed during the year.

A key feature of euro area government bond markets in 2013 was that long-term yields tended to converge across most euro area countries – a process that began with the steps undertaken towards a resolution of the euro area sovereign debt crisis in 2012 and the ECB's announcement of Outright Monetary

Chart 13 Government bond spreads of selected euro area countries

(basis points; daily data)



Source: Thomson Reuters.
Note: Spread between the yield on ten-year government bonds and that on corresponding German government bonds.

Transactions (see Chart 13). The convergence of yields took place against the background of tentative signs of a turnaround in economic activity, even in those countries that were experiencing the deepest recessions, and an improvement in perceptions of latent risks to financial stability. Even though the year was still characterised by the emergence of domestic uncertainties in a number of euro area countries, there were fewer spillovers of financial market stress between countries than often observed before. On a similar note, market conditions for bonds issued by low-rated sovereigns deteriorated only briefly when the Federal Reserve indicated its willingness to start scaling back its bond purchases and global financial market volatility spiked. That stood in contrast to more long-lasting effects on the bond markets in emerging economies. Moreover, the effect on bond market conditions in the euro area was modest when the Federal Reserve announced in late December that it had decided to taper its bond purchase programme. Primary market conditions also improved in the stressed segments of government bond markets. Some euro area countries were able to extend their bond maturities after having increased their reliance on bonds with shorter maturities in 2012, and two of the EU-IMF programme countries, Ireland and Portugal, made progress towards regaining access to bond markets.

In light of the tentative improvement in the economic outlook for the euro area, real yields on five and ten-year government bonds there increased over the year, namely by around 80 and 75 basis points respectively, to around -0.1% and 0.5% at the end of 2013, while the real five-year yield five years ahead rose by around 70 basis points to around 1.1%. At the end of 2013 the five-year forward break-even inflation rate five years ahead implied by inflation-linked bonds stood at around 2.5%, slightly lower than at the beginning of the year. This was the result of a decline of 25 basis points in five-year break-even inflation rates, to around 1.2%, and a decrease of around 15 basis points in the ten-year break-even rate, to around 1.8%. By comparison, the five-year inflation swap rate five years ahead was close to 2.2%, likewise slightly lower than at the beginning of the year. Overall, after taking into account both the inflation risk and liquidity premia embodied in break-even inflation rates, market-based indicators suggest that inflation expectations remain fully consistent with the ECB's price stability objective.

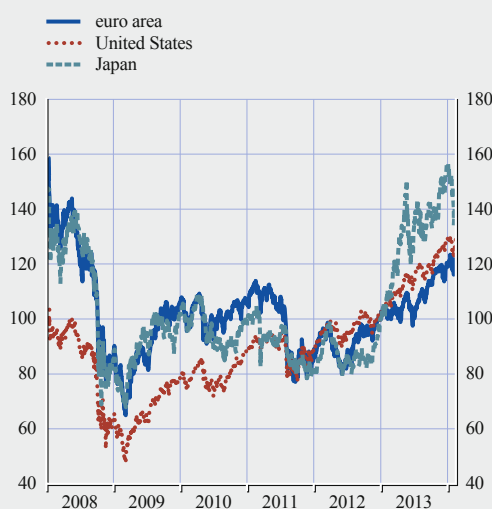
EURO AREA EQUITY PRICES ROSE SHARPLY IN THE SECOND HALF OF 2013

Equity prices in the euro area and the United States rose by 20% and 30% respectively in 2013 (see Chart 14). This compares with an increase of 57% in Japan. Many of the factors that shaped bond market developments also affected equity markets.

In the first three months of 2013 euro area equity price developments were relatively muted, while stock prices rose in the United States. In the euro area, stock prices continued to benefit from the improvement in risk appetite that stemmed from the advances made in 2012 in resolving the sovereign debt crisis, and from the ECB's announcement of Outright Monetary

Chart 14 Major stock market indices

(indices rebased to 100 on 1 January 2013; daily data)



Source: Thomson Reuters.

Note: The indices used are the Dow Jones EURO STOXX broad index for the euro area, the Standard & Poor's 500 index for the United States and the Nikkei 225 index for Japan.

Transactions. In parallel, economic data releases for the euro area continued to disappoint and confirmed prospects for weak growth over the short term. In late spring euro area equity prices increased despite the continued release of weaker than expected data, including first quarter GDP figures and survey indicators. The favourable development of equity markets was driven by diminishing domestic uncertainties in some euro area countries, and by low yields on alternative investments such as government and corporate bonds. However, from late May, when expectations intensified that the Federal Reserve could soon begin to taper its bond purchases, equity prices declined sharply, most likely on grounds of fear that this might derail a fragile economic recovery in the euro area if financing conditions there were to tighten accordingly.

In the United States, equity market sentiment was generally more positive than in the euro area in the first half of the year, with the S&P 500 index increasing by 13%, compared with a 1% increase for the Dow Jones EURO STOXX broad index. In the first few months political agreements to temporarily avoid the so-called fiscal cliff and raise the federal debt ceiling had a positive influence on market sentiment. Economic data releases were mixed, but generally improved towards the summer, suggesting a pick-up in economic activity. Speculation about the Federal Reserve's forthcoming tapering of bond purchases had a negative impact, but it was less pronounced than that in the euro area, probably because any decision to taper would be closely linked to positive domestic economic developments there.

In both economic areas, stock market uncertainty, as measured by implied volatility, rose when speculation about a reduced pace of bond purchases set in, but the change in implied volatility between early 2013 and the end of June was limited.

In the first half of 2013 equity markets in emerging economies experienced declines in prices and came under selling pressure from foreign investors as uncertainty about the future stance of monetary policy in the United States increased. In Japan, equity prices were very volatile in the first part of the year. They initially increased sharply after the announcement of new monetary policy measures by the Bank of Japan and surprisingly strong GDP growth. In late spring, however, they declined in line with global equity markets, thereby limiting the overall increase.

In the second half of the year equity price indices in the euro area and in the United States developed along more comparable lines, with the Dow Jones EURO STOXX index increasing by 19% and the S&P 500 by 15%. In addition, there was a significant decline in stock market uncertainty, as measured by implied volatility, in both economic areas.

Equity markets in the euro area rallied in the context of the Governing Council's communication on forward guidance and some tentative signs that the euro area economic recovery might be picking up. Stock market sentiment also remained highly sensitive to signals about the evolution of the Federal Reserve's bond purchases and benefited, on average, from the postponement of the start of tapering. Another factor contributing to the increase in equity prices in the euro area was lower perceptions of financial stability risk, which helped euro area financial equity prices, in particular, to outperform the equity prices of non-financial companies. The advances towards the establishment of the Single Supervisory Mechanism under the auspices of the ECB and the expectation of more clarity on banks' balance sheet quality with the forthcoming asset quality review, as well as progress with respect to the design of other elements of banking union, may also have benefited financial sector equities. In late December the eventual announcement by the Federal Reserve of its decision to taper its bond purchase programme was received positively, probably owing to the reduction in uncertainty, and the accompanying reinforcement of forward guidance.

In the United States too, equity prices increased in the second half of the year, but slightly less markedly than in the euro area. The upward movement of equity prices there was supported by a continued economic recovery, albeit at a moderate pace, and a continuation of the very accommodative monetary policy stance of the Federal Reserve. Akin to the reaction in the euro area, equity prices increased when the decision to taper the bond purchase programme was finally announced in late December. Concerns related to the federal debt ceiling agreement and the temporary shutdown of the central government gave rise to uncertainty and may have had a negative impact on equity prices for a while. Over the same period equity prices in Japan continued to rise, while equity prices in emerging market economies rebounded to some extent.

The broad equity index in the United States reached an all-time high in March, and again on other occasions later in the year, while the broad Dow Jones EURO STOXX index at the end of 2013 stood around 30% below its pre-crisis peak. Simple equity valuation measures seem to indicate that investors are willing to pay a higher price per unit of current earnings or dividends for US-based companies than for companies based in the euro area.⁴

HOUSEHOLD BORROWING STABILISED IN 2013

In 2013 the annual rate of change of total loans to households stabilised, standing at -0.2% in December 2013, broadly unchanged from the 0.2% observed in December 2012. This stabilisation was mirrored by similar developments in MFI loans to households (when adjusted for loan sales and securitisation). This apparent analogy reflects the fact that MFIs remain the main provider of loans to households, while the provision of loans to households by non-MFIs can largely be explained by the loan sales and securitisation activities of MFIs, which, depending on national accounting practices, result in household loans being shifted from the MFI sector to that of financial intermediaries other than insurance corporations and pension funds (OFIs).

Lending for house purchase remained the main driver of growth in MFI loans to households. The annual growth rate of loans for house purchase, which had stood at 1.3% at the end of 2012, was 0.7% in December 2013. The euro area growth rates mask significant cross-country heterogeneity that was again caused, as in the preceding year, by differing degrees of indebtedness in 2013, which resulted in varying deleveraging needs, by diverging economic situations and by disparities in banks' ability and willingness to lend. Furthermore, the growth profile of lending to households for house purchase is likely to have reflected borrowers' risk related to the general prospects for housing markets, as well as macroeconomic uncertainty. Housing market prospects were also identified in the euro area bank lending survey as an important driver of the decline in net demand for housing loans in the first half of 2013. The first net increase in demand for loans since the fourth quarter of 2010 was, however, partly reversed in the fourth quarter. From a supply-side perspective, the net tightening of credit standards declined in the course of 2013, as the ECB's standard and non-standard policy measures (in particular, the two three-year LTROs, as well as the changes in the collateral framework) and the announcements of the Outright Monetary Transactions, as well as the forward guidance, helped to reduce financial fragmentation and generally eased the funding difficulties faced by a number of banks. This improvement eased constraints on banks' lending to households. Banks' lending rates for loans for house purchase stabilised throughout the euro area in the course of 2013, although the heterogeneity of such lending rates across countries remained sizeable.

⁴ See, for example, the box entitled "Stock market developments in the light of the current low-yield environment", *Monthly Bulletin*, ECB, August 2013.

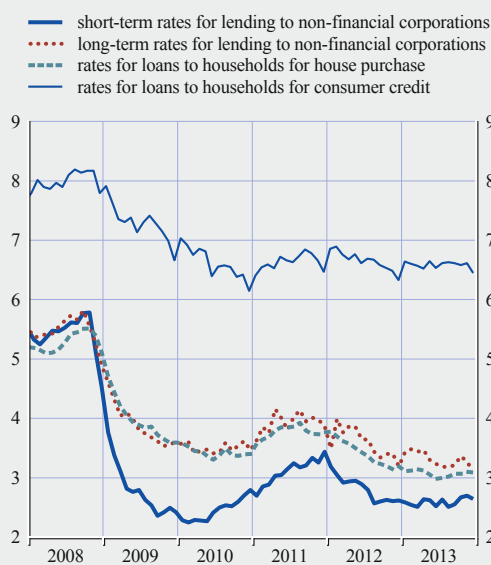
After declining further in the first half of 2013, the annual rate of change of consumer credit stabilised in the second half of the year. It remained in negative territory, however, standing at -3.1% in December 2013, after -2.9% in December 2012. The weak development of consumer credit was due largely to demand factors (which affect this form of lending in particular) and was, at the same time, in line with the results of consumer surveys. Subdued growth in households' real disposable income and the fact that household indebtedness remained at very high levels in a number of euro area countries continued to dampen demand for consumer credit. In line with these findings, the bank lending survey reported both a net decline in demand in the first half of 2013, followed by a marginal increase in the third quarter and a subsequent slight decline in the fourth quarter, and – following a slight easing of credit standards for this type of loan in the second quarter of 2013 – a marginal net tightening in the second half of 2013. The developments in demand for consumer credit were driven mainly by a smaller negative impact not only of household spending on durable goods, but also of consumer confidence and household saving. Banks' lending rates for consumer credit generally stabilised in the third and fourth quarters of the year, although they remained higher than the levels prevailing in December 2012 (see Chart 15).

HOUSEHOLD INDEBTEDNESS STABILISED AT HIGH LEVELS

In 2013 household indebtedness remained high, at levels observed since mid-2010. More particularly, the ratio of household debt to nominal gross disposable income was estimated at 98.5% in the fourth quarter of 2013, in line with the levels observed in mid-2010 (see Chart 16). The development of this ratio reflected slight increases in total household debt and stagnating income, both of which mirrored the persistent weakness of economic activity and the high level of unemployment. The interest payment burden of households, expressed as a percentage of their gross disposable income, remained broadly unchanged in 2013, after

Chart 15 Interest rates for lending to households and non-financial corporations

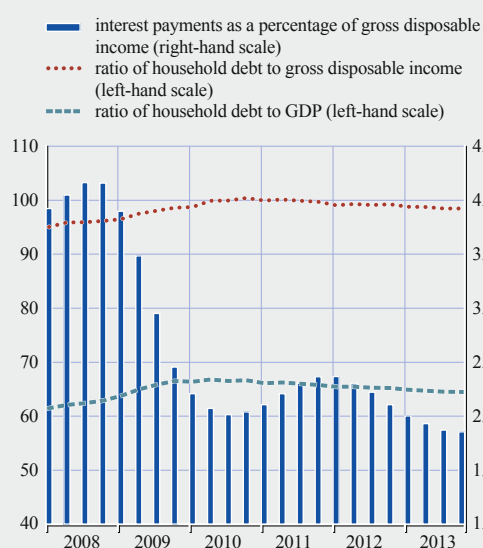
(percentages per annum; excluding charges; rates on new business)



Source: ECB.

Chart 16 Household debt and interest payments

(percentages)



Sources: ECB and Eurostat.

Notes: Household debt comprises total loans to households from all institutional sectors, including the rest of the world. Interest payments do not include the full financing costs paid by households, as they exclude the fees for financial services. Data for the last quarter shown have partly been estimated.

having gradually decreased between early 2012 and early 2013. The household debt-to-GDP ratio is estimated to have declined marginally, standing at 64.5% in the fourth quarter of 2013, compared with 65.2% in the fourth quarter of 2012.

FURTHER DECLINE IN THE COST OF EXTERNAL FINANCING FOR NON-FINANCIAL CORPORATIONS

The overall nominal cost of external financing for non-financial corporations decreased by 40 basis points between the end of 2012 and the end of 2013 (based on three-month moving averages). The decline was due mainly to a considerable drop in the cost of equity, while the cost of market-based debt and the cost of bank lending decreased somewhat (see Chart 17). At the same time, heterogeneity across euro area countries remained significant.

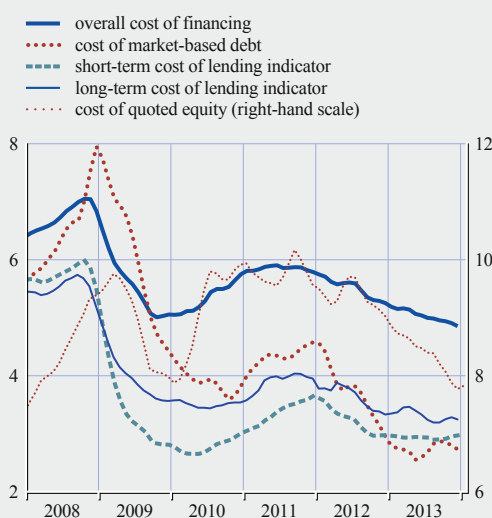
The overall improvement in financial market confidence and an increased risk appetite of investors contributed to a decline in the market-based cost of external financing for non-financial corporations in the first part of the year, i.e. up to May 2013, whereas the cost of bank lending for such corporations was broadly stable over this period. The downturn in the cost of market-based debt financing was partly reversed around the middle of the year, while the cost of equity moderated further. The cuts in monetary policy rates implemented since November 2011, which brought them to historically low levels in November 2013, contributed to easing the external financing costs of non-financial corporations, despite financial fragmentation across the euro area and sizeable risk premia related to weak economic conditions.

With regard to the cost of bank-based financing, the short-term nominal cost of bank lending was unchanged in December 2013, as compared with the end of 2012, at 3.0% (based on three-month moving averages). Over the same period short-term market rates increased slightly, with the three-month EURIBOR standing at 0.3% in December 2013, implying a small contraction of the spread between the two rates. The long-term cost of bank lending decreased by around 10 basis points (based on three-month moving averages) between the end of 2012 and December 2013. The spread between the long-term nominal cost of bank lending and the five-year overnight index swap rate narrowed by around 35 basis points over the period.

While the cuts in the key ECB interest rates implemented in late 2011 and mid-2012 may have been reflected in lending rates by the end of 2013, the pass-through of the cuts in key ECB interest rates implemented in May and November 2013 may still be incomplete. Moreover, in some euro area countries, the transmission of the monetary policy stance through the bank lending channel remains constrained by the high risk aversion of banks towards borrowers of lesser creditworthiness. Banks in some jurisdictions may also have been reluctant to pass on key ECB interest

Chart 17 Overall cost of the external financing of non-financial corporations and components

(percentages per annum; three-month moving averages)



Sources: ECB, Thomson Reuters and Merrill Lynch.
Notes: The overall cost of the external financing of non-financial corporations is calculated as a weighted average of the cost of bank lending, the cost of debt securities and the cost of equity, based on their respective amounts outstanding (see the box entitled "A measure of the real cost of the external financing of euro area non-financial corporations", *Monthly Bulletin*, ECB, March 2005).

rate cuts in the context of deleveraging strategies and adjustments to meet higher regulatory capital requirements.

The cost of market-based debt financing declined by around 20 basis points between the end of 2012 and December 2013 (based on three-month moving averages). It had fallen to historically low levels in the first part of the year, until May 2013, reflecting improved overall financial market sentiment, as well as investors' increasing search for yield and generally rising risk appetite. In the second half of the year, however, it first increased somewhat in the context of higher uncertainty in financial markets about the future evolution of monetary policy in the United States, but declined again towards the end of 2013.

The cost of issuing quoted equity declined considerably in 2013, standing around 125 basis points lower in December 2013 than at the end of 2012 (based on three-month moving averages). This decrease, which took place mainly in the second half of 2013, reflected stock price increases that were related to a general improvement in financial market sentiment, the Governing Council's communication on forward guidance and tentative signs of an economic recovery in the euro area, as well as the reduction of uncertainty about the withdrawal of monetary policy accommodation in the United States.

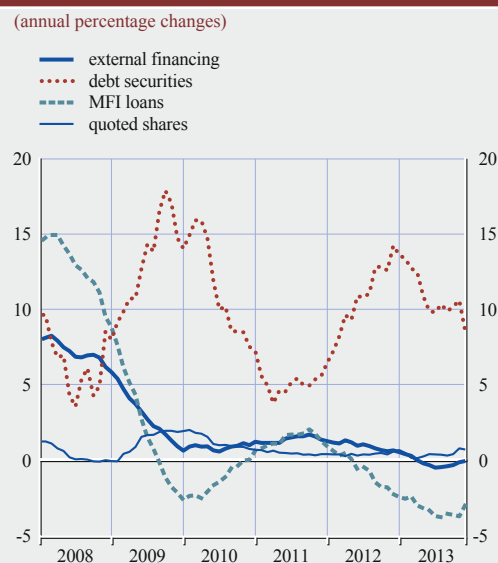
STILL SUBDUED RECOURSE TO EXTERNAL FINANCING

Euro area non-financial corporations' recourse to external financing remained subdued in 2013. In terms of components, the decline in new MFI loans to non-financial corporations was partly offset by issuance of market-based debt, while issuance of quoted shares remained low. Overall, larger non-financial corporations' market-based financing may have offered some relief in terms of their overall access to external financing, but remained a comparatively minor source of financing for euro area firms, on average.

In more detail, loans to non-financial corporations declined further in 2013, the annual rate of change standing at -3.0% in December 2013, after -2.3% at the end of 2012. The annual growth rate of debt securities issuance, although declining, remained high at 8.5% in December 2013, compared with 14.2% at the end of 2012 (see Chart 18). Issuance of quoted shares remained low, with an annual growth rate of 0.7% in December 2013, compared with 0.5% in December 2012.

The weakness of demand for external financing reflected the state of the business cycle. According to the euro area bank lending survey, demand for corporate loans in the euro area

Chart 18 External financing of euro area non-financial corporations, broken down by instrument



Source: ECB.
Note: External financing is defined as the sum of MFI loans (not adjusted for loan sales and securitisation), debt securities and euro-denominated quoted shares issued by non-financial corporations.

contracted in net terms in 2013, on the back of a still negative impact of fixed investment and subdued financing needs for inventories. At the same time, according to the evidence provided by the bank lending survey, the decline in net demand for loans by enterprises decelerated in the course of the year.

Turning to the supply of credit, the euro area bank lending survey showed that euro area banks' credit standards for loans to enterprises were tightened less in 2013 than in 2012. This reflected some tentative signs of stabilisation in credit conditions for firms. While borrowers' risks in relation to the economic outlook remained dominant in explaining the tightening of credit standards, their impact became smaller over the year. In addition, the factors related to banks' funding costs and balance sheet positions contributed to a slight net easing, on average, of credit standards during 2013, reflecting the improvement in funding conditions for euro area banks. With respect to small and medium-sized enterprises (SMEs), evidence from the survey on the access to finance of SMEs in the euro area (SAFE) indicated that their financing conditions were heterogeneous across euro area countries, with generally larger financing obstacles for SMEs in countries that were more strongly affected by the financial crisis.

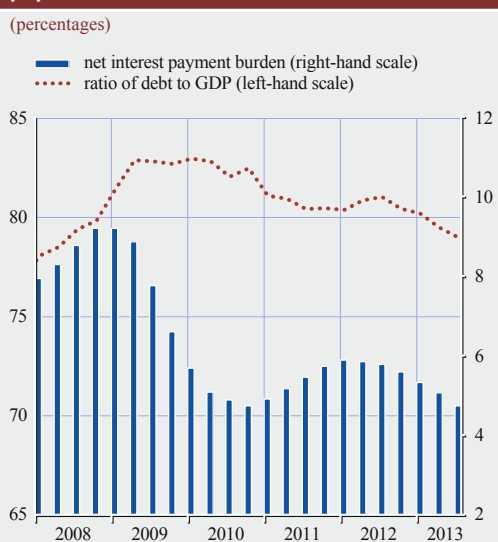
The movements in external financing flows recorded in 2013 suggest that some firms were able to diversify their sources of financing in response to still tight bank lending conditions. At the same time, such substitution away from bank financing remained limited to larger companies, which traditionally have greater access to corporate bond markets.

GRADUAL CORPORATE DELEVERAGING

Deleveraging by the euro area corporate sector continued to take place gradually at the aggregate level in 2013. The weakness of economic activity and corporate profits may have prevented stronger deleveraging. The debt-to-GDP ratio of euro area non-financial corporations declined slightly, to 79% in the third quarter of 2013, from 80% at the end of 2012. Taking a longer-term perspective, the ratio has come down somewhat from the peak of 83% recorded in 2009-10 (see Chart 19).

At the same time, a more nuanced picture can be obtained through a breakdown by euro area country, by sector of economic activity and by certain firm characteristics.⁵ Indeed, deleveraging was more pronounced for firms in those euro area countries and sectors that had increased their debt most strongly prior to the financial crisis, in particular the construction and real estate services sectors. At the same time, corporate debt ratios remained high in these areas. In addition, as shown by the financial statements of firms, deleveraging has

Chart 19 Euro area non-financial corporations – leverage and interest payment burden



Source: ECB.

Notes: Debt is reported on the basis of the quarterly European sector accounts. It includes loans (excluding inter-company loans), debt securities issued and pension fund reserves. The net interest payment burden is defined as the difference between interest payments and interest receipts of non-financial corporations, in relation to their gross operating surplus (four-quarter moving sum). Information up to the third quarter of 2013 is included.

5 See the article entitled "Deleveraging patterns in the euro area corporate sector", *Monthly Bulletin*, ECB, February 2014.

been stronger in the case of firms with high initial levels of leverage, in particular smaller highly indebted firms. By contrast, the average leverage of firms with low levels of indebtedness has continued to increase since the start of the financial crisis.

With respect to debt sustainability, the ability of firms to service their debt continued to be supported by the low interest rate environment and depressed corporate bond yields. The net interest payment burden declined further in 2013, to levels below the historical average recorded over the period since 2000. At the same time, firms with a high share of debt financed at variable interest rates remain exposed to changes in short-term financing conditions.

2.3 PRICE AND COST DEVELOPMENTS

In 2013 headline HICP inflation in the euro area was 1.4%, on average, compared with 2.5% in 2012 and 2.7% in 2011. This marked decrease in the course of 2013 took place slightly faster than expected and reflected primarily the strong decline in energy and food price inflation.

As evidenced by developments in producer prices and survey data, pipeline pressures in the supply chain eased further throughout 2013. Industrial producer price inflation turned slightly negative in 2013, to stand at -0.2% on average, compared with an annual average of 2.8% in 2012. Oil price developments and the unwinding of the spike in international food prices over the summer of 2012 were the main factors behind this decline.

Domestic cost pressures stemming from labour costs remained subdued in the first three quarters of 2013, in line with the continued weakness in labour markets. The relatively smooth pattern of wage growth at the euro area level concealed substantial divergence in wage developments across countries.

Consumer inflation perceptions and short-term inflation expectations came down slightly in 2013 compared with 2012 and 2011. Longer-term inflation expectations, according to survey data, were very stable, remaining firmly anchored in line with the Governing Council's aim of keeping inflation below, but close to, 2% over the medium term.

HICP INFLATION DECREASED MARKEDLY IN 2013

The marked decrease in euro area annual HICP inflation in 2013 was attributable primarily to the sharp decline in energy price inflation as of October 2012. A rapid fall in food price inflation in the second half of the year also played a role. However, excluding the volatile components food and energy, HICP inflation moderated in an environment of weak economic activity (see Table 1 and Chart 20).

The annual rate of change in the energy component, which carries a weight of 11.0% in the HICP basket of goods and services, fell substantially in the course of 2013, recording a 12-month average of 0.6%, compared with 7.6% in 2012. This was mainly the result of falling oil prices in US dollar terms and the appreciation of the euro. In the latter part of the year the squeeze on refining margins also contributed to the overall downward trend, which nevertheless exhibited some volatility, owing to oil price developments, and positive and negative base effects. The greatest impact of these factors was on the prices of items derived directly from oil, such as liquid fuels, fuels and lubricants for personal transport equipment, although the prices of electricity, gas and heating fuel were also affected.

Table I Price developments

(annual percentage changes, unless otherwise indicated)

	2011	2012	2013	2012 Q4	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2013 Dec.	2014 Jan.
HICP and its components¹⁾										
Overall index	2.7	2.5	1.4	2.3	1.9	1.4	1.3	0.8	0.8	0.7
Energy	11.9	7.6	0.6	6.3	3.2	0.3	0.1	-0.9	0.0	-1.2
Unprocessed food	1.8	3.0	3.5	4.3	3.9	4.8	4.2	1.3	1.5	.
Processed food	3.3	3.1	2.2	2.4	2.3	2.1	2.5	2.1	2.0	.
Non-energy industrial goods	0.8	1.2	0.6	1.1	0.8	0.8	0.4	0.3	0.3	0.2
Services	1.8	1.8	1.4	1.7	1.7	1.3	1.4	1.2	1.0	1.1
Other price and cost indicators										
Industrial producer prices	5.7	2.8	-0.2	2.4	1.2	-0.1	-0.6	-1.1	-0.8	.
Oil prices (EUR per barrel)	79.7	86.6	81.7	84.4	85.0	79.0	82.5	80.3	80.8	78.8
Non-energy commodity prices	12.2	0.5	-8.2	4.4	-3.0	-5.2	-12.7	-11.8	-11.4	-9.3

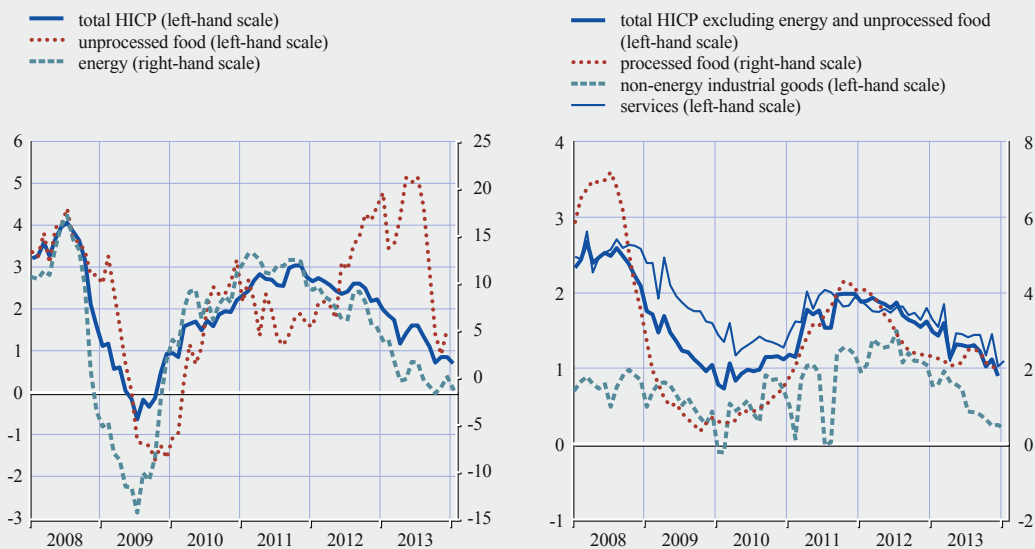
Sources: Eurostat, ECB and ECB calculations based on Thomson Reuters data.

1) The figures for HICP inflation and its components (excluding unprocessed food and processed food) in January 2014 refer to Eurostat's flash estimates.

Reflecting developments in both international food commodity prices and local supply conditions, the annual rate of change in food prices remained at the high level of around 3% for the first eight months of 2013. From August, food price inflation declined quite rapidly, as the earlier upward impact of adverse weather conditions on fruit and vegetable prices unwound. This development reflected, in particular, the profile of unprocessed food price inflation, which had increased at an annual rate of close to 5% in the first half of the year and was also the fastest-growing main component of the overall HICP in the year as a whole, with an average rate of change of 3.5%. This was markedly higher than in 2012 (3.0%) and 2011 (1.8%). By contrast, processed food price

Chart 20 Breakdown of HICP inflation: main components

(annual percentage changes; monthly data)



Source: Eurostat.

inflation declined from the autumn of 2011. The average annual rate of change of 2.2% in 2013 was markedly lower than that in 2012 (3.1%) and 2011 (3.3%). The gradual decline was interrupted in July and August, when processed food prices increased at a rate of 2.5%, which was slightly above average and mostly reflected a sharp rise in the annual rate of change in tobacco prices. This impact was reversed from October 2013. As a result, processed food price inflation dropped to 2.1% in the fourth quarter.

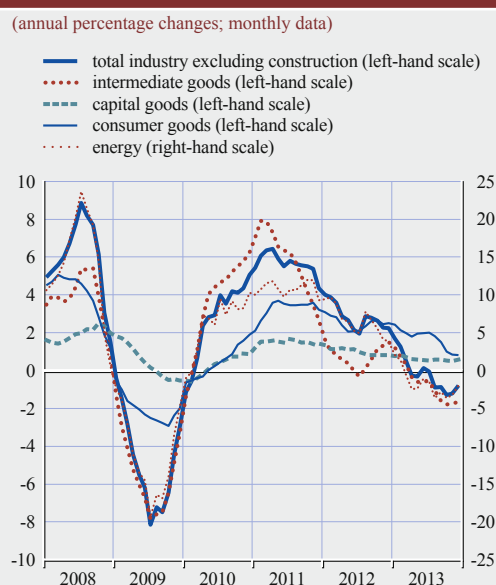
Average HICP inflation, excluding the volatile components food and energy, moderated during 2013, albeit to a much lesser extent than headline inflation. While HICP inflation excluding these components was 1.5%, on average, in 2012, it fell to close to 1% in the second half of 2013. The two main components of the HICP basket excluding food and energy items, i.e. non-energy industrial goods and services, recorded lower than expected annual rates of change in late 2013, reflecting overall subdued demand conditions. After exhibiting some volatility in the first few months of the year, non-energy industrial goods price inflation hovered at a rather low level from July 2013. This pattern can be attributed to the very low, and occasionally even negative, annual rates of change in the prices of garments and footwear, which were the result of the winter and summer sales. More generally, weak demand continued to dampen the prices of non-energy industrial goods, especially durable goods, such as cars. The annual rate of change in the services component, which is the largest component of the HICP, was relatively constant throughout most of 2013. After a period of volatility in March and April, owing to the timing of Easter, services price inflation stabilised at 1.4% between June and September, before easing further to 1.2%, on average, in the fourth quarter of the year.

PRODUCER PRICE INFLATION CONTINUED TO DECLINE IN 2013

Throughout 2013 pipeline pressures in the supply chain eased further at the producer level. Annual producer price inflation continued its downward trend, owing to declining oil and non-oil commodity prices. The volatility in the monthly profile mainly reflected positive and negative base effects related to energy and food price developments one year earlier. Pipeline pressures on non-energy industrial goods prices remained relatively stable at subdued levels, while those on food prices moderated in the first half of the year, before falling towards the autumn.

The annual rate of change in producer prices for industrial goods (excluding construction) in the euro area turned negative in 2013, to stand at -0.2% on average, down from 2.8% in 2012 and 5.7% in 2011. The annual rate of change in industrial producer prices excluding construction and energy also declined further in 2013, to 0.4% on average, compared with 1.4% in 2012 and 3.8% in 2011. The easing of price pressures was more visible at the earlier stages of the price chain (producer prices for intermediate goods) than at the later stages (producer prices for consumer goods) (see Chart 21).

Chart 21 Breakdown of industrial producer prices



Sources: Eurostat and ECB calculations.

DOMESTIC PRICE PRESSURES REMAINED SUBDUED IN 2013

Domestic price pressures stemming from labour costs remained subdued in the first three quarters of 2013, in line with the continued weakness in euro area labour markets. Having shown some signs of moderation in 2012 compared with 2011, growth in labour costs picked up slightly in the first quarter of 2013 at the euro area level, before slowing again in the second and third quarters. The relatively smooth pattern of wage growth at the euro area level concealed substantial divergences in wage developments across countries. While nominal wages grew at robust rates in countries with relatively resilient labour markets, nominal wages and unit labour costs grew only slightly, or even declined, in countries implementing fiscal consolidation measures and experiencing persistently high levels of unemployment.

Euro area negotiated wages slowed in the course of 2013, growing at 1.7%, year on year, in the second and third quarters, compared with an annual average of 2.2% in 2012. The annual rate of growth in compensation per employee was 1.6% in the first three quarters of 2013, which was slightly lower than the average of 1.7% in 2012 (see Table 2). Other wage indicators, such as hourly labour cost growth, decreased substantially in 2013 by comparison with what was seen in 2012, primarily owing to the marked increase in hours worked. Overall, wages and salaries grew at a much faster rate than the non-wage component of euro area hourly labour costs.

After stagnating in 2012, labour productivity growth per employee recovered only slightly in the first three quarters of 2013, increasing to around 0.3% on average. This slight pick-up, together with the decrease in the annual rate of change of compensation per employee, led to a slowdown in unit labour cost growth, to 1.1% year on year in the third quarter, compared with 1.7% in 2012.

Following the rebound that had started in mid-2009, corporate profits remained broadly unchanged in 2011 and 2012. After moderate improvements in previous quarters, profit levels went up more significantly from the second quarter of 2013. Reflecting the increase in unit labour cost growth and the adverse economic conditions, the annual rate of change in corporate profits was negative throughout 2012 and turned positive in the first quarter of 2013. This rebound in corporate profit growth is attributable mainly to a rise in unit profits (i.e. the margin per unit of output).

Table 2 Labour cost indicators

(annual percentage changes, unless otherwise indicated)

	2010	2011	2012	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3
Negotiated wages	1.7	2.0	2.2	2.2	2.2	1.9	1.7	1.7
Hourly labour cost index	1.5	2.2	1.9	2.0	1.6	1.9	1.1	1.0
Compensation per employee	1.9	2.1	1.7	2.0	1.5	1.6	1.6	1.6
<i>Memo items:</i>								
Labour productivity	2.4	1.3	0.0	-0.1	-0.3	-0.2	0.4	0.5
Unit labour costs	-0.6	0.8	1.7	2.1	1.8	1.8	1.2	1.1

Sources: Eurostat, national data and ECB calculations.

RESIDENTIAL PROPERTY PRICES BOTTOMED OUT

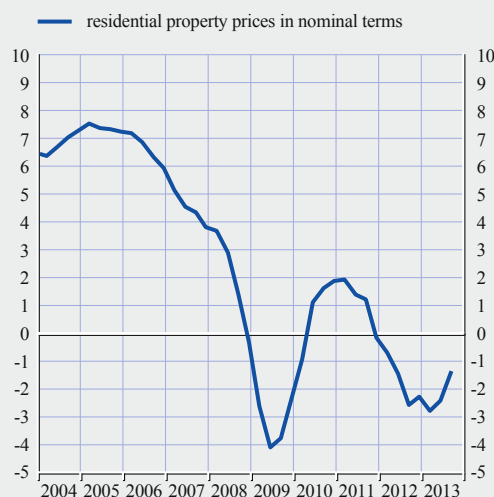
Euro area residential property prices, which are not included in the HICP, started to decline in the autumn of 2011 (see Chart 22). In the third quarter of 2013 they fell by 1.4% year on year, which was less than in the first and the second quarters (-2.8% and -2.4% respectively). This could be indicative of a bottoming-out in the annual rate of change in house prices. Significant divergence in annual house price growth among the euro area countries was also observed in 2013. While annual house price growth was negative and continued to decline in many euro area countries, it remained positive in Belgium, Estonia, Finland, Germany, Luxembourg and Austria.

DEVELOPMENTS IN INFLATION EXPECTATIONS

Data from Consensus Economics, the Euro Zone Barometer and the ECB Survey of Professional Forecasters show that survey-based longer-term inflation expectations (five years ahead) were close to 2.0% in 2013. Market-based indicators, such as long-term break-even inflation rates derived from inflation-linked bonds and comparable rates extracted from inflation-linked swaps, were also fully consistent with the Governing Council's definition of price stability.⁶

Chart 22 Residential property price developments in the euro area

(annual percentage changes; quarterly data)



Source: ECB calculations based on non-harmonised national data. Note: Data for 2013 include data up to the third quarter of 2013.

2.4 OUTPUT, DEMAND AND LABOUR MARKET DEVELOPMENTS

ECONOMIC ACTIVITY STARTED TO RECOVER IN THE COURSE OF 2013

Following an extended period of weakness, economic activity in the euro area started to improve in the course of 2013 (see Table 3). Domestic demand strengthened gradually in line with improving business and consumer sentiment, albeit from low levels. Private consumption was affected by the adverse impact of falling employment on aggregate income, particularly at the beginning of the year. This was offset later in the year by the positive impact on real income from falling commodity prices. Investment, which benefited from declining uncertainty, continued to be hampered by ongoing deleveraging needs, in both the financial and non-financial sectors, as well as by credit supply constraints. Continuing low rates of capacity utilisation and subdued demand prospects are additional elements that are likely to have constrained investment. Meanwhile, public consumption was held back by continued fiscal consolidation efforts in several euro area countries, although the overall fiscal stance was less restrictive than in 2012. There was also a turnaround in the inventory cycle in 2013 as the strong adjustment that started in the second half of 2011 came to an end. At the same time, external trade continued to contribute positively to euro area real GDP growth in 2013. Overall, a weak first quarter of the year, together with a negative carry-over effect from the previous year of 0.5%, led to a further reduction in GDP of 0.4% for 2013 as a whole. This compares with a fall of 0.7% in 2012.

⁶ For further details, see the box entitled "The anchoring of long-term inflation expectations in the euro area", *Monthly Bulletin*, ECB, October 2013.

Table 3 Composition of real GDP

(percentage changes, unless otherwise indicated; seasonally adjusted)

	Annual rates ¹⁾								Quarterly rates ²⁾				
	2011	2012	2013	2012	2013	2013	2013	2013	2012	2013	2013	2013	2013
				Q4	Q1	Q2	Q3	Q4	Q4	Q1	Q2	Q3	Q4
Real gross domestic product	1.6	-0.7	-0.4	-1.0	-1.2	-0.6	-0.3	0.5	-0.5	-0.2	0.3	0.1	0.3
<i>of which:</i>													
Domestic demand ³⁾	0.7	-2.2	.	-2.3	-2.1	-1.4	-0.5	.	-0.7	-0.3	0.0	0.5	.
Private consumption	0.3	-1.4	.	-1.5	-1.2	-0.6	-0.4	.	-0.5	-0.1	0.1	0.1	.
Government consumption	-0.1	-0.5	.	-0.7	-0.1	0.1	0.5	.	0.0	0.3	0.0	0.2	.
Gross fixed capital formation	1.6	-4.1	.	-4.7	-5.5	-3.5	-2.4	.	-1.2	-2.0	0.3	0.5	.
Changes in inventories ^{3),4)}	0.3	-0.5	.	-0.3	-0.3	-0.4	0.1	.	-0.2	0.1	-0.2	0.3	.
Net exports ³⁾	0.9	1.6	.	1.2	0.9	0.7	0.2	.	0.1	0.1	0.3	-0.4	.
Exports ⁵⁾	6.5	2.5	.	1.9	0.1	1.3	0.9	.	-0.6	-0.9	2.1	0.3	.
Imports ⁵⁾	4.5	-1.0	.	-0.8	-1.9	-0.3	0.6	.	-1.0	-1.1	1.5	1.2	.
Real gross value added													
<i>of which:</i>													
Industry excluding construction	3.0	-1.1	.	-1.4	-1.7	-1.0	-1.0	.	-1.6	0.0	0.5	0.0	.
Construction	-1.6	-4.2	.	-5.3	-5.4	-4.6	-3.4	.	-1.7	-1.3	-0.4	-0.0	.
Services	1.8	0.0	.	-0.3	-0.4	-0.1	0.2	.	-0.1	-0.2	0.3	0.2	.

Sources: Eurostat and ECB calculations.

Notes: Annual data are calculated using non-seasonally adjusted data. Eurostat's second estimate of national accounts for the fourth quarter of 2013 (which includes the expenditure breakdown) took place after the cut-off date for data for this report.

1) Percentage change compared with the same period a year earlier.

2) Percentage change compared with the previous quarter.

3) As a contribution to real GDP growth; in percentage points.

4) Including acquisitions less disposals of valuables.

5) Imports and exports cover goods and services and include internal cross-border trade in the euro area. Since intra-euro area trade is not cancelled out in the import and export figures used in national accounts, these data are not fully comparable with balance of payments data.

In terms of quarter-on-quarter developments, after a decline of 0.5% in the last quarter of 2012, euro area real GDP contracted by a further 0.2% in the first quarter of 2013. The decline in output in the first quarter was partly exacerbated by cold weather in parts of Europe, which mainly affected activity in the construction sector. In the second quarter of 2013 output rose by 0.3%, quarter on quarter, thereby rising for the first time in six quarters. This increase was partly attributable to temporary factors affecting output in some countries, notably the rebound in construction activity from its weakness in the first quarter, as well as high energy consumption in response to an unusually cold spring. The level of output rose by a further 0.1% on a quarterly basis in the third quarter, in line with developments in short-term indicators. This was partly on the back of a continued increase in domestic demand (excluding changes in inventories), which outpaced net trade in terms of quarterly contributions to GDP growth for the first time since the first quarter of 2011. Eurostat's first estimate for the fourth quarter puts the quarter-on-quarter change in real GDP at 0.3%. No breakdown is available for the fourth quarter as yet, but the latest information points towards a continued positive contribution from domestic demand alongside a moderate positive contribution from net exports.

DOMESTIC DEMAND IMPROVED AFTER A SLOW START TO THE YEAR

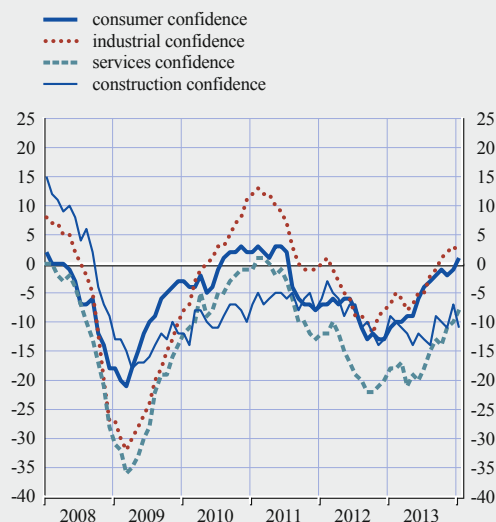
Private consumption posted positive, albeit modest, growth rates in both the second and third quarters of the year, following six quarters of contraction. Developments in consumption were in line with the continued reduction in real disposable income. However, despite a stronger fall in employment, the decline in real disposable income was smaller in 2013 than in 2012. This is partly explained by the less restrictive fiscal policy stance and the fall in commodity prices, both of which supported real household income. At the same time, households drew on their savings in order to lessen the effect of lower disposable income on spending patterns. As a result, the saving ratio fell

slightly further in 2013, reaching unprecedented low levels. The indicator of consumer confidence, which provides a reasonably good indication of trends in consumption, improved markedly throughout 2013, more than making up for the sharp fall in the second half of 2012. However, confidence only returned to a level close to its long-term average at the end of 2013 (see Chart 23). Looking at the year as a whole, private consumption declined further, albeit not as sharply as in 2012. This very much reflected a carry-over effect from depressed developments in 2012 and weak growth at the beginning of 2013.

Following eight quarters of negative growth, dynamics in investment strengthened in the course of 2013, with positive quarterly growth rates being recorded in both the second and third quarters of 2013. This improvement, which reflected developments in both construction and non-construction investment, took place alongside rising business sentiment and declining uncertainty. At the same time, the ongoing deleveraging process and balance sheet restructuring needs on the part of both firms and banks in some countries, as well as the continuing high oil price, again dampened investment in 2013. Box 4 reviews some stylised facts about so-called creditless recoveries in the context of recent developments. Further adjustments in the housing markets in most regions also exerted downward pressure on residential investment. In 2013 as a whole, investment declined by less than in 2012, when it contracted by more than 4%. This annual decline is fully explained by a negative carry-over effect from weak growth in 2012, coupled with a poor start to the year.

Chart 23 Confidence indicators

(percentage balances; seasonally adjusted)



Sources: European Commission Business and Consumer Surveys. Note: Data shown are calculated as deviations from the average over the period since January 1985 for consumer and industrial confidence, and since April 1995 for services confidence.

Box 4

BANK LOANS AND THE RECOVERY IN THE EURO AREA

The importance of bank credit in boosting economic activity is well established. Bank loans to the private sector are a key factor for financing investment and consumption, particularly in bank-based financial systems such as that of the euro area. Thus it has been argued that weak credit growth resulting from deleveraging needs in the private sector, weak credit demand or constraints in the supply of credit may dampen the economic recovery in the euro area. At the same time, historical evidence suggests that, initially, output can also recover in the absence of credit growth. This box reviews some stylised facts about such “creditless” recoveries and provides some evidence on recent developments and the empirical relationship between output and loan growth in the euro area.

Creditless recoveries

The prospects for economic activity in the absence of credit growth have been a subject of public debate in recent years, particularly in those euro area countries with significant balance sheet problems that have been undergoing an adjustment process. The literature shows that recoveries in output without a coincident pick-up in credit are not rare events. Recent empirical research on a sample of advanced, emerging and low-income countries suggests that one in five recoveries is creditless.¹ The fact that such recoveries tend to be more frequent after a banking or currency crisis suggests that impaired financial intermediation may play an important role in the sluggishness of credit growth.

Creditless recoveries are typically preceded by large declines in economic activity and by financial stress, particularly if private sector indebtedness is high and the country is reliant on foreign capital inflows.² Creditless recoveries tend to be relatively weak, with average real GDP growth rates being around a third lower than during recoveries associated with a normal development of credit. Activity in sectors that are more dependent on external finance is also comparatively more curtailed during creditless recoveries. Investment – which is more dependent on credit than consumption – makes a disproportionately small contribution to growth in creditless recoveries relative to other recoveries, although consumption also tends to be weaker.

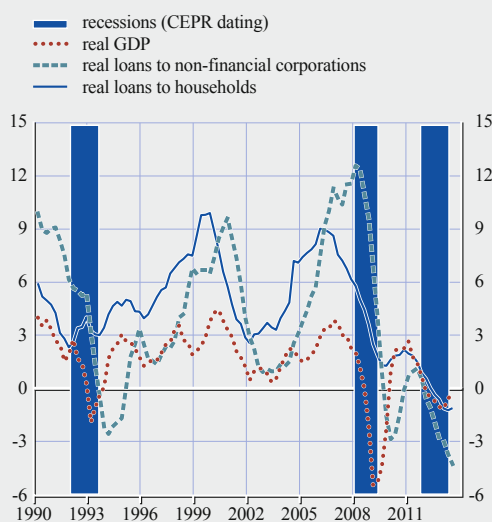
There are various explanations for the phenomenon of rebounding output growth without credit. For example, recoveries may be financed by alternative sources of financing, such as retained earnings, securities issuance or inter-company credit (including across borders). Moreover, a reallocation of economic activity to less credit-dependent sectors, or the take-up of unused production capacity, may help firms to increase their output in the absence of credit growth.

Economic recoveries and loan growth in the euro area

Comparing the current cycle with earlier downturns shows that real loan growth both to firms and to households has fallen by more in the most recent recession than in the other recessions that have occurred since the 1990s (see Chart A). An extended period of low credit supply to firms, especially new firms, may create barriers to entry, thereby having a negative impact on growth in total factor

Chart A Annual growth of real GDP, real loans to households and real loans to non-financial corporations

(annual percentage changes)



Sources: ECB, Eurostat and Centre for Economic Policy Research (CEPR).

Notes: The latest observation is for the third quarter of 2013. Shaded areas delimit recessions for the euro area according to the chronology of the CEPR Business Cycle Dating Committee. Real series have been derived by deflating nominal series with the GDP deflator.

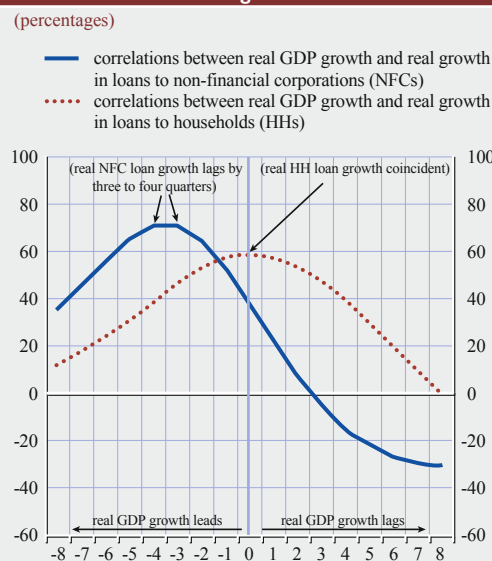
1 See Abiad, A., Dell’Ariccia, G. and Li, B., “Creditless recoveries”, *IMF Working Paper*, No 11/58, 2011. In this paper, a creditless recovery is defined as an episode where real credit growth is negative in the three years following a recession.

2 See Bijsterbosch, M. and Dahlhaus, T., “Determinants of creditless recoveries”, *Working Paper Series*, No 1358, ECB, 2011.

productivity. While the weakness in loans to non-financial corporations continued, a turning point in real household loan growth appears to have taken place in 2013. This seems to have broadly coincided with a turning point in real GDP growth, which is in line with historical patterns. An analysis based on simple correlations suggests that real loans to non-financial corporations tend to lag behind annual real GDP growth by three to four quarters, while the growth of loans to households broadly coincides with annual real GDP growth (see Chart B). An analysis based on turning points implies similar lead/lag relationships with reference to peaks and troughs.³ However, these correlations are not perfectly stable, and specific factors, such as those typically associated with creditless recoveries, may imply deviations from historical regularities.

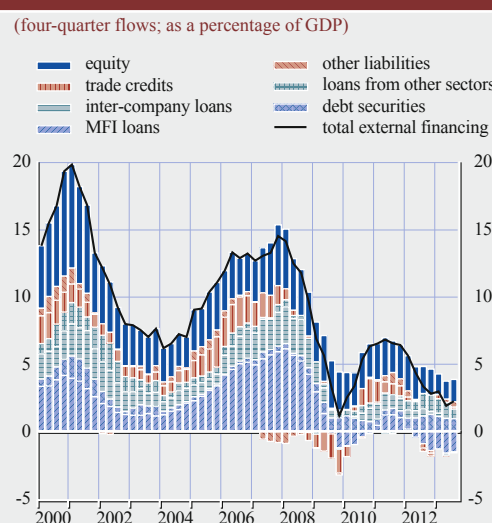
There are some signs that euro area firms have partially compensated for weak loans – reflecting firms’ and banks’ deleveraging needs – with other financing sources since the start of the crisis in 2008 (see Chart C). Firms have – at least partially – offset the drop in bank financing by increasing their issuance of debt securities. Nevertheless, the number of firms issuing debt securities is relatively small, and they are often larger in size and unevenly spread across euro area countries and sectors. Though alternative sources of financing, such as the issuance of debt securities and equities, as well as loans from other sectors, have partly made up for weak MFI loan growth, the total amount of financing provided to firms as a percentage of GDP has been lower over the past few years than in previous cycles. To some extent, this reflects the ongoing necessary correction of past excesses in debt accumulation, especially in certain countries and sectors, and illustrates the fact that credit conditions have been far tighter during the crisis than in previous recessions.

Chart B Correlations at different leads/lags: growth in real loans to households and in real loans to non-financial corporations relative to real GDP growth



Sources: ECB, Eurostat and ECB calculations.
 Notes: Data are for the period between the first quarter of 1981 and the third quarter of 2013. Real series have been derived by deflating nominal series with the GDP deflator.

Chart C Euro area non-financial corporations’ external financing and its main components



Source: ECB.
 Note: “Other liabilities” include other accounts payable and pension fund reserves.

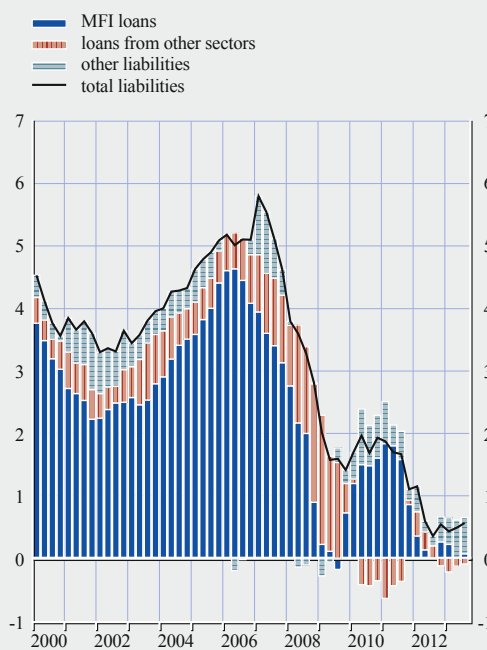
³ See the box entitled “Stylised facts of money and credit over the business cycle”, *Monthly Bulletin*, ECB, October 2013.

For the euro area household sector, bank loans are essentially the only source of external financing. Although growth in such loans to households has declined substantially over recent years (see Chart D), flows have remained positive, in contrast to those to the corporate sector.

To conclude, the real growth rate of loans has been considerably lower in recent years than in the past for all levels of GDP growth. In addition to demand factors – such as the low level of investment – constraints in the supply of financing also play a role in the weakness of credit growth. Nevertheless, there are no indications thus far that the cyclical relationship between the business cycle and loans to the private sector is out of line with historical regularities observed for the euro area. At the same time, there are some signs that firms, in particular, have tried to substitute loans with other financing sources during the recent crisis. These are typical features of a recovery following a balance sheet crisis.

Chart D Euro area households' external financing and its main components

(four-quarter flows; as a percentage of GDP)



Source: ECB.

Following a decline in 2012, annual growth in government consumption in all likelihood turned marginally positive in 2013 (see Table 3). The recovery in public spending was largely the result of the pace of fiscal consolidation slowing in a number of euro area countries. In particular, the reduction in compensation of government employees, which accounts for about half of total government consumption in the euro area, seems to have come to a halt. Social transfers in kind continued to rise broadly in line with the trend in previous years. Intermediate consumption expenditure remained broadly constant in 2013.

Finally, there was a turnaround in the inventory cycle in 2013 as the strong inventory adjustment that started in the second half of 2011 came to an end. The euro area returned to moderate restocking in the course of the year. As a result, the contribution of inventories to growth is likely to have been close to neutral in 2013 for the year as a whole, compared with a negative contribution in 2012 (-0.5 percentage point of GDP) and positive contributions in 2011 and 2010 (0.3 and 0.6 percentage point of GDP respectively).

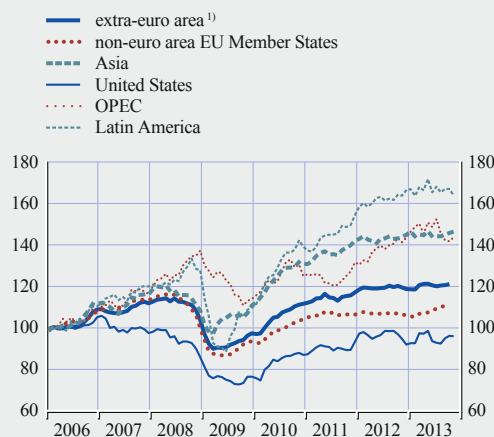
NET TRADE CONTINUED TO HOLD UP

External trade continued to contribute positively to euro area real GDP growth in 2013. The contribution to growth from net trade was weaker than in 2012 as export growth slowed, while imports started to recover in the second quarter of the year after falling considerably in 2012. The lower export growth, while still positive for the year as a whole, reflects weak foreign demand and,

to a lesser extent, the impact of the appreciation of the euro in nominal effective terms. Nevertheless, continued improvements in price competitiveness in the wake of the ongoing rebalancing process supported export growth in several euro area countries (see Box 5). At the same time, the current account surplus widened further on the back of the positive contribution to GDP growth from net trade. Looking at the geographical breakdown, exports to EU Member States outside the euro area picked up notably, while trade with Asia and the United States failed to gain momentum (see Chart 24). Intra-euro area trade showed signs of a nascent recovery in the second half of the year. Although annual import growth in the euro area was subdued in 2013, a recovery began in the second quarter following two years of a trend decline. The recovery was broadly in line with the gradual recovery in domestic demand and was also supported by the appreciation of the euro.

Chart 24 Euro area export volumes to selected trading partners

(indices: Q1 2006 = 100; seasonally adjusted; three-month moving averages)



Source: ECB.

Note: The latest observation is for November 2013, except for the extra-euro area and the non-euro area EU Member States, for which the latest observation is for October 2013.

1) Extra-euro area refers to exports from the euro area as a whole to the rest of the world.

Box 5

TRENDS IN EXPORT MARKET SHARES IN THE EURO AREA

This box describes trends in the export performance of the euro area and its member countries between 1999 and 2012. It reviews the export market performance by calculating euro area exports of goods and services relative to world exports, in terms of both volume and value. The analysis of export market shares in volume terms might offer some insights that are useful when assessing a country's price competitiveness at the macroeconomic level, as these shares may be relevant for GDP growth and can be expected to react directly to changes in price competitiveness. Shares in value terms, which partially capture terms of trade developments, may be more suitable for assessing income generated from exports and can be affected by changes in either volumes or values. Finally, export shares expressed in value terms may be affected somewhat differently by movements in the exchange rate compared with export shares in volume terms.¹

Euro area export market shares

The extra-euro area export market share of goods and services in value terms decreased from 18.8% in 1999 to 15.5% in 2012 in a context of the rapid integration of emerging markets into the world economy (see Chart A).²

1 It needs to be acknowledged that a simple export market share analysis is not able to capture the impact of globalisation on international production systems. For instance, for countries that use offshoring strategies, export market shares will be lower if sales are undertaken mainly from foreign affiliates rather than domestic parent companies.

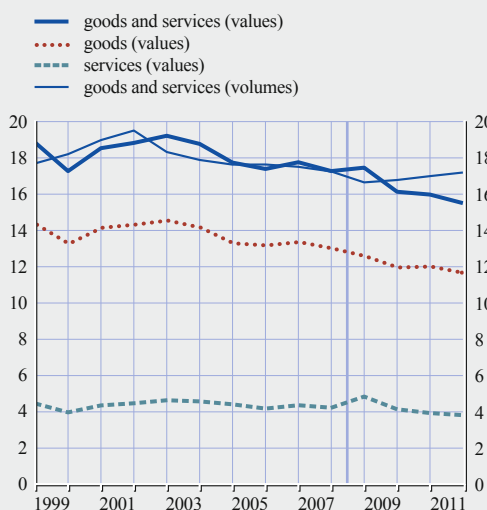
2 Over the period 1999-2012 the export market share of emerging economies surged from 25.7% to 43.8% in value terms.

The dynamics of the export market share of goods and services in value terms were mainly driven by trade in goods, as it accounts for around three-quarters of euro area exports. Between 1999 and 2008 the decline in the extra-euro area market share for goods amounted to 9.3%, whereas that for services was milder, standing at 5.3% (see Chart A). The declining trend in export market shares continued after 2009 for both goods and services.

In volume terms, however, between 1999 and 2008 the extra-euro area export market share in goods and services dropped less pronouncedly than in value terms, declining by 2.5% (see Charts A and B). Since 2009 the extra-euro area export market share in volume terms has rebounded, recording a cumulative rise of 3.3% up to 2012. The gains in volume terms were mainly driven by positive developments in German export volumes, which remained resilient, and by the efforts of a number of member countries to improve competitiveness (see Chart B). However, over the period 1999-2012 the extra-euro area market share declined by 2.8% in volume terms.

Chart A Extra-euro area export market shares

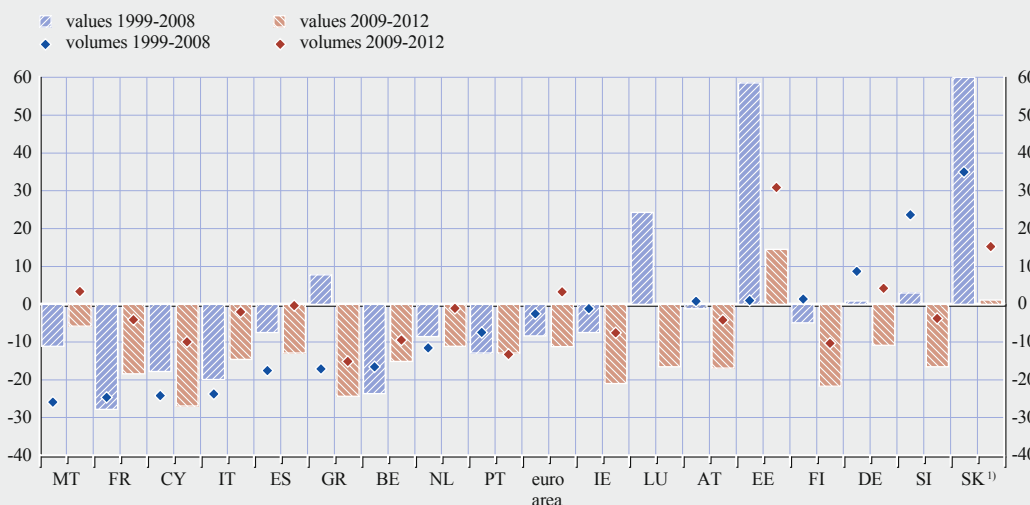
(annual data; as a percentage of world exports)



Sources: ECB calculations based on IMF World Economic Outlook and balance of payments data.
Note: Intra-euro area trade is excluded.

Chart B Export market shares of euro area countries

(annual data; percentage change; goods and services)



Sources: ECB calculations based on IMF World Economic Outlook and balance of payments data.
Notes: For the euro area, intra-euro area trade is excluded. Owing to data unavailability, volume data for Luxembourg are missing. Countries are ranked according to the change in export market share in volume terms over the period 1999-2008.
1) The export market share of Slovakia in value terms increased by 128.3% over the period 1999-2008.

The differences in market share developments observed, depending on whether value or volume data are used, reflect relative price developments. If the loss of export market share in value terms is larger than in volume terms, it suggests that the export prices of the country in question increased less than the world export prices. Over the period 1999-2012 the euro area's losses of export market share in goods and services in volume terms (2.8%) were less pronounced than in value terms (17.7%), suggesting that prices of euro area exports increased less than world export prices (see Chart B). This may be related to a loss in euro area terms of trade, possibly owing to relative commodity price increases.³

Developments in export market shares of euro area countries

Between 1999 and 2012 most euro area countries recorded a loss in their export market shares for goods and services in both volume and value terms. However, differences across countries can be observed (see Chart B).

In particular, between 1999 and 2008 Slovakia, Slovenia, Estonia and Germany gained export market share both in value and volume terms.⁴ Germany and Slovenia gained more in volume terms than in value terms (see Chart B). This suggests that export prices of those countries increased less than world export prices, reflecting for Germany domestic wage growth moderation. Austria and Finland also improved their relative price competitiveness as they gained in volume terms. Over the same period Malta, Spain, Cyprus, Italy and the Netherlands experienced slightly higher losses in export shares in volume terms than in value terms, pointing to losses in price competitiveness. Greece experienced pronounced losses in volume terms, indicating that export prices for Greek products grew faster than world export prices, leading to a continuous loss of price competitiveness. For some of these economies, the decline in export market shares could be explained by the fact that they were booming during this period, and therefore their incentive to sell abroad was smaller. The opposite trend was apparent in France, Belgium, Ireland and Portugal, which lost more in value terms, gaining price competitiveness marginally in relative terms.

Between 2009 and 2012 some euro area economies (Belgium, France, Italy, Ireland, Greece and Cyprus) experienced a much less pronounced decline in their export market shares in volume terms than in value terms. While the export market share in value terms also declined for Spain and the Netherlands, their export market share in volume terms stabilised. These developments reflect the general efforts to regain or maintain competitiveness in many of these economies, and the incentive of some of these economies to sell more abroad, since domestic demand remained weak over the same period.

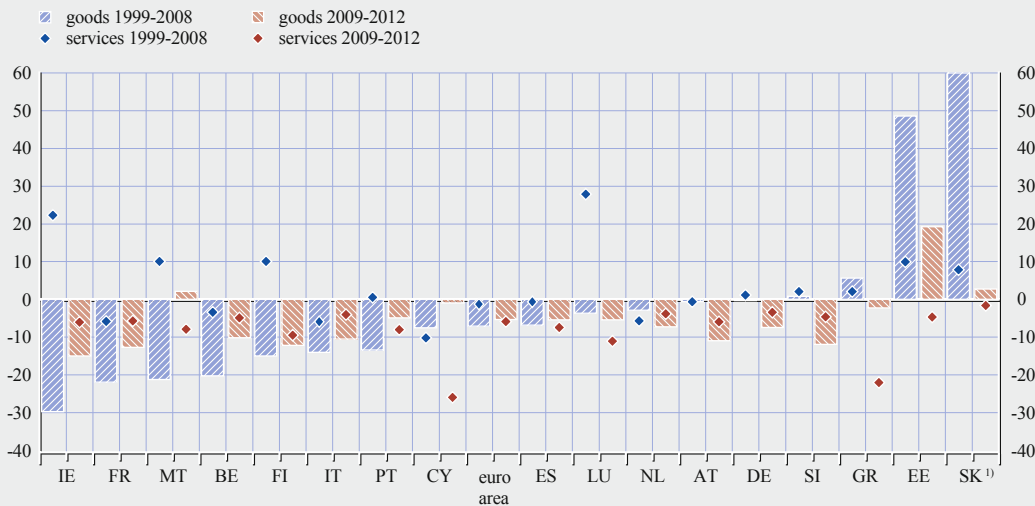
Between 2009 and 2012 Germany's export market share remained resilient, reflecting further improvements in its relative price competitiveness. Estonia and Slovakia registered positive growth in their export market shares, which was more pronounced in volume terms. Malta's share grew marginally in volume terms, while in Portugal the decline in both volume and value

³ Price factors only partly explain developments in export market shares. It should be noted that over a longer time horizon other non-price factors are found to also contribute to the evolution of export performance (see "Competitiveness and the export performance of the euro area", *Occasional Paper Series*, No 90, ECB, June 2005). See also Dieppe et al. (2011), di Mauro and Forster (2008), Benkovskis and Wörz (2012), Antras et al. (2010) and Altomonte et al. (2013).

⁴ Slovakia's export market share gains also reflect non-price competitiveness factors (the country's ability to attract sizeable foreign direct investment inflows and its integration in the production of components in the automotive and electronic sectors). However, there might also be some statistical bias owing to exchange rate conversion issues prior to Slovakia's entry into the euro area.

Chart C Contributions of goods and services to export market shares

(annual data; percentage change; in value terms)



Sources: ECB calculations based on IMF World Economic Outlook and balance of payments data.

Notes: For the euro area, intra-euro area trade is excluded. Countries are ranked according to the contribution of goods to export market share over the period 1999-2008.

1) The contribution of goods to the export market share of Slovakia increased by 120.4% over the period 1999-2008.

terms was similar. While experiencing growth in export market shares in volume terms before the crisis, Austria, Finland and Slovenia witnessed a deterioration in their export market shares between 2009 and 2012. This fall in export market shares was smaller in volume terms than in value terms.

Decomposing the growth in the value of export market shares into goods and services, the exports of services tend to outperform the exports of goods in value terms when measured as a share of total world exports. Between 1999 and 2008 most euro area countries recorded a loss in their export market shares of goods, with the exception of Slovakia, Estonia and Greece (see Chart C).⁵ For Austria, Germany and Slovenia, the contribution of goods to the change in total export market share was neutral. Over the same period, for Luxembourg, Ireland, Finland, Malta, Estonia, Slovakia, Slovenia, Greece, Germany and Portugal, services contributed positively to the growth of export market shares. Between the onset of the financial crisis and 2012 these gains were reversed, and there was a general decline of export market shares for both goods and services, with services remaining relatively more resilient than goods.

Overall, the euro area has been faced with a general decline in export market shares, linked to the emergence of developing countries. However, some positive developments in volume terms since the onset of the crisis reveal a relative improvement in euro area price competitiveness. At the country level, this is reflected in the improvement of competitiveness in several member countries and in the resilience of German exports. While goods contributed more to the decline of export market shares, services appear to have been more resilient.

⁵ The percentage contributions of goods and services to total export market share growth are computed by weighting the percentage growth of export market shares in goods and services by their respective shares in a country's total exports (the shares are calculated in the initial year of the reference period).

ACTIVITY IN THE INDUSTRIAL SECTOR INCREASED SLIGHTLY

Despite some volatility, activity in the industrial sector improved somewhat throughout the year, in line with the gradual recovery in GDP. In December 2013 industrial production (excluding construction) stood 0.5% above its level one year earlier, whereas in December 2012 it had been 2.4% below its level at the same time the year before. Among the components of industrial production (excluding construction), intermediate goods recorded the strongest increase in 2013 (see Chart 25). However, value added in industry (excluding construction) declined on an annual basis, falling by 1.2% on average during the first three quarters of the year, compared with a contraction of 1.1% in 2012.

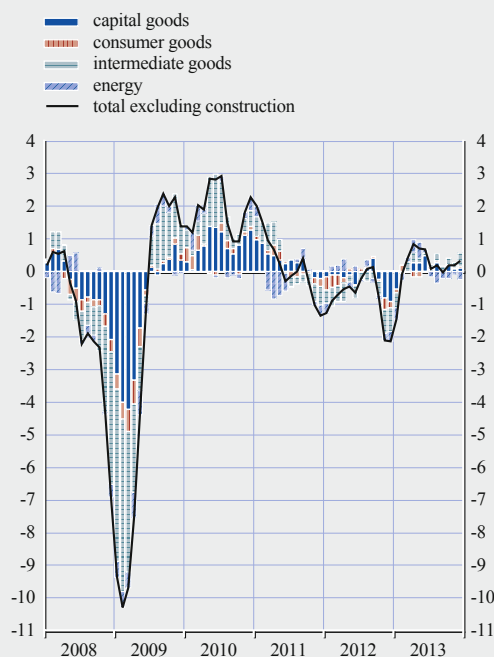
Construction production declined further in 2013, continuing its extended period of weakness. After a decline of 4.2% in 2012, value added in construction fell by 4.5% on average, year on year, in the first three quarters of 2013 (based on seasonally adjusted data). Meanwhile, value added in services, which remained stable in 2012, recorded a modest decline of 0.1% during the same period.

LABOUR MARKETS BOTTOMED OUT IN 2013

Headcount employment, which declined by 0.7% in 2012, fell further in 2013 (see Chart 26). As a result, in the third quarter of 2013 euro area employment stood about 0.8% below its level one year earlier. However, quarter-on-quarter employment developments show that the labour market situation has stabilised. Headcount employment remained broadly stable, quarter on quarter, in the second and third quarters of 2013. These developments followed seven consecutive quarters of decline. Moreover, survey results have improved in the course of the year, pointing to a stable or slightly positive rate of job creation in the fourth quarter of 2013. Overall, employment is likely to have fallen by around 1% in 2013 as a whole. From a sectoral perspective, this decline in headcount employment was broadly based across the main sectors.

Chart 25 Industrial production and contributions

(growth rate and percentage point contributions; monthly data; seasonally adjusted)



Sources: Eurostat and ECB calculations.
Note: Data shown are calculated as three-month moving averages against the corresponding average three months earlier.

Chart 26 Labour market developments

(quarter-on-quarter growth rate, percentage of the labour force; seasonally adjusted)



Source: Eurostat.

As in 2012, total hours worked recorded a somewhat more pronounced decline than headcount employment in 2013. This suggests that many firms continued to reduce their labour input by cutting hours worked per person rather than by reducing headcount. This pattern of reduced working hours appears to have reversed in the latter half of 2013, which would be in line with indications of a gradual improvement in the labour market, where a normalisation of hours worked often precedes renewed hiring.

As labour market developments tend to lag behind overall cyclical developments, the decline in employment growth was greater than that in output growth. This implies that annual productivity growth per person rose from -0.3% in the last quarter of 2012 to +0.5% in the third quarter of 2013. The average annual growth rate over the first three quarters of the year was 0.2%, which compares with no growth in the previous year. The increase in productivity growth affected all sectors. As a result of the sharper decline in hours worked than in jobs, annual growth in overall productivity measured by hours worked stood at 0.7% on average during the first three quarters of 2013, which is similar to the growth rate recorded in 2012.

After bottoming out in the first half of 2011, the euro area unemployment rate continued to increase in 2012 and the first three quarters of 2013, reaching levels not seen since the start of the series in 1995. However, the increase in 2013 was not as sharp as in 2012, and was halted by a small decline in the unemployment rate in October (see Chart 26). Thereafter, the unemployment rate remained stable at 12.0% until the end of 2013, despite an ongoing decline in the number of unemployed. Nevertheless, in December the unemployment rate stood more than 2 percentage points above its trough of April 2011. For 2013 as a whole the unemployment rate averaged 12.1%, compared with 11.4% in 2012.

2.5 FISCAL DEVELOPMENTS

The euro area government deficit is expected to have declined further in 2013, reflecting sizeable consolidation efforts in most countries. Compared with its peak in 2009, the euro area-wide deficit has more than halved. After several years of comprehensive and often painful budgetary adjustments, the euro area has made relatively more progress in restoring sound fiscal positions than other major advanced economies. However, general government debt-to-GDP ratios are still very high and, in many countries, have not yet stabilised. The euro area's main fiscal policy challenge is, therefore, to sustain fiscal consolidation over the medium term. This is necessary to reduce excessive debt ratios and create fiscal buffers against future shocks, particularly in light of the detrimental impact of ageing populations on public finances.

FISCAL CONSOLIDATION IN 2013

According to the European Commission's autumn 2013 economic forecast, the aggregate general government deficit for the euro area is expected to have declined by 0.6 percentage point, to 3.1% of GDP in 2013 (see Table 4). The reduction in the budget deficit in 2013 was largely driven by a 0.5 percentage point increase in the government revenue ratio, to 46.7% of GDP. This reflected, in particular, a broadening of tax bases and increases in tax rates in several countries. At the same time, the expenditure ratio declined only marginally (by 0.1 percentage point), to 49.8% of GDP.

The average general government gross debt-to-GDP ratio for the euro area is expected to have increased significantly, from 92.7% in 2012 to 95.7%, albeit at a slower pace than in 2012. According to the European Commission's autumn 2013 economic forecast, 13 of the 17 euro area

Table 4 Fiscal positions in the euro area and euro area countries

(as a percentage of GDP)

	General government surplus (+)/deficit (-)				General government gross debt			
	European Commission			Stability programme	European Commission			Stability programme
	2011	2012	2013	2013	2011	2012	2013	2013
Belgium	-3.7	-4.0	-2.8	-2.5	98.0	99.8	100.4	100.0
Germany	-0.8	0.1	0.0	-0.5	80.0	81.0	79.6	80.5
Estonia	1.1	-0.2	-0.4	-0.5	6.1	9.8	10.0	10.2
Ireland	-13.1	-8.2	-7.4	-7.5	104.1	117.4	124.4	123.3
Greece ¹⁾	-9.5	-9.0	-13.5	-	170.3	156.9	176.2	-
Spain	-9.6	-10.6	-6.8	-6.3	70.5	86.0	94.8	91.4
France	-5.3	-4.8	-4.1	-3.7	85.8	90.2	93.5	93.6
Italy	-3.8	-3.0	-3.0	-2.9	120.7	127.0	133.0	130.4
Cyprus	-6.3	-6.4	-8.3	-	71.5	86.6	116.0	-
Luxembourg	0.1	-0.6	-0.9	-0.7	18.7	21.7	24.5	23.8
Malta	-2.8	-3.3	-3.4	-2.7	69.5	71.3	72.6	74.2
Netherlands	-4.3	-4.1	-3.3	-3.4	65.7	71.3	74.8	74.0
Austria	-2.5	-2.5	-2.5	-2.3	72.8	74.0	74.8	73.6
Portugal ¹⁾	-4.3	-6.4	-5.9	-5.5	108.2	124.1	127.8	122.3
Slovenia	-6.3	-3.8	-5.8	-7.9	47.1	54.4	63.2	61.8
Slovakia	-5.1	-4.5	-3.0	-2.9	43.4	52.4	54.3	54.8
Finland	-0.7	-1.8	-2.2	-1.9	49.2	53.6	58.4	56.3
Euro area	-4.2	-3.7	-3.1	-2.9	88.0	92.7	95.7	93.4

Sources: European Commission's autumn 2013 economic forecast, April 2013 update of the stability programmes and ECB calculations.
 Note: Data are based on ESA 95 definitions.

1) For Greece and Portugal, figures refer not to the stability programme targets but to the review of the second adjustment programme. The targets for Greece have been set in primary balance terms.

countries recorded government debt-to-GDP ratios above the Maastricht reference value of 60% in 2013; in eight of these countries, the general government debt ratio exceeded 90% of GDP. The rise in the aggregate euro area debt ratio is the result of the large impact of interest expenditure and stock-flow adjustment.

As indicated in Table 4, according to the European Commission's autumn 2013 economic forecast, for several countries, the budget balance is expected to have turned out worse than government plans outlined in countries' April 2013 stability programmes or, in the case of Portugal, the economic adjustment programme target. Overall, the planned fiscal targets are projected to have been missed in all countries except for Germany, Estonia, Ireland, the Netherlands, Portugal and Slovenia. Some countries, such as Italy and Slovakia, are expected to have missed their targets by a very small margin of 0.1%. Regarding the countries covered by EU-IMF financial assistance programmes, the fiscal deficit declined in Ireland and Portugal, while it rose in Greece and Cyprus. In the case of Greece, a primary surplus is expected to have been achieved in 2013, thereby exceeding the programme target. Box 6 reviews the 2013 developments in the euro area countries under an EU-IMF adjustment programme or receiving financial assistance.

DEVELOPMENTS IN 2013 IN EURO AREA COUNTRIES UNDER AN EU-IMF ADJUSTMENT PROGRAMME OR RECEIVING FINANCIAL ASSISTANCE

This box provides an overview of developments in 2013 in the four euro area countries under an EU-IMF adjustment programme, as well as in Spain, which has an EU financial sector assistance programme.¹ All five countries made significant progress in reducing their economic imbalances, addressing structural rigidities, especially in labour markets, and improving financial stability. Moreover, Ireland and Spain successfully concluded their respective programmes. Looking ahead, it is necessary to consolidate the achievements that have already been made and to proceed with the reform agenda.

Greece

In 2013 Greece made further progress in restoring fiscal sustainability and improving competitiveness. The economy started to stabilise in the second quarter of the year, following a deep and protracted recession. The far-reaching labour market reforms implemented in 2012 are beginning to show results, with encouraging data on net hiring in the private sector. While the decline in unit labour costs has been slow to translate into price adjustments, the process of price reductions gained momentum in 2013 and should also support continuous improvement in the country's current account.

As a result of the very strong consolidation efforts over the period 2010-13, a sizeable primary surplus (according to the programme definition) is expected to have been achieved in 2013. This outcome is better than the programme target of a balanced primary budget, mainly owing to underspending. In the period ahead, the Medium-Term Fiscal Strategy provides for an increase in the primary surplus-to-GDP ratio, with targets of 1.5% in 2014, 3.0% in 2015 and 4.5% in 2016.

Notwithstanding the progress made in implementing structural reforms, the remaining deep-rooted structural rigidities will need to be addressed more forcefully to create the basis for sustained economic growth and employment creation. Looking ahead, political commitment will be crucial for the necessary broadening and deepening of the structural reform agenda. In particular, product and services market reforms and institutional reforms need to be stepped up. The financial sector was strengthened by the capital increase in 2012-13. However, asset quality deteriorated further, with non-performing loans exceeding 30%.

Ireland

The implementation of the adjustment programme for Ireland remained on track, enabling the authorities to conclude the programme successfully in December 2013. While the pace of growth of the Irish economy slowed somewhat in the first half of 2013, high-frequency indicators pointed towards a further strengthening in activity in the second half of the year. The labour market

¹ A longer-term perspective of the rebalancing process in the euro area since the start of the crisis is provided in Box 5 of the ECB's Annual Report 2012.

continued to show signs of strengthening. Competitiveness gains continued to be achieved and the current account improved further.

In 2013 the fiscal position continued to improve and Ireland met its fiscal targets, despite the weak economy. The general government deficit is expected to have slightly outperformed the programme target in 2013. The 2014 budget foresees further consolidation, mainly on the expenditure side, aimed at reducing the general government deficit to 4.8% of GDP in 2014 and to below 3.0% of GDP in 2015. Looking ahead, Ireland needs to address the remaining fiscal vulnerabilities, especially in healthcare spending, and to continue to comply with its fiscal targets in order to provide a positive signal to markets.

Ireland's exit from the programme underlines the success of the necessary, but sometimes painful, measures. It is crucial for Ireland to continue implementing the necessary reforms, particularly in the banking sector, in order to safeguard market access and its long-term economic prospects.

Portugal

After a sharp contraction in 2011-12 real GDP and employment returned to positive growth rates in the second quarter of 2013. The correction of external imbalances has been remarkable in the past three years. The current account reached a surplus position in 2013.

The pace of fiscal consolidation, as measured by the change in the structural deficit, was very strong throughout the period 2011-13. In mid-2013 the deficit path was adjusted to allow the partial operation of automatic stabilisers, while safeguarding the debt-to-GDP ratio over the medium term. The deficit targets (excluding financial sector support) were revised from 4.5% of GDP to 5.5% in 2013 and from 2.5% to 4% in 2014. In 2013 the deficit was below the target thanks to a better than expected macroeconomic performance combined with strict budgetary control. The 2014 budget includes consolidation measures of more than 2% of GDP, mainly on the expenditure side.

Progress on structural reforms has been broadly in line with the programme conditionality. Most of the legislation on labour and product market policies included in the programme is now in force. Looking ahead, attention should focus on the effective implementation of the reforms, as well as on fostering the reform process, with the aim of removing the remaining obstacles to competition, investment decisions and job creation.

Cyprus

The EU-IMF adjustment programme for Cyprus was approved in April 2013. The large accumulated imbalances, the delay in starting the adjustment programme and the banking crisis led to a severe contraction in economic activity, although the downturn in 2013 was less deep than initially expected. At the same time, unemployment increased sharply and lending came to a standstill.

As a result of the deepening macroeconomic downturn, the fiscal position deteriorated in 2013. The programme set a primary deficit target of around 4¼% of GDP in 2013, including a one-off cost of 1.8% of GDP to compensate provident funds and retirement funds held with the Cyprus Popular Bank in order to ensure comparable treatment to funds held with the Bank of

Cyprus. Fiscal targets for 2013 were met by a considerable margin and in 2014 the primary deficit is expected to be lower than the original programme target of 4¼% of GDP. The 2014 budget seeks to bring forward part of the consolidation needed in later years in order to achieve and maintain a long-term primary fiscal surplus of 4% of GDP, thereby putting public debt on a downward path.

Good progress was made in 2013 in implementing structural and regulatory reforms. In addition, further progress was achieved in stabilising and restructuring the financial sector. In August 2013 the authorities published a roadmap, containing milestones, guiding the gradual relaxation of administrative measures and capital controls while safeguarding financial stability. Looking ahead, Cyprus will continue to face major challenges, particularly in the financial sector. It is therefore crucial that the programme continues to be implemented rigorously.

Spain

On 14 November 2013 the Eurogroup confirmed the positive assessment of the implementation of the financial sector assistance programme for Spain. The programme has helped to significantly improve the funding situation and structure of the Spanish banking sector. After more than two years in recession, real GDP growth turned slightly positive in the third quarter of 2013. The unemployment rate remains at very high levels and only started to decline gradually in the second half of 2013. The Spanish economy is benefiting from ongoing downward adjustments in unit labour costs which have helped to shift the current account into surplus.

Spain has recently achieved substantial fiscal consolidation and, with the help of additional consolidation measures passed in the autumn, is expected to have reached a deficit for 2013 close to the target of 6.5%. Further efforts are needed to meet the 5.8% target for 2014.

Looking ahead, it is crucial that the momentum of the reform process is maintained in the broader governance of the banking sector and in public administration and the labour markets.

CYCLICALLY ADJUSTED INDICATORS

As shown in Table 5, fiscal consolidation continued in 2013, even when accounting for the impact of the economic cycle on countries' budgetary situations. According to the European Commission's autumn 2013 economic forecast, both the cyclically adjusted balance and the cyclically adjusted primary balance (which excludes the effects of interest payments) are expected to have improved at the same pace as in 2012, i.e. by 1 and 0.9 percentage point of GDP respectively. The euro area structural deficit (which excludes one-off and temporary measures) further improved (by 0.7 percentage point of GDP, after 1.5 percentage points in 2012). However, these cyclically adjusted fiscal indicators should be interpreted with caution, as real-time estimates of the cyclical impact on budget balances are subject to a considerable degree of uncertainty, particularly in countries undergoing a significant rebalancing of their economies. Box 7 reviews progress with fiscal consolidation since the start of the crisis across the major advanced economies.

Table 5 Changes in the cyclically adjusted balance, the cyclically adjusted primary balance and the structural balance in the euro area and euro area countries

(in percentage points of GDP)

	Change in cyclically adjusted budget balance			Change in cyclically adjusted primary budget balance			Change in structural budget balance		
	2011	2012	2013	2011	2012	2013	2011	2012	2013
Belgium	-0.3	0.2	1.5	-0.3	0.3	1.3	0.0	0.3	0.8
Germany	2.2	1.4	0.4	2.2	1.2	0.3	1.2	1.3	0.3
Estonia	-1.3	-1.9	0.4	-1.3	-1.9	0.4	0.2	0.6	-0.4
Ireland	16.3	4.3	0.7	16.4	4.8	1.5	1.1	0.2	0.9
Greece	3.2	2.0	-4.3	4.6	-0.1	-5.1	3.1	4.7	2.2
Spain	-0.1	-0.7	3.9	0.5	-0.2	4.3	0.2	2.1	1.1
France	1.3	1.0	1.1	1.5	1.0	0.9	1.0	1.1	0.9
Italy	0.4	1.8	0.7	0.8	2.3	0.5	0.0	2.3	0.6
Cyprus	-1.1	0.4	0.7	-1.0	1.1	1.6	-0.9	-0.3	1.3
Luxembourg	0.4	0.1	-0.6	0.5	0.1	-0.5	0.4	0.1	-0.6
Malta	0.9	-0.2	-0.3	1.0	-0.1	-0.3	1.2	-0.4	0.3
Netherlands	0.5	1.1	1.3	0.5	0.9	1.3	0.4	1.1	0.6
Austria	1.2	0.1	0.4	1.1	0.1	0.4	1.1	0.7	0.0
Portugal	5.9	-1.3	1.0	7.2	-1.0	1.0	2.3	2.4	0.5
Slovenia	-1.2	3.2	-1.5	-0.9	3.4	-1.0	-0.2	2.2	-0.1
Slovakia	2.8	0.8	1.9	3.0	1.1	2.0	2.2	1.0	1.7
Finland	0.6	-0.4	0.0	0.7	-0.5	0.0	0.6	-0.4	-0.1
Euro area	1.5	1.0	1.0	1.7	1.1	0.9	0.8	1.5	0.7

Source: European Commission's autumn 2013 economic forecast.

Notes: Positive numbers correspond to fiscal improvements and negative numbers to fiscal deteriorations. For Ireland, Spain, Austria, Portugal and Slovenia, changes in the cyclically adjusted and cyclically adjusted primary balances include the phasing-out of sizeable financial sector support measures. In the case of Greece, changes in the cyclically adjusted and cyclically adjusted primary balances include the bank recapitalisation costs, the transfers received from Member States corresponding to profits on Greek bonds held by the Eurosystem central banks and other small factors.

Box 7

PROGRESS WITH FISCAL CONSOLIDATION: AN INTERNATIONAL COMPARISON

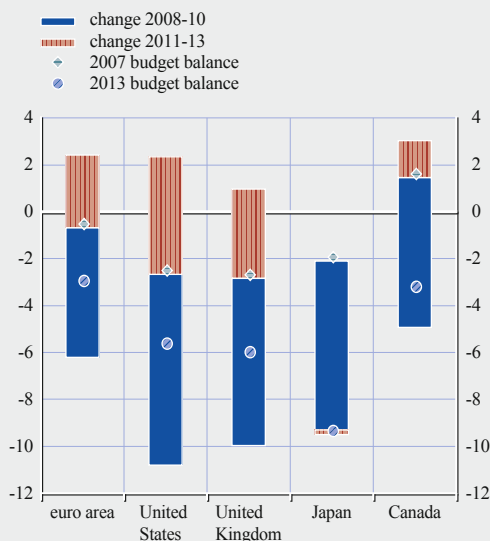
This box reviews progress with fiscal consolidation since the start of the crisis across the major advanced economies, namely the euro area, the United States, the United Kingdom, Japan and Canada. All the major advanced economies, including individual euro area countries, have achieved significant progress in reducing fiscal imbalances since 2010. Nonetheless, both the headline deficit and debt ratios remain very high and above pre-crisis levels. Looking ahead, it is important that fiscal consolidation efforts are maintained to ensure a return to sound fiscal positions.

Fiscal developments in the largest advanced economies since 2008

The international financial crisis of 2008, and the contraction in economic activity that followed, required swift and decisive policy action, especially in the major advanced economies which were particularly hit by the crisis. Since the end of 2008 emergency measures have been adopted in most major advanced economies, including in euro area countries, to provide financial support to banks in difficulty and preserve international financial stability. At the same time, and in order to limit the negative fall-out of the crisis for economic activity, governments have adopted significant budgetary stimuli. These policy actions, combined with the working of automatic stabilisers, caused the budget deficits and the debt-to-GDP ratios to rise to very high levels. Over the period 2008-10 nominal budget deficits increased by 5.5 percentage points of GDP

Chart A Government budget balance

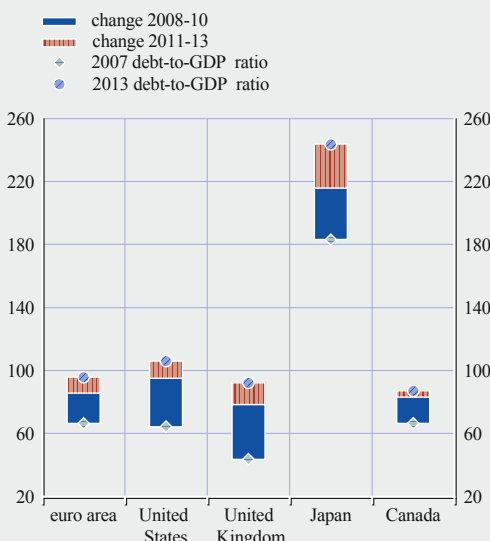
(as a percentage of GDP; percentage points of GDP)



Sources: IMF World Economic Outlook and ECB calculations.
Note: For all countries, data are reported on a calendar year basis.

Chart B Government debt-to-GDP ratio

(as a percentage of GDP; percentage points of GDP)



Sources: IMF World Economic Outlook and ECB calculations.
Note: For all countries, data are reported on a calendar year basis.

in the euro area, 6.4 percentage points in Canada, slightly above 7 percentage points in Japan and the United Kingdom, and about 8 percentage points in the United States (see Chart A). Double-digit increases were recorded in the debt-to-GDP ratios, with Japan and the United Kingdom experiencing the largest increases (see Chart B).

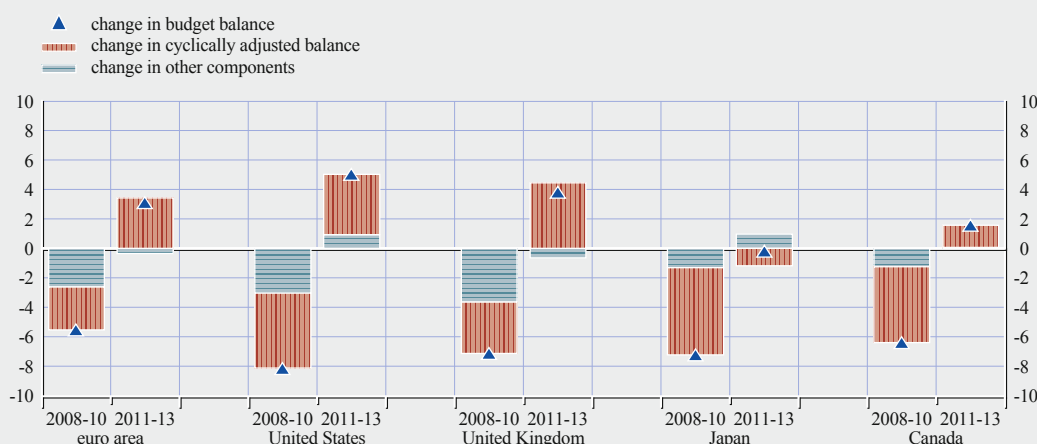
Since 2010 most advanced economies have embarked on fiscal consolidation. At that time, the IMF recommended an improvement in the cyclically adjusted balance of 1 percentage point of GDP per year, as of 2011, as being the appropriate pace of consolidation to strike the right balance between the need to address market concerns about fiscal fundamentals and the need to avoid an abrupt withdrawal of support to the then nascent recovery.¹ The effective pace of consolidation, however, varied greatly across countries depending on the severity of financial market pressures, on the degree of fiscal imbalances and, specifically in the euro area, on the requirements of the Stability and Growth Pact.

Compared with the United Kingdom, the United States and Japan, the budget deficit in the euro area at the beginning of the sovereign debt crisis was lower, whereas Canada recorded a surplus of 1.5% of GDP. Over the period 2011-13 the United States and the United Kingdom experienced the largest reduction in their budget deficit, followed by the euro area and Canada, whereas the deficit deteriorated slightly in Japan (see Chart C). According to IMF data, the annual average consolidation effort over the period 2011-13, as measured by the change in the cyclically adjusted balance, was above 1 percentage point of GDP in the euro area, the United States and the United Kingdom. It was about half that size in Canada and negative in Japan.

¹ See “Fiscal exit: from strategy to implementation”, *IMF Fiscal Monitor*, November 2010. Box 2 of the April 2013 IMF Fiscal Monitor confirms that a pace of adjustment of 1% of GDP in cyclically adjusted terms is broadly appropriate for countries not under market pressure.

Chart C Decomposition of the change in the budget balance over the periods 2008-10 and 2011-13

(percentage points of GDP)



Sources: IMF World Economic Outlook and ECB calculations.

Notes: For all countries, data are reported on a calendar year basis. For the United States, data from the October 2013 Fiscal Monitor are used as the cyclically adjusted balance is corrected for the government support to the financial sector. For Japan, the structural balance is used. The item “change in other components” includes the cyclical component and factors beyond the output cycle which affect the budget balance.

Consolidation efforts have started to bear fruit. Although nominal budget deficits in all the advanced economies remain high and above the pre-crisis levels, they have halved compared with their peak levels during the crisis in the United States and the euro area. In the euro area, the budget deficit and the cyclically adjusted balance in 2013 are expected to be the lowest among major advanced economies; the adjustment process has succeeded in bringing the cyclically adjusted deficit below its pre-crisis level in the euro area and the United Kingdom. Debt-to-GDP ratios, however, continued to trend upwards, following the rapid accumulation of sovereign liabilities in the aftermath of the crisis. The increase in the debt ratio was particularly pronounced in the United Kingdom, rising from 44% of GDP in 2007 to more than 90% of GDP in 2013, with Japan recording by far the highest (gross) government debt-to-GDP level, at 244% of GDP in 2013 (see Chart B).

Developments within the euro area

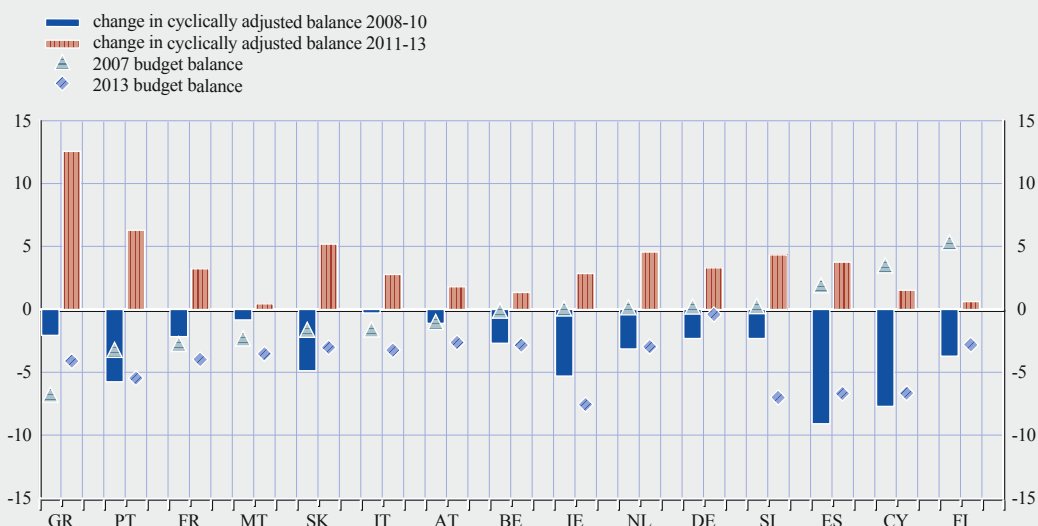
Individual euro area countries were also severely hit by the financial and economic crisis of 2008-09, and the 2010 sovereign debt crisis further added to the existing fiscal imbalances.

As in the other major advanced economies, in most euro area countries the fiscal stance turned more restrictive in the course of 2010. The pace and timing of fiscal adjustment were set within the framework of the Stability and Growth Pact and the principles agreed at the October 2009 ECOFIN Council;² the latter were reflected in the excessive deficit procedure (EDP) recommendations of 2009. In response to the euro area sovereign debt crisis, several countries stepped up significantly their consolidation efforts in an attempt to regain financial market confidence. This marked the beginning of a period of significant consolidation efforts, which

² In October 2009 the ECOFIN Council agreed on the principles for a coordinated exit from the fiscal stimulus adopted earlier. It was agreed that the specificities of country circumstances should be taken into account when defining the pace of adjustment, but that fiscal consolidation in all euro area countries should start by 2011 at the latest; countries with sustainability concerns had to start consolidating earlier. The planned pace of fiscal consolidation was recommended to be ambitious and well beyond the benchmark of 0.5% of GDP per annum in structural terms in most Member States.

Chart D Government budget balance and change in cyclically adjusted balance – euro area countries

(as a percentage of GDP; percentage points of GDP)



Sources: IMF World Economic Outlook and ECB calculations.

Notes: Countries are ranked according to the budget balance in 2007. Estonia and Luxembourg are missing due to the unavailability of data from the IMF World Economic Outlook. In the case of Greece, the change in the cyclically adjusted balance excludes the bank recapitalisation costs, the transfers received from Member States corresponding to profits on Greek bonds held by the Eurosystem central banks and other small factors.

for many countries, especially those under a joint EU-IMF financial assistance programme and those that experienced significant tensions in financial markets, turned out much larger than assumed at the time the 2009 EDP recommendations were issued.

Although the consolidation efforts of the period 2010-13 succeeded in reversing the trend of rising budget deficits in most countries, deficit ratios remain above the pre-crisis values in many of them (see Chart D). Likewise, debt-to-GDP ratios remained well above the pre-crisis level and continued to increase, owing predominantly to a large positive differential between the interest rate on outstanding debt and the growth rate of the economy as well as the financial support granted to the banking sector.³

The outlook for fiscal consolidation over the period 2014-16

Looking ahead, the IMF October 2013 World Economic Outlook projects fiscal consolidation in the largest advanced economies, including euro area countries, to proceed in the next three years, although at a slightly slower pace than in the past. Japan is the exception, as it is expected to step up its fiscal adjustment, including an increase in the VAT rates in April 2014 and October 2015. The debt-to-GDP ratio is projected to start declining in Canada in 2014 and in the euro area and the United States in 2015. It is projected to stabilise in Japan at a level of about 242% of GDP, whereas in the United Kingdom it is expected to remain on an upward trend.

³ For more details on progress with fiscal consolidation in euro area countries, see the box entitled “Fiscal consolidation in the euro area: past progress and plans for 2014”, *Monthly Bulletin*, ECB, December 2013.

Consolidation needs remain large in several countries and the debt reduction process is subject to several challenges. The large debt stock in most advanced economies requires sustained fiscal efforts to place debt-to-GDP levels onto a downward trajectory, also taking into account unfavourable demographic trends which imply growing age-related spending (i.e. healthcare and pensions). Should countries fail to credibly announce and implement medium-term fiscal consolidation plans which tackle their fiscal imbalances at the root causes, sovereign bond yields might increase, thereby further impeding fiscal adjustment.

IMPLEMENTATION OF THE STABILITY AND GROWTH PACT

According to the European Commission's autumn 2013 economic forecast, all euro area countries except Belgium, Germany, Estonia, Italy, Luxembourg, Austria, Slovakia and Finland are expected to have recorded a deficit above the 3% of GDP reference value in 2013. At the end of the year, 13 euro area countries were subject to the excessive deficit procedure (EDP), with deadlines for reducing government deficit ratios below the reference value ranging from 2013 for Belgium to 2016 for Spain, Cyprus and Greece. In June 2013 the ECOFIN Council abrogated the EDP for Italy and reopened it for Malta, with a deadline for correcting the excessive deficit by 2014. At the same time, and particularly in light of the worse than expected macroeconomic developments, the ECOFIN Council granted extensions to the EDP deadlines for a number of countries: one-year extensions for the Netherlands (to 2014) and Portugal (to 2015); two-year extensions for France and Slovenia (to 2015) and for Spain (to 2016); and a four-year extension for Cyprus (to 2016). Moreover, the ECOFIN Council recommended giving notice to Belgium to take measures to correct its excessive deficit by 2013, as it missed the 3% of GDP reference value by the 2012 EDP deadline and was deemed not to have taken effective action.

FURTHER FISCAL CONSOLIDATION EXPECTED IN 2014

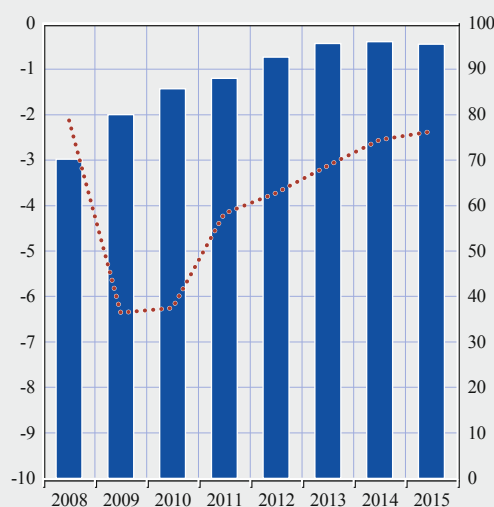
In 2014 a continued gradual further improvement in the euro area budgetary position is expected. According to the European Commission's autumn 2013 economic forecast, the general government deficit-to-GDP ratio for the euro area is projected to decline by 0.6 percentage point to 2.5% of GDP (see Chart 27), i.e. below the Maastricht deficit reference value. The fiscal adjustment is projected to be entirely expenditure-based, with the expenditure ratio declining to 49.3% of GDP and the revenue ratio remaining broadly unchanged at 46.7% of GDP. Furthermore, the general government gross debt ratio is projected to increase only marginally and peak in 2014 at 95.9% of GDP.

As regards fiscal developments at the country level in 2014, nine euro area countries are projected to record deficit ratios above the 3% of GDP reference value. At the same time, debt ratios are projected to exceed 100% of GDP in six countries, namely Belgium, Ireland, Greece, Italy, Cyprus and Portugal.

Chart 27 Fiscal developments in the euro area

(as a percentage of GDP)

— general government gross debt (right-hand scale)
 general government budget balance (left-hand scale)



Source: European Commission's autumn 2013 economic forecast.

Note: Figures for budget balances exclude proceeds from the sale of UMTS licences.

FISCAL CONSOLIDATION NEEDS TO BE SUSTAINED OVER THE MEDIUM TERM

After years of comprehensive and often painful budgetary adjustment, the euro area has made notable progress towards restoring sound fiscal positions, which compares favourably with the progress made in other major advanced economies (see Box 7). Nevertheless, the euro area's main fiscal policy challenge is still to sustain fiscal consolidation over the medium term, thereby reducing high government debt ratios. This is all the more important in view of the detrimental impact of ageing populations on public finances. Fiscal adjustment should proceed in line with the strengthened EU fiscal and economic governance framework and should be implemented in a growth-friendly manner that preserves efficient and growth-enhancing public investment. Countries should ensure that a safety margin is included in their budget plans to avoid missing the target if growth turns out to be slightly lower than expected.

3 ECONOMIC AND MONETARY DEVELOPMENTS IN NON-EURO AREA EU MEMBER STATES

ECONOMIC ACTIVITY

Real GDP growth remained relatively sluggish in the majority of the 11 non-euro area EU Member States in 2013 (see Table 6).⁷ Substantial headwinds remained, including economic weakness in the euro area, while deleveraging continued in most of these countries. External demand gradually recovered from the end-2012 slump in some countries, whereas imports declined in others owing to weak domestic absorption, with the result that the contribution of net exports to real GDP growth was mixed across non-euro area EU Member States. Domestic demand continued to drive GDP growth. Looking at the main components of domestic demand, public consumption increased in the majority of the non-euro area EU Member States. Growth in private consumption generally

Table 6 Real GDP growth in the non-euro area EU Member States and the euro area

(annual percentage changes)								
	2010	2011	2012	2013 ¹⁾	2013 Q1	2013 Q2	2013 Q3	2013 Q4 ¹⁾
Bulgaria	0.4	1.8	0.8	0.6	0.4	0.2	0.7	1.0
Czech Republic	2.5	1.8	-1.0	.	-2.3	-1.7	-1.2	.
Denmark	1.4	1.1	-0.4	.	-0.7	0.5	0.5	.
Croatia	-2.3	-0.2	-1.9	.	-1.0	-0.7	-0.6	.
Latvia	-1.3	5.3	5.2	.	6.7	4.5	4.1	.
Lithuania	1.6	6.0	3.7	3.4	3.8	3.8	2.3	3.5
Hungary	1.1	1.6	-1.7	1.1	-0.3	0.5	1.6	2.7
Poland	3.9	4.5	1.9	1.5	0.8	1.2	1.8	2.2
Romania	-0.9	2.3	0.4	3.3	2.3	1.6	4.0	5.1
Sweden	6.6	2.9	0.9	.	1.6	0.6	0.3	.
United Kingdom	1.7	1.1	0.3	1.9	0.7	2.0	1.9	2.8
EU8 ²⁾	2.0	3.1	0.7	.	0.5	0.7	1.5	.
EU11 ³⁾	2.3	1.9	0.4	.	0.7	1.4	1.5	.
Euro area	2.0	1.6	-0.7	-0.4	-1.2	-0.6	-0.3	0.5

Source: Eurostat.

Note: Annual data are calculated using non-seasonally adjusted data. Quarterly data are seasonally and working day-adjusted for all countries except Romania, for which the data are only seasonally adjusted.

1) Figures for 2013 and for the fourth quarter of 2013 are flash estimates, i.e. preliminary data.

2) The EU8 aggregate comprises the eight non-euro area EU Member States that joined the EU in 2004, 2007 or 2013.

3) The EU11 aggregate comprises the eleven non-euro area EU Member States as at 31 December 2013.

7 Croatia joined the EU on 1 July 2013. Latvia became a member of the euro area on 1 January 2014.

remained subdued as households continued to repair their balance sheets and remained cautious given the uncertain global economic outlook. Aggregate investment increased in certain countries, but decreased in others. Alongside low growth, unemployment remained elevated in the majority of non-euro area EU Member States. Employment, however, increased in several countries and compensation per employee rose in all non-euro area EU Member States except Croatia. Nevertheless, the increase in unit labour costs was generally lower than that observed in 2012. Credit continued to grow weakly in many countries, reflecting a combination of tight supply-side conditions and low demand.

Overall, while annual real GDP growth increased in 2013 in comparison with 2012 in weighted average terms, there were substantial cross-country differences. Among the non-euro area EU Member States, real GDP growth was highest in Latvia, Lithuania and Romania, whereas Croatia and the Czech Republic saw a contraction in output in 2013. Economic growth in Latvia and Lithuania remained dynamic in 2013 as domestic demand became a more prominent driver of growth. In Bulgaria, the Czech Republic, Poland and Romania, domestic demand remained weak and net exports constituted the main source of growth. GDP growth in Romania was also supported by a good harvest. The economic recovery was slow in Denmark, as consumption was dampened by low growth in real disposable income and household debt consolidation. Croatia remained in recession for the fifth consecutive year as economic growth was held back by weak competitiveness and the bursting of the construction bubble. In Hungary, economic growth was attributable to changes in inventories as well as developments in domestic demand, construction and, in the latter part of 2013, manufacturing. After a speedy recovery from the crisis, Sweden's economic growth moderated, reflecting weak investment and a deterioration in net exports. GDP growth recovered sharply in the United Kingdom in the course of 2013, driven mainly by household consumption, which benefited from a marked decrease in the household saving ratio as well as diminishing uncertainty about the economic outlook, both domestically and abroad. Finally, there were some signs of economic recovery in a number of non-euro area EU Member States towards the end of the year, supported by an accommodative monetary policy stance and improved prospects in the euro area combined with stronger household real disposable income and labour market dynamics.

PRICE DEVELOPMENTS

Inflation slowed down in the majority of non-euro area EU Member States, with the weighted average annual inflation rate decreasing from 3.0% in 2012 to 1.9% in 2013 (see Table 7), reflecting reduced commodity price pressures and the fading-out of the effects of indirect tax hikes in the previous year. The weighted average HICP inflation excluding energy and unprocessed food in the non-euro area EU Member States also declined, from 2.5% in 2012 to 1.7% in 2013. The cross-country variation in 12-month HICP inflation remained significant in 2013, with the highest annual inflation in 2013 being experienced by Romania (3.2%), while the inflation rate in Latvia fell to 0.0%, the lowest among the non-euro area EU Member States. The decline in food and energy prices had a particularly pronounced effect on the aggregate HICP in countries such as Lithuania, Poland and Romania because of the relatively large share of their consumption basket accounted for by those commodities. Reductions in administered prices also contributed to lower inflation in Bulgaria, the Czech Republic, Hungary and Lithuania. Indirect tax reductions in Denmark and Romania also had a dampening effect on inflation, while subdued domestic demand was an important factor driving the low rates of HICP inflation observed in Hungary. In Sweden, HICP inflation remained subdued, partially as a result of low import prices arising from the weak external environment and krona appreciation. While the United Kingdom has experienced elevated price pressures in recent years, inflation declined towards the end of 2013, partially reflecting subdued domestic cost pressures.

Table 7 HICP inflation in the non-euro area EU Member States and the euro area

(annual percentage changes)								
	2010	2011	2012	2013	2013 Q1	2013 Q2	2013 Q3	2013 Q4
Bulgaria	3.0	3.4	2.4	0.4	2.1	1.1	-0.7	-1.0
Czech Republic	1.2	2.1	3.5	1.4	1.7	1.5	1.2	1.1
Denmark	2.2	2.7	2.4	0.5	0.9	0.5	0.2	0.4
Croatia	1.1	2.2	3.4	2.3	4.2	2.3	2.2	0.6
Latvia	-1.2	4.2	2.3	0.0	0.4	-0.1	0.0	-0.2
Lithuania	1.2	4.1	3.2	1.2	2.2	1.4	0.5	0.5
Hungary	4.7	3.9	5.7	1.7	2.7	1.9	1.6	0.7
Poland	2.7	3.9	3.7	0.8	1.3	0.5	0.9	0.6
Romania	6.1	5.8	3.4	3.2	4.8	4.4	2.4	1.3
Sweden	1.9	1.4	0.9	0.4	0.6	0.3	0.7	0.3
United Kingdom	3.3	4.5	2.8	2.6	2.8	2.7	2.7	2.1
EU8 ¹⁾	3.1	3.8	3.7	1.4	2.2	1.5	1.2	0.6
EU11 ²⁾	3.1	3.9	3.0	1.9	2.3	2.0	1.9	1.3
Euro area	1.6	2.7	2.5	1.4	1.9	1.4	1.3	0.8

Source: Eurostat.

1) The EU8 aggregate comprises the eight non-euro area EU Member States that joined the EU in 2004, 2007 or 2013.

2) The EU11 aggregate comprises the eleven non-euro area EU Member States as at 31 December 2013.

FISCAL POLICIES

The budget balance-to-GDP ratios are projected to deteriorate in most non-euro area EU Member States in 2013; only the Czech Republic, Denmark, Lithuania and Romania expect an improvement (see Table 8). Deficits close to 5% of GDP or higher are projected for Croatia, Poland and the United Kingdom, while deficits at or close to the 3% of GDP reference value were projected by the European Commission's autumn 2013 economic forecast for the Czech Republic, Hungary and Lithuania.

Table 8 General government finances

(as a percentage of GDP)											
	Budget balance					April 2013 stability/ convergence programme 2013	Gross debt				April 2013 stability/ convergence programme 2013
	European Commission						European Commission				
	2010	2011	2012	2013			2010	2011	2012	2013	
Bulgaria	-3.1	-2.0	-0.8	-2.0	-1.3	16.2	16.3	18.5	19.4	17.9	
Czech Republic	-4.7	-3.2	-4.4	-2.9	-2.8	38.4	41.4	46.2	49.0	48.5	
Denmark	-2.5	-1.8	-4.1	-1.7	-1.6	42.7	46.4	45.4	44.3	44.0	
Croatia	-6.4	-7.8	-5.0	-5.4	-3.6	44.9	51.6	55.5	59.6	56.2	
Latvia	-8.1	-3.6	-1.3	-1.4	-1.1	44.4	41.9	40.6	42.5	44.5	
Lithuania	-7.2	-5.5	-3.2	-3.0	-2.5	37.8	38.3	40.5	39.9	39.7	
Hungary	-4.3	4.3	-2.0	-2.9	-2.7	82.2	82.1	79.8	80.7	78.1	
Poland	-7.9	-5.0	-3.9	-4.8	-3.5	54.9	56.2	55.6	58.2	55.8	
Romania	-6.8	-5.6	-3.0	-2.5	-2.4	30.5	34.7	37.9	38.5	38.6	
Sweden	0.3	0.2	-0.2	-0.9	-1.4	39.4	38.6	38.2	41.3	42.0	
United Kingdom	-10.1	-7.7	-6.1	-6.4	-6.8	78.4	84.3	88.7	94.3	94.9	
EU8 ¹⁾	-6.5	-3.7	-3.5	-3.7	-2.9	48.6	50.4	51.5	53.3	51.8	
EU11 ²⁾	-7.4	-5.3	-4.6	-4.7	-4.8	63.4	67.0	70.1	73.5	73.4	
Euro area	-6.2	-4.2	-3.7	-3.1	-2.9 ³⁾	85.7	88.0	92.7	95.7	93.4 ³⁾	

Sources: European Commission's autumn 2013 economic forecast, April 2013 stability/convergence programme updates, national sources and ECB calculations.

Note: Data are based on ESA 95 definitions.

1) The EU8 aggregate comprises the eight non-euro area EU Member States that joined the EU in 2004, 2007 or 2013.

2) The EU11 aggregate comprises the eleven non-euro area EU Member States as at 31 December 2013.

3) For Greece and Portugal, the figures from the second adjustment programme were used.

At the end of 2013 the Czech Republic, Denmark, Poland and the United Kingdom remained subject to an EU Council decision on the existence of an excessive deficit. For Hungary, Latvia, Lithuania and Romania, the excessive deficit procedure (EDP) was abrogated by the ECOFIN Council in June 2013. The deadlines set for correcting the excessive deficit situation remain unchanged at 2013 for the Czech Republic and Denmark and at the financial year 2014/15 for the United Kingdom. The EDP deadline for Poland was extended by two years to 2014 by the ECOFIN Council in June 2013. In December 2013 the ECOFIN Council assessed Poland not to have taken effective action in response to the Council recommendation of 21 June 2013. Nevertheless, despite the lack of effective action, the ECOFIN Council in December 2013 issued a revised EDP recommendation, extending the EDP deadline by an additional year to 2015. The Council decided on 28 January 2014 to open an EDP for Croatia given that neither the deficit nor the debt criterion had been met.

The gross general government debt-to-GDP ratios are expected to have increased in all non-euro area EU Member States except Denmark and Lithuania in 2013. The debt-to-GDP ratio remained well above the 60% reference value in Hungary and the United Kingdom and just below this value in Croatia and Poland.

BALANCE OF PAYMENTS DEVELOPMENTS

In 2013 the combined current and capital account balance (as a percentage of GDP) continued to improve in all non-euro area EU Member States except the United Kingdom (see Table 9). As a result, surpluses were registered in all countries with the exception of the United Kingdom. The Czech Republic, Poland and Romania moved to surpluses for the first time since they joined the EU. In most non-euro area EU Member States in central and eastern Europe, the external adjustment was largely brought about by an improvement in the goods and services balances backed by robust export growth and, to a smaller extent, favourable developments in the income balance. Both Denmark's and Sweden's combined current and capital account surplus widened, notably reflecting developments in the income balance. The larger deficit of the United Kingdom meanwhile reflected a deterioration of the services and income balances.

Table 9 Balance of payments of the non-euro area EU Member States and the euro area

(as a percentage of GDP)

	Current and capital account balance				Net direct investment flows				Net other investment flows			
	2010	2011	2012	2013 ¹⁾	2010	2011	2012	2013 ¹⁾	2010	2011	2012	2013 ¹⁾
Bulgaria	-0.7	1.4	0.1	3.2	2.7	3.1	3.0	1.9	-2.7	-4.4	4.6	0.7
Czech Republic	-3.0	-2.3	-1.1	0.9	2.5	1.2	4.7	2.3	-1.8	0.3	-2.9	-1.8
Denmark	5.9	6.3	6.0	6.6	-3.6	0.2	-1.6	-0.8	4.2	-2.9	-1.1	-7.0
Croatia	-0.8	-0.8	0.1	1.3	0.9	2.3	2.6	1.5	1.7	0.3	-5.5	-3.4
Latvia	4.9	0.0	0.5	1.5	1.5	4.9	3.2	1.8	-0.8	-7.2	-5.1	-4.7
Lithuania	2.7	-1.2	2.0	3.5	2.2	3.2	0.7	1.4	-9.2	-1.5	-5.1	-2.4
Hungary	2.0	2.8	3.6	5.6	0.8	0.9	2.1	0.1	0.6	-3.7	-12.7	-12.1
Poland	-3.3	-3.0	-1.5	0.4	1.4	2.4	1.1	0.7	2.1	0.5	-1.2	0.5
Romania	-4.2	-3.9	-3.0	0.8	1.8	1.4	1.7	1.3	4.7	1.7	-3.0	-5.8
Sweden	6.2	5.9	5.9	6.1	-4.4	-3.2	-2.4	-4.6	-8.8	-9.8	-3.4	-4.7
United Kingdom	-3.0	-1.1	-3.5	-3.8	0.9	-2.3	-0.6	2.4	0.0	6.2	15.5	2.9
EU8 ²⁾	-2.2	-2.0	-0.8	1.4	1.7	2.0	2.1	1.1	0.9	-0.3	-3.2	-2.6
EU11 ³⁾	-1.1	0.0	-1.0	-0.5	0.2	-1.0	-0.2	1.0	-0.4	1.9	7.3	-0.2
Euro area	0.1	0.2	1.4	2.2	-0.9	-0.9	0.0	-1.4	-0.2	-1.8	-2.1	-3.1

Source: ECB.

1) Figures for 2013 refer to the four-quarter average up to the third quarter of 2013.

2) The EU8 aggregate comprises the eight non-euro area EU Member States that joined the EU in 2004, 2007 or 2013.

3) The EU11 aggregate comprises the eleven non-euro area EU Member States as at 31 December 2013.

On the financing side, net foreign direct investment inflows into the non-euro area EU Member States represented on aggregate about 1% of GDP in 2013. Denmark and Sweden remained net exporters of foreign direct investment, whereas the United Kingdom turned from being a net exporter of foreign direct investment flows into a net recipient. Even though non-euro area EU Member States in central and eastern Europe remained net importers of foreign direct investment, net inflows slowed down in comparison to 2012, notably in the Czech Republic and Hungary. The United Kingdom continued to record portfolio investment outflows, in contrast to the considerable inflows observed for Latvia and Romania. Regarding other investment flows, all non-euro area EU Member States except Bulgaria, Poland and the United Kingdom experienced net outflows in 2013, reflecting to some degree the ongoing process of deleveraging.

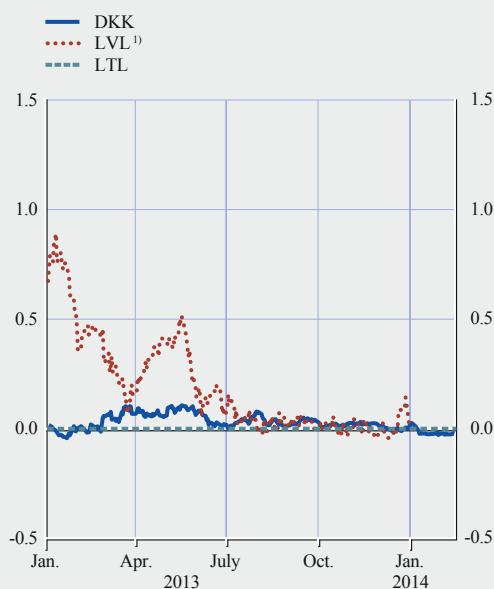
EXCHANGE RATE DEVELOPMENTS

Exchange rate developments in the currencies of non-euro area EU Member States reflected the different exchange rate regimes that were in place in individual countries. The currencies of Denmark, Latvia and Lithuania participated in the exchange rate mechanism II (ERM II). The Latvian lats and the Lithuanian litas were subject to a standard fluctuation band of $\pm 15\%$ around their central rates against the euro, and the Danish krone was subject to a narrower band of $\pm 2.25\%$ (see Chart 28). ERM II participation was, in the case of the Baltic States, accompanied by unilateral commitments to maintain a narrower fluctuation band (Latvia) or a currency board regime (Lithuania). These unilateral commitments place no additional obligations on the ECB. The Lithuanian litas joined ERM II with its existing currency board arrangement in place, and the Latvian authorities decided to maintain the exchange rate of the lats at its central rate against the euro with a fluctuation band of $\pm 1\%$. During 2013 the Lithuanian litas remained at its central rate, while the Latvian lats fluctuated within the unilaterally set band of $\pm 1\%$ vis-à-vis the euro. On 9 July 2013 the EU Council adopted a decision allowing Latvia to adopt the euro as its currency from 1 January 2014. The conversion rate was set at LVL 0.702804 to the euro, which was also the central rate of the Latvian lats throughout Latvia's membership of ERM II (see also Chapter 3).

Turning to the currencies of non-euro area EU Member States that did not participate in ERM II in 2013, a general weakening against the euro over the course of the year was observed (see Chart 29). This reflected the broad-based strengthening of the euro vis-à-vis major currencies that began in the second half of 2012, when euro area financial market

Chart 28 Developments in ERM II EU currencies

(daily data; deviation from the central parity in percentage points)



Source: ECB.

Notes: A positive (negative) deviation from the central rate against the euro implies that the currency is on the strong (weak) side of the band. For the Danish krone, a fluctuation band of $\pm 2.25\%$ applies. For the other currencies, the standard fluctuation band of $\pm 15\%$ applies. The latest observation is for 14 February 2014. An increase indicates an appreciation of the currency.

1) Latvia joined the euro area on 1 January 2014.

sentiment improved and risk aversion declined. The relative stabilisation of the economic situation in the euro area also translated into lower volatility of the bilateral exchange rates of currencies of non-euro area EU Member States against the euro. As a result, in early January 2014 all these currencies, with the exception of the Bulgarian lev, which is in a currency board, traded below the levels at the beginning of 2013. The largest decline was observed for the Czech koruna, which weakened by about 8½% over this period. A large part of this downward movement resulted from foreign exchange interventions by Česká národní banka in November 2013.

FINANCIAL DEVELOPMENTS

The normalisation of financial markets in non-euro area EU Member States, which started in the second half of 2012, continued overall. During the first months of 2013 financial conditions mostly improved in the context of improved risk appetite stemming from the progress made in 2012 towards resolving the euro area sovereign debt crisis and continued accommodative monetary policy in the major economic areas. Financial conditions deteriorated sharply for all countries in the late spring of 2013, after the US Federal Reserve indicated that it could soon begin tapering its monthly bond purchases under its quantitative easing programme. Financial market sentiment remained very sensitive to signals from the Federal Reserve, but on average improved from the late summer of 2013 as market participants' fears about an impending tapering of bond purchases receded. Financial market reactions were generally muted when the Federal Reserve eventually announced in December that it would taper its bond purchase programme beginning in January 2014.

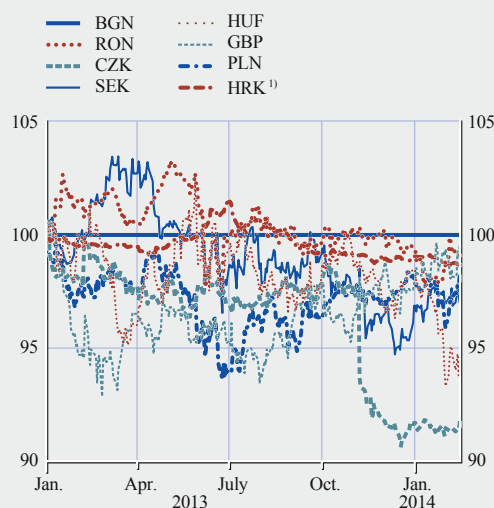
In the course of 2013 long-term interest rates, as measured by ten-year government bond yields, increased for most countries, with the notable exceptions of Hungary, Lithuania and Romania. Long-term interest rates in Denmark, Sweden and the United Kingdom increased the most, as they followed closely the rise in global low-risk interest rates. By contrast, money market interest rates declined in most non-euro area EU Member States. Developments in credit risk premia, as measured by credit default swaps (CDSs), were stable compared with those over the last few years. In late 2013 sovereign CDS premia stood close to their lowest level since the outbreak of the financial crisis in 2008, with Croatia and Hungary being the exceptions. Stock market developments varied markedly among the non-euro area EU Member States, but on average stock prices rose by 15% in 2013, compared with the 20% increase observed for the euro area. Equity prices increased the most in Bulgaria (by 42%) and only decreased in the Czech Republic (by 5%).

MONETARY POLICY

The primary objective of monetary policy in all non-euro area EU Member States is price stability. Monetary policy strategies, however, continued to differ considerably from country to country in 2013 (see Table 10).

Chart 29 Developments in non-ERM II EU currencies vis-à-vis the euro

(daily data; index: 1 January 2013 = 100)



Source: ECB.

Notes: An increase (decrease) indicates an appreciation (depreciation) of the currency. The latest observation is for 14 February 2014.

1) Croatia joined the EU on 1 July 2013.

Limited inflationary pressure arising from subdued economic growth and declining commodity prices set the environment for the measures taken by several central banks of the non-euro area EU Member States. Since the end of December 2012 five NCBs have cut their key policy interest rates. The key policy rates were reduced in Hungary (in 14 steps for a total of 3.05 percentage points), Poland (6 steps totalling 1.75 percentage points), Romania (6 steps totalling 1.75 percentage points), Latvia (3 steps totalling 2.25 percentage points) and Sweden (1 step of 0.25 percentage point). In all countries, the decisions were driven by weak cyclical positions, as well as an outlook characterised by negative output gaps and subdued inflationary pressures. As a consequence, the monetary policy stance in these economies remained very accommodative. Denmark's Nationalbank first raised its repo rate by 0.1 percentage point in January 2013 (following foreign exchange sales in the market) and then cut the rate by a similar amount in May (following the ECB's policy rate cut).

A number of central banks of non-euro area EU Member States introduced new unconventional monetary policy measures to combat economic weakness. In Hungary, the Magyar Nemzeti Bank announced a funding programme (Funding for Growth Scheme) in April 2013, targeting an improvement in the financing conditions of small and medium-sized enterprises (SMEs) and a reduction in the vulnerability of the economy. In the United Kingdom, the Bank of England and the Treasury announced an extension of the Funding for Lending Scheme in April 2013. Specifically, the scheme will be extended for one year (until the end of January 2015), and strong incentives

Table 10 Official monetary policy strategies of the non-euro area EU Member States

	Monetary policy strategy	Currency	Features
Bulgaria	Exchange rate target	Bulgarian lev	Exchange rate target: fixed to the euro at BGN 1.95583 per euro within the framework of a currency board arrangement.
Czech Republic	Inflation target	Czech koruna	Inflation target: 2% \pm 1 percentage point. Managed floating exchange rate.
Denmark	Exchange rate target	Danish krone	Participates in ERM II with a \pm 2.25% fluctuation band around a central rate of DKK 7.46038 per euro.
Croatia	Managed floating exchange rate	Croatian kuna	Croatia joined the EU on 1 July 2013. No pre-announced fluctuation band. The exchange rate is managed within a tight range.
Latvia	Exchange rate target	Latvian lats	Latvia joined the euro area on 1 January 2014. Prior strategy: participated in ERM II with a \pm 15% fluctuation band around a central rate of LVL 0.702804 per euro. Latvia had a fluctuation band of \pm 1% as a unilateral commitment.
Lithuania	Exchange rate target	Lithuanian litas	Participates in ERM II with a \pm 15% fluctuation band around a central rate of LTL 3.45280 per euro. Lithuania continues with its currency board arrangement as a unilateral commitment.
Hungary	Inflation target	Hungarian forint	Inflation target: 3% medium-term target since 2007 with \pm 1 percentage point to assess target achievement (ex post). Free-floating exchange rate.
Poland	Inflation target	Polish zloty	Inflation target: 2.5% \pm 1 percentage point (12-month increase in the CPI). Free-floating exchange rate.
Romania	Inflation target	Romanian leu	Inflation target: 2.5% \pm 1 percentage point since 2013. Managed floating exchange rate.
Sweden	Inflation target	Swedish krona	Inflation target: annual increase in the CPI of 2%. Free-floating exchange rate.
United Kingdom	Inflation target	Pound sterling	Inflation target: 2% as measured by the 12-month increase in the CPI. In the event of a deviation of more than 1 percentage point, the Governor of the Bank of England is expected to write an open letter on behalf of the Monetary Policy Committee to the Chancellor of the Exchequer. Free-floating exchange rate.

Source: ESCB.

Note: For the United Kingdom the CPI is identical to the HICP.

will be provided to increase net lending to SMEs and certain non-bank providers of credit. In November 2013 the scheme was also modified to remove direct incentives to expand household lending in 2014, keeping only those for non-financial corporations. On 7 November Česká národní banka started intervening in the foreign exchange market to weaken the koruna against the euro, using the exchange rate as an additional instrument for easing monetary conditions. Česká národní banka decided to maintain an exchange rate of the koruna against the euro close to CZK 27. Two non-euro area EU Member State NCBs introduced forward guidance for future monetary policy rates in 2013. In Poland, Narodowy Bank Polski introduced forward guidance in July by declaring that, given low inflation pressures and a moderate expected economic recovery, policy rates should be kept at the current low levels at least until the end of 2013. In November this period was extended until the end of the first half of 2014. The Bank of England announced in August its intention not to raise the main policy rate until a number of conditions are met. Initially the forward guidance programme emphasised that the main policy rate would not be raised until the official measure of the unemployment rate had fallen to a threshold of 7%. As unemployment fell more rapidly than had been anticipated, the policy criteria were subsequently revised such that the decision on whether to raise the main policy rate will be based on a broader set of conditions, specifically: (i) the extent to which the recovery is entrenched and broadly based; (ii) the extent to which supply responds to demand; and (iii) the evolution of cost and price pressures. The Board of Česká národní banka indicated on a number of occasions in 2013 its intention to leave policy rates unchanged over a longer horizon until inflation pressures increase significantly.



The installation of the facades for the double office tower continued throughout 2013.

A combination of different geometries makes the high-rise look like a large crystal, with oblique panels on the western and eastern facades and hyperbolic paraboloid surfaces on the northern and southern facades. A hyperbolic paraboloid surface can be constructed from rectilinear elements. On this basis, the facades of each tower consist of flat glass panels, 90% of which are identical. The glass panels run the entire height of each storey, which means only the vertical fixings are visible. The result is a homogeneous curved glass surface made up of straight panels.

CHAPTER 2

CENTRAL BANK OPERATIONS AND ACTIVITIES

I MONETARY POLICY INSTRUMENTS, FOREIGN EXCHANGE OPERATIONS AND INVESTMENT ACTIVITIES

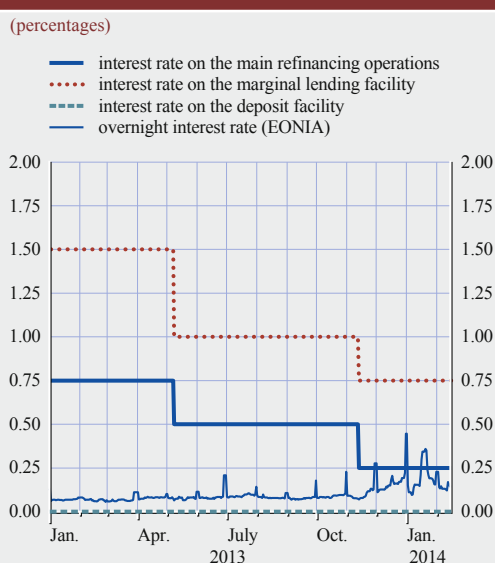
I.1 MONETARY POLICY INSTRUMENTS

The monetary policy instruments used by the Eurosystem in 2013 comprised open market operations, such as main refinancing operations (MROs), longer-term refinancing operations (LTROs) and fine-tuning operations, as well as standing facilities and minimum reserve requirements. In addition, counterparties were given for the first time the option to repay on a weekly basis amounts outstanding from the three-year LTROs allotted in December 2011 and February 2012.

During 2013 the Governing Council changed key ECB interest rates on two occasions (see Chart 30). On 8 May 2013 the width of the interest rate corridor around the rate on the MROs decreased from 150 basis points to 100 basis points, as the interest rates on the MROs and the marginal lending facility were reduced by 25 and 50 basis points to 0.50% and 1.00% respectively, while the rate on the deposit facility remained unchanged at 0.00%. In addition, on 13 November 2013 the interest rate corridor narrowed further to 75 basis points and became asymmetric, as the interest rates on the MROs and the marginal lending facility were reduced by 25 basis points each to 0.25% and 0.75% respectively, while the rate on the deposit facility remained unchanged at 0.00%.

Banks' early repayment since January 2013 of amounts outstanding from the two three-year LTROs resulted in a decline in excess liquidity¹. These early repayments by counterparties (of more than €440 billion since early 2013) reflected a shift in the banking system's demand for liquidity buffers (see Chart 31), which by the end of 2013 had returned to levels last seen in autumn 2011, before the allotment of the first three-year LTRO. An easing of financial market tensions and improved market funding conditions also contributed to reduced recourse by the euro area banking system to central bank liquidity, despite the full allotment and fixed rate tender procedures used in all liquidity-providing refinancing operations.²

Chart 30 ECB interest rates and the overnight interest rate



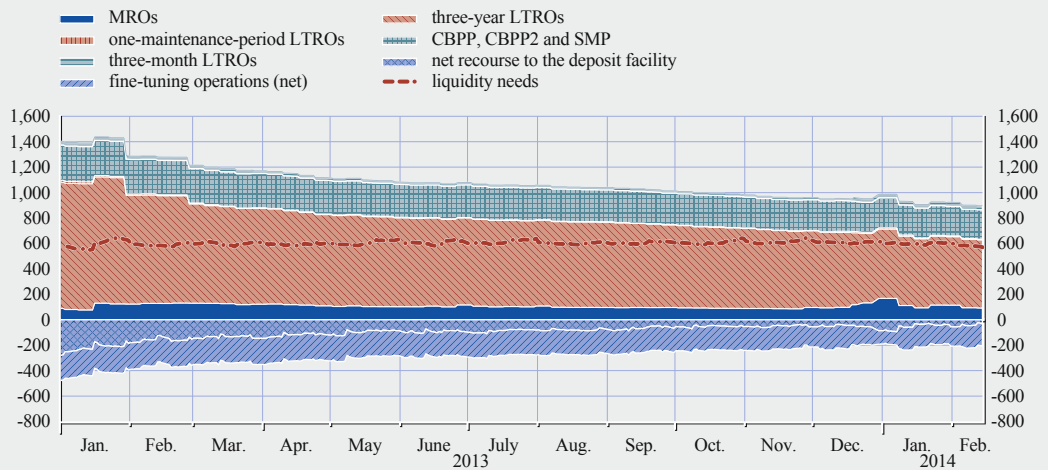
Source: ECB.

1 Excess liquidity can be defined as the sum of net usage of the deposit facility (deposit facility minus marginal lending facility) plus the daily reserve surplus (current accounts minus reserve requirements).

2 The rates in the three-month LTROs were fixed at the average rate of the MROs over the lifetime of the LTROs.

Chart 31 Outstanding volume of monetary policy operations

(EUR billions)

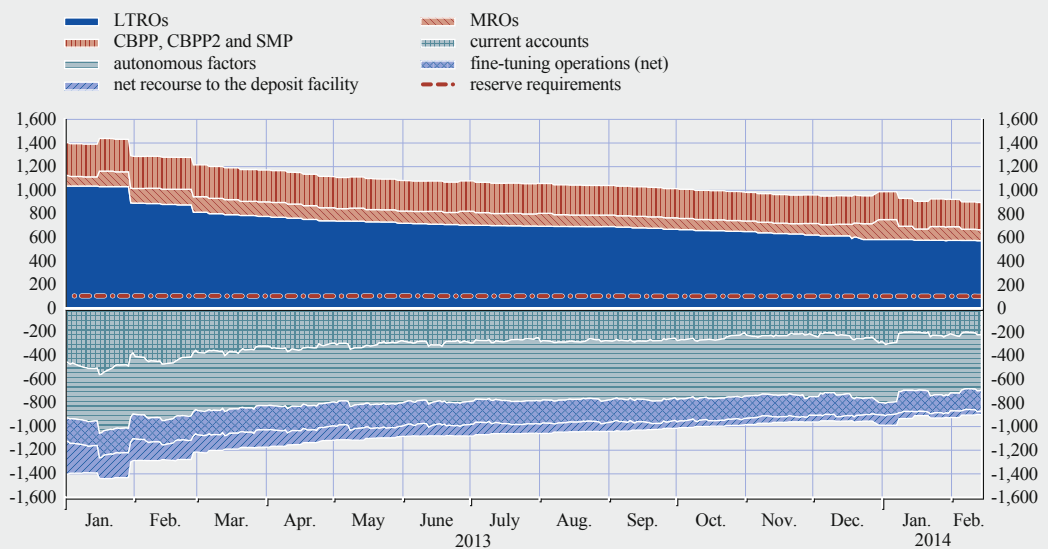


Source: ECB.

During the 12 maintenance periods of 2013 (from 16 January 2013 to 14 January 2014), the average daily liquidity needs of the euro area banking system – defined as the sum of autonomous factors³ and reserve requirements – amounted to €604.9 billion, which was 24% higher than during

Chart 32 Liquidity factors in the euro area in 2013

(EUR billions)



Source: ECB.

³ Autonomous factors are those items on the Eurosystem's balance sheet, such as banknotes in circulation and government deposits, which have an impact on credit institutions' current account holdings, but are not under the direct control of the ECB's liquidity management function.

the 12 maintenance periods of 2012, when they came to €487.6 billion. The marked increase in liquidity needs was the result of a decrease in net foreign assets accompanied by an increase in other autonomous factors owing partly to the reduction of emergency liquidity assistance provided in the euro area (see Chart 32). Minimum reserve requirements decreased from €106 billion on average during the 12 maintenance periods of 2012 to €104.5 billion during the 12 maintenance periods of 2013.

The average daily amount of excess reserves (current account holdings in excess of reserve requirements) in the period under review stood at €196.8 billion, broadly unchanged from their 2012 average level (€216.5 billion). This rather large amount of excess reserves is mainly the outcome of the deposit rate standing at zero for the whole of 2013, which made banks indifferent as to whether they used the deposit facility overnight or left excess reserves on their current accounts (see Chart 32). Excess reserves declined gradually throughout the year, however, largely because banks reduced their recourse to Eurosystem operations and repaid early (i.e. before the scheduled maturity) part of the three-year LTROs as market functioning gradually normalised. Excess reserves thus declined from approximately €361 billion in the first maintenance period of the year to €144.8 billion in the last maintenance period. The average daily use of the deposit facility also declined in the course of the year: it stood at around €184 billion in the first maintenance period and steadily decreased to €60 billion in the last maintenance period.

OPEN MARKET OPERATIONS

In 2013 the Eurosystem used MROs, regular three-month LTROs, special-term refinancing operations with a maturity of one maintenance period and fine-tuning operations to manage the liquidity situation in the money market. All liquidity-providing credit operations have to be fully collateralised. The fine-tuning operations were used to absorb the liquidity injected through the Securities Markets Programme (SMP) as announced by the Governing Council on 10 May 2010. In addition, counterparties were given the option to repay outstanding amounts borrowed in the three-year LTROs via weekly procedures, although these did not, strictly speaking, constitute tender operations.

MROs are regular operations with a weekly frequency which normally have a maturity of one week. They are the main instrument for signalling the ECB's monetary policy stance. In 2013 all 53 MROs were conducted as fixed rate tender procedures in which all bids were satisfied. However, given the declining, yet still abundant excess liquidity from the three-year LTROs, the relative importance of MROs in terms of outstanding liquidity remained low. The number of counterparties which are eligible to participate in open market operations decreased from 2,298 at the end of 2012 to 1,740 at the end of 2013, while the number of euro area MFIs declined from 7,059 at the end of 2012 to 6,790 at the end of 2013. On average, 76 counterparties participated in the MROs conducted in 2013. The average volume allotted in the MROs in 2013 was €108 billion, compared with €98 billion in 2012. MRO allotment volumes in 2013 ranged between €77.7 billion (on 9 January) and €168.7 billion (on 30 December), while the number of bidders fluctuated between 62 (on 22 May) and 181 (on 30 December).

In the twelve maintenance periods of 2013 the daily average outstanding volume of liquidity allotted in the regular three-month LTROs and the special-term refinancing operations with a maturity of one maintenance period was €12.5 billion. Participation in the regular three-month

LTROs averaged €7.2 billion and ranged from a minimum of €1.9 billion allotted in October to a maximum of €20.9 billion allotted in December. The average number of participating counterparties was 46. The average volume allotted in the one-month special-term refinancing operations was €5.3 billion and the average number of participating counterparties was 21. In the same period the daily average outstanding volume of liquidity allotted via the three-year LTROs was €694.8 billion. The outstanding amount of the two three-year LTROs dropped from €992 billion at the beginning of 2013 to €544.4 billion by the end of the year, down by almost €440 billion, as counterparties gradually repaid part of their outstanding amounts.

In addition to the open market operations used for the implementation of monetary policy, the ECB can also provide eligible counterparties with liquidity in other currencies (see Section 1.2 of this chapter).

SECURITIES MARKETS PROGRAMME

The Governing Council decided in May 2010 to establish the SMP. The objective of this temporary programme was to address the malfunctioning of certain euro area debt securities market segments and to restore an appropriate monetary policy transmission mechanism. With the announcement of the technical features of the Outright Monetary Transactions (OMTs) on 6 September 2012, the SMP was terminated. As in the past, the liquidity injected through the SMP continued to be absorbed on a weekly basis in 2013. The securities bought under the SMP will in principle be held to maturity. However, Eurosystem accounting rules allow sales of held-to-maturity securities when the remaining time to maturity is less than one month. The Eurosystem therefore participated in the public buy-back offer initiated by the Irish National Treasury Management Agency on 17 December 2013 and sold all of its SMP holdings of the Irish security maturing on 15 January 2014 at the offer price. At the programme's peak, the Eurosystem held SMP securities for a total settlement amount of €219.5 billion. By the end of 2013 the Eurosystem's holdings of SMP securities had been reduced to €178.8 billion owing to redemptions and participation in the Irish buy-back operation. In February 2013 the Governing Council decided to publish details of the Eurosystem's holdings of securities acquired under the SMP. This decision was taken in line with the transparency envisaged for the OMTs.⁴

THE FIRST AND SECOND COVERED BOND PURCHASE PROGRAMMES

As part of its non-standard monetary operations, the ECB conducted two covered bond purchase programmes in 2009-10 (CBPP) and 2011-12 (CBPP2). These programmes were launched with the purpose of easing funding conditions for banks and companies and encouraging banks to maintain or expand lending to their customers. While it is intended that the bonds purchased under both programmes will be held until maturity, the Governing Council decided to make the portfolios of the programmes available for securities lending. Lending is voluntary and conducted through securities lending facilities offered by central securities depositories, or via matched repurchase transactions with eligible counterparties. This lending activity remained limited in terms of amounts in 2013. Nevertheless, it is considered useful from a market functioning perspective that the securities held under the programmes are, in principle, available for lending. By the end of 2013 the Eurosystem's holdings of covered bonds amounted to €41.6 billion under the first programme and €15.4 billion under the second programme, compared with €60 billion and €16.4 billion at the end of the respective programmes.

⁴ More information on the SMP can be found in the ECB's press release of 10 May 2010, the ECB's Decision of 14 May 2010 establishing a securities markets programme, the ECB's press release of 21 February 2013 and the weekly financial statements of the Eurosystem.

OUTRIGHT MONETARY TRANSACTIONS

In August 2012 the Governing Council announced the setting-up of the OMTs, the technical features of which were further specified in September 2012.⁵ These OMTs aim to safeguard an appropriate monetary policy transmission and the singleness of the monetary policy in the euro area.

A necessary condition for OMTs is strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme. This conditionality aims to ensure that governments will make the appropriate structural reforms and maintain fiscal discipline. The Governing Council will consider OMTs to the extent that they are warranted from a monetary policy perspective as long as programme conditionality is fully respected, and terminate them once their objectives have been achieved or when there is non-compliance with the macroeconomic adjustment or precautionary programme. OMTs will be considered for future cases of ESM macroeconomic adjustment programmes or precautionary programmes (such as an enhanced conditions credit line). They may also be considered for Member States already under a macroeconomic adjustment programme as they regain bond market access. OMTs would not take place while a given programme is under review and would resume after the review period once programme compliance has been assured.

Transactions would be focused on the shorter part of the yield curve, and in particular on sovereign bonds with a residual maturity of between one and three years. No ex ante quantitative limits are set on the size of OMTs. The Eurosystem intends to accept the same (pari passu) treatment as private or other creditors with respect to bonds issued by euro area countries and purchased by the Eurosystem through OMTs. The liquidity created through the OMTs would be fully sterilised, as has been the case for the SMP. At the same time, the transparency regarding the composition of the OMT portfolio would be greater than that of the SMP portfolio, reflecting the operational differences between the OMTs and the SMP. The OMTs had not been activated by the end of 2013.

FINE-TUNING OPERATIONS

In order to absorb the liquidity injected through the SMP, the ECB conducted weekly fine-tuning operations to collect one-week fixed-term deposits corresponding to the outstanding size of the SMP as recorded in the weekly financial statement published during the same week. These fine-tuning operations were carried out as variable rate tender procedures with a maximum bid rate equal to the prevailing MRO rate.

STANDING FACILITIES

Counterparties can use the two standing facilities on their own initiative to obtain overnight liquidity against eligible collateral or to place overnight deposits with the Eurosystem. At the end of 2013 1,983 counterparties had access to the marginal lending facility and 2,460 counterparties had access to the deposit facility. The use of the deposit facility stood at significant levels during the first half of 2013, with a peak of €211.8 billion on 28 January. Owing to the reduction of excess liquidity as a result of early repayment of the three-year LTROs, the average recourse to the deposit facility decreased from €125.3 billion during the first six maintenance periods of 2013 to €63.6 billion during the last six maintenance periods, as banks left larger amounts on their current accounts. The average daily use of the deposit facility over the 12 maintenance periods of 2013 was €93.2 billion (compared with €484.3 billion for the 12 maintenance periods of 2012 and €120 billion for the 12 maintenance periods of 2011). In 2013 the use of the deposit facility followed a broadly similar pattern during each reserve maintenance period: the deposit facility amounts were lower at the beginning of each period, but increased subsequently as more counterparties fulfilled their

⁵ See the ECB's press release of 6 September 2012.

reserve requirements. The average daily recourse to the marginal lending facility was €0.47 billion (compared with €1.76 billion in 2012 and €2.1 billion in 2011).

MINIMUM RESERVE SYSTEM

Credit institutions in the euro area are required to hold minimum reserves on current accounts with the Eurosystem. From 1999 to 2011 the minimum reserve requirements were equal to 2% of credit institutions' reserve base liabilities of up to two years' maturity. On 8 December 2011 the Governing Council decided, as an additional enhanced credit support measure, to reduce the reserve ratio from 2% to 1%, as from the reserve maintenance period starting on 18 January 2012. The minimum reserve requirements amounted to €104.7 billion on average during the 12 maintenance periods of 2013 (compared with €106 billion in 2012). As the Eurosystem remunerates reserve holdings at a rate corresponding to the MRO rate, the minimum reserve system does not impose a tax on the banking sector.

ELIGIBLE ASSETS FOR CREDIT OPERATIONS

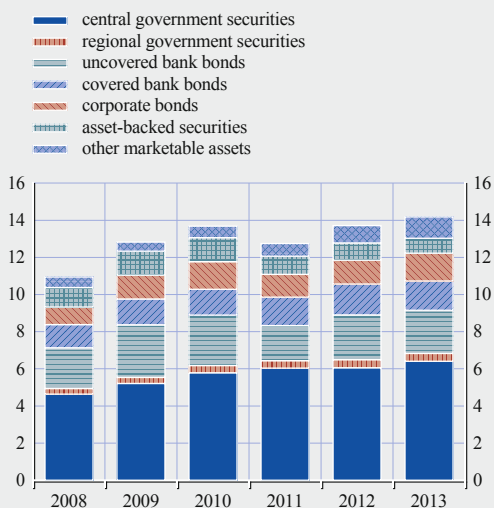
As stipulated in Article 18.1 of the Statute of the ESCB, all credit operations of the Eurosystem are based on adequate collateral. This is standard central bank practice worldwide. Collateral adequacy implies that the Eurosystem is to a large extent protected from losses in its credit operations (see below for more details on risk management issues). Furthermore, the Eurosystem ensures that sufficient collateral is available to a wide set of counterparties, so that the Eurosystem can provide the amount of liquidity it deems necessary in its monetary policy operations.

The Eurosystem accepts a broad range of assets as collateral in all its credit operations. This feature of the Eurosystem's collateral framework, together with the fact that access to Eurosystem open market operations is granted to a large pool of counterparties, has been key in supporting the implementation of monetary policy in times of stress. The inbuilt flexibility of its operational framework has allowed the Eurosystem to provide the necessary liquidity to address the impaired functioning of the money market during the financial crisis, without counterparties encountering widespread collateral constraints. In 2013 the Eurosystem adopted several measures related to its collateral eligibility criteria. On 20 March 2013 a decision was adopted which prevents, as of 1 March 2015, the use as collateral in Eurosystem credit operations of uncovered government-guaranteed bank bonds that have been issued by the counterparty itself or an entity closely linked to that counterparty. In addition, on 2 May 2013 it was announced that marketable debt instruments issued or fully guaranteed by the Republic of Cyprus which do not meet the Eurosystem's requirements for credit quality thresholds but do fulfil all other eligibility criteria would again constitute eligible collateral for the purposes of Eurosystem credit operations, subject to special haircuts. Moreover, the ECB loosened its eligibility criteria and reduced its haircuts for asset-backed securities (ABSs) which comply with loan-level reporting requirements. Additional information regarding the ABS loan-level data and changes to the Eurosystem's collateral risk control framework is provided in the section below on risk management issues.

In 2013 the average amount of marketable assets eligible as collateral was €14.2 trillion, a 3% increase compared with 2012 (see Chart 33). This development was related in particular to an increase in the eligibility of corporate bonds and other marketable assets. Central government securities, which amounted to €6.4 trillion, accounted for 45% of total eligible collateral, followed by uncovered bank bonds (€2.3 trillion, or 16%) and covered bank bonds (€1.6 trillion, or 11%), and corporate bonds (€1.5 trillion, or 11%). As well as marketable collateral, eligible collateral includes non-marketable assets, mostly in the form of credit claims (also referred to as bank loans). In contrast to the situation for marketable assets, the volume of potentially eligible non-marketable

Chart 33 Eligible marketable assets

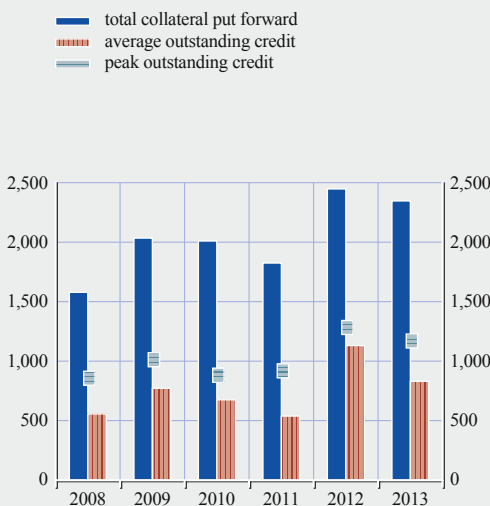
(EUR trillions)



Source: ECB.
Notes: Nominal amounts; averages of end-of-month data. The data shown in this chart are published on a quarterly basis on the ECB's website.

Chart 34 Collateral put forward in Eurosystem credit operations and outstanding credit in monetary policy operations

(EUR billions)



Source: ECB.
Notes: "Collateral put forward" refers to assets deposited as collateral in countries operating a pooling system and assets used as collateral in countries operating an earmarking system. Collateral value after valuation and haircuts; averages of end-of-month data. The data shown in this chart are published on a quarterly basis on the ECB's website.

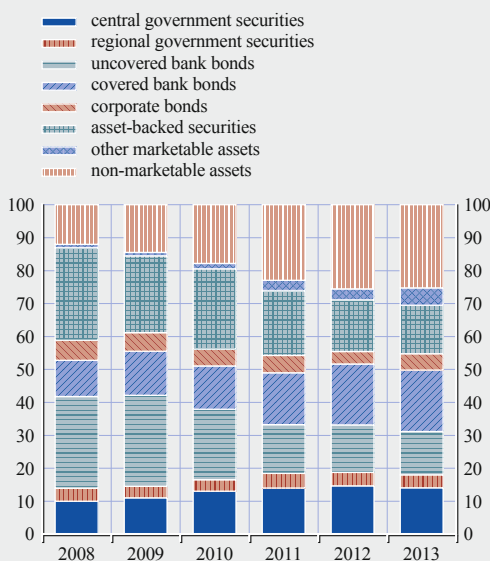
assets cannot easily be measured. The deposited amount of non-marketable assets remained almost unchanged at €0.6 trillion in 2013.

The average amount of collateral put forward by counterparties decreased slightly to €2,347 billion in 2013, from €2,448 billion in 2012 (see Chart 34). At the same time, the average amount of outstanding credit decreased from €1,131 billion in 2012 to €830 billion in 2013. Consequently, both the share and the absolute amount of deposited collateral not used to cover credit operations increased during 2013. The level of over-collateralisation shows that, at the aggregate level, the Eurosystem's counterparties experienced no shortage of collateral.

As regards the composition of collateral put forward (see Chart 35), non-marketable assets (mostly credit claims and fixed-term deposits) were the largest component in 2013, accounting for 25% of the total (the same share as in 2012). The share of covered bank bonds also remained

Chart 35 Breakdown of assets (including credit claims) put forward as collateral by asset type

(percentages)



Source: ECB.
Notes: Collateral value after valuation and haircuts; averages of end-of-month data. The data shown in this chart are published on a quarterly basis on the ECB's website.

the same at 19%, while the share of ABSs declined. The share of central government bonds decreased slightly from 15% in 2012 to 14% in 2013.

RISK MANAGEMENT ISSUES RELATED TO MONETARY POLICY CREDIT OPERATIONS

In the implementation of monetary policy, the Eurosystem conducts credit operations with counterparties fulfilling certain eligibility criteria defined in the “General Documentation”⁶. Although the eligibility criteria require such counterparties to be financially sound, the Eurosystem may still be exposed to the risk of unexpected counterparty defaults. This risk is mitigated by requiring counterparties to submit adequate collateral. However, in the event of a counterparty default, the Eurosystem would also be exposed to credit, market and liquidity risks associated with the resolution of collateral assets. In addition, liquidity-providing operations in foreign currencies against euro-denominated collateral, as well as euro-denominated liquidity-providing operations against foreign collateral, entail currency risk. In order to reduce all these risks to acceptable levels, the Eurosystem maintains high credit standards for assets accepted as collateral, values collateral on a daily basis and applies appropriate risk control measures such as valuation haircuts.

As a matter of prudence, the Eurosystem has established a buffer against potential shortfalls resulting from the eventual resolution of collateral received from defaulted counterparties. The level of the buffer is reviewed annually, pending the possible disposal of the received collateral and in line with the prospect of recovery. More generally, financial risks in credit operations are continuously monitored and quantified at the Eurosystem level and regularly reported to the ECB’s decision-making bodies.

In the course of 2013 the Eurosystem adopted several measures that further enhanced its eligibility criteria and risk control framework. As of 3 January 2013 loan-level data had to be reported for residential mortgage-backed securities (RMBSs) and ABSs backed by loans to small and medium-sized enterprises (SME ABSs) in order for them to be eligible as collateral for Eurosystem credit operations. The reporting requirements for commercial mortgage-backed securities (CMBSs) became applicable on 1 March 2013. These loan-level data, which are also available to all market participants and investors, should allow for a more informed credit risk analysis of structured finance transactions. The smooth transition to full compliance with the loan-level data requirements for RMBSs and SME ABSs was facilitated by the decision of the Governing Council, announced on 9 September 2013, to require originators to provide explanations for any missing data (in accordance with pre-specified tolerance thresholds) and an action plan for reaching full compliance with reporting requirements. In September 2013 the Governing Council also decided to implement a loan-level template for ABSs backed by credit card receivables, mandatory as of 1 April 2014. The use of the templates for the other asset classes (i.e. auto loans, consumer finance loans and leasing receivables) became mandatory on 1 January 2014.

In July 2013 the Governing Council decided to further strengthen its risk control framework, in the context of a regular review conducted with the aim of maintaining adequate risk protection and enhancing risk equivalence across the various asset classes that are used as collateral in Eurosystem monetary policy operations. This was done by adjusting the Eurosystem collateral eligibility rules and haircuts, for both marketable and non-marketable instruments. The introduced changes related in particular to the treatment of retained covered bonds and of ABSs. A new valuation markdown for retained covered bonds (covered bonds that are pledged as collateral by the issuer or by closely related entities) was introduced. The markdown of the collateral value was set at 8% for retained

⁶ “The implementation of monetary policy in the euro area – General documentation on Eurosystem monetary policy instruments and procedures”, available on the ECB’s website.

covered bonds in credit quality steps 1 and 2 and 12% for those in credit quality step 3. The ECB also revised the eligibility criteria for ABSs primarily to reflect their increased transparency and standardisation as a result of the loan-level reporting requirement, and to bring their treatment closer to the eligibility criteria for other types of asset. In particular, the ECB replaced the requirement of two triple-A ratings for ABSs subject to loan-level reporting requirements with a requirement of at least two single-A ratings. Furthermore, the haircuts applicable to ABSs eligible under both the general and the temporary collateral framework were reduced. The new eligibility criteria and haircut schedule resulting from the review of the Eurosystem risk control framework entered into force on 1 October 2013 (except for the valuation markdowns for own-use covered bonds, which were applied from 1 November 2013). In addition, the Eurosystem introduced a methodology for determining the minimum haircuts applied by NCBs to pools of credit claims and certain types of additional credit claim eligible under the temporary Eurosystem collateral framework, applicable as of January 2014.

With regard to the Eurosystem credit assessment framework (ECAAF), on 6 September 2013 the Governing Council decided to readmit the rating tool of Cerved Group to the ECAAF. This followed Cerved's completion of the amendments necessary to comply with the Basel II definition of default. Additionally, on 28 June and 14 November 2013 the Governing Council approved the in-house credit assessment system of, respectively, the Banca d'Italia and the Nationale Bank van België/Banque Nationale de Belgique for use within the ECAAF.

1.2 FOREIGN EXCHANGE OPERATIONS AND OPERATIONS WITH OTHER CENTRAL BANKS

In 2013 the Eurosystem did not intervene in the foreign exchange markets. Furthermore, the ECB did not undertake any foreign exchange operations in the currencies that participate in ERM II. The standing agreement between the ECB and the IMF to facilitate the initiation of special drawing right (SDR) transactions by the IMF on behalf of the ECB with other SDR holders was not activated in 2013. The last time that it was activated was in 2011.

The temporary liquidity swap line which the ECB established with the Federal Reserve System in 2007, which was reactivated in May 2010 to counter strains in the European US dollar funding markets, was extended on 13 December 2012 until 1 February 2014. In close cooperation with other central banks, the Eurosystem provided US dollar funding to counterparties against eligible collateral in operations which took the form of repurchase agreements and were carried out as fixed rate tender procedures with full allotment. In addition to these regular weekly seven-day operations, the ECB, in coordination with the Federal Reserve, the Bank of Canada, the Bank of England, the Bank of Japan and the Swiss National Bank, continued to conduct every four weeks US dollar liquidity-providing operations with a maturity of 84 days. In 2013, from a value-date perspective, the Eurosystem conducted 50 operations with a seven-day maturity, as well as one 15-day operation at the year-end and thirteen 84-day operations. The temporary bilateral swap arrangements established in 2011 between the ECB, the Bank of Canada, the Bank of England, the Bank of Japan and the Swiss National Bank to enhance their capacity to provide liquidity support to the global financial system and to ease strains in financial markets were not used in 2013. They are seen, however, as effective in easing financial strains and mitigating their effects on economic conditions. These swap arrangements were extended on 13 December 2012 until 1 February 2014. On 31 October 2013 the ECB announced, in cooperation with the Bank of Canada, the Bank of England, the Bank of Japan, the Federal Reserve and the Swiss National Bank, the conversion of

their temporary bilateral swap arrangements to standing arrangements that will remain in place until further notice. These arrangements allow for the provision of liquidity in each jurisdiction in any of the five currencies foreign to that jurisdiction, should the two central banks in a particular bilateral swap arrangement judge that market conditions warrant such action in one of their currencies. The standing arrangements will continue to serve as a prudent liquidity backstop. They will enable the Eurosystem to continue to provide euro to those central banks when required and to provide to its counterparties, when necessary, Japanese yen, pounds sterling, Swiss francs and Canadian dollars in addition to the existing liquidity-providing operations in US dollars.

On 16 September 2013 the Governing Council decided, in agreement with the Bank of England, to extend the liquidity swap arrangement with the Bank of England until 30 September 2014. The swap facility agreement of 17 December 2010 had been authorised until 30 September 2013. Under this facility, the Bank of England can provide, if necessary, up to GBP 10 billion to the ECB in exchange for euro. The agreement allows pounds sterling to be made available to the Central Bank of Ireland as a precautionary measure, for the purpose of meeting any temporary liquidity needs of the banking system in that currency.

On 10 October 2013 the ECB announced the establishment of a bilateral currency swap agreement with the People's Bank of China. The swap line has a maximum size of €45 billion or CNY 350 billion. From the perspective of the Eurosystem, the swap line will serve as a backstop liquidity facility and to reassure euro area banks of the continuous provision of Chinese renminbi. The swap line should be seen in the context of rapidly growing bilateral trade and investment between the euro area and China, as well as the need to ensure the stability of financial markets.

1.3 INVESTMENT ACTIVITIES

The ECB invests the funds related to its foreign reserve portfolio as well as its own funds. These investment activities, which are separate from monetary policy programmes such as the OMTs, the SMP, the CBPP and the CBPP2, are organised in such a way as to ensure that no inside information about central bank policy actions may be used when making investment decisions.

FOREIGN RESERVE MANAGEMENT

The ECB's foreign reserve portfolio was originally set up through transfers of foreign reserve assets from the euro area NCBs. Over time, the composition of the portfolio reflects changes in the market value of the invested assets, as well as foreign exchange and gold operations of the ECB. The main purpose of the ECB's foreign reserves is to ensure that, whenever needed, the Eurosystem has a sufficient amount of liquid resources for its foreign exchange policy operations involving non-EU currencies. The objectives for the management of the ECB's foreign reserves are, in order of importance, liquidity, security and return.

The ECB's foreign reserve portfolio consists of US dollars, Japanese yen, gold and SDRs. The US dollar and Japanese yen reserves are actively managed by the ECB and those euro area NCBs that wish to take part in this activity as agents for the ECB. Since January 2006 a "currency specialisation model" has been in operation to increase the efficiency of the ECB's investment operations. Under this scheme, each NCB that wishes to be involved in ECB foreign reserve management, or group of NCBs acting jointly for this purpose, is as a rule allocated a share in the US dollar or the Japanese yen portfolio.⁷

⁷ For more details, see the article entitled "Portfolio management at the ECB", *Monthly Bulletin*, ECB, April 2006.

The value of the ECB's net foreign reserve assets⁸ at current exchange rates and market prices decreased from €64.8 billion at end-2012 to €54.8 billion at end-2013, of which €40.1 billion was in foreign currencies and €14.7 billion was in gold and SDRs. The marked decrease in the value of the ECB's net foreign reserve assets was mainly the result of a significant decline in the gold price, combined with a 21.2% depreciation of the Japanese yen against the euro. Positive contributions from capital gains and interest income generated by portfolio management activities offset some of these losses. Applying end-2013 exchange rates, US dollar-denominated assets represented 82% of the foreign currency reserves, while those assets denominated in Japanese yen accounted for 18%. The value of gold and SDR holdings decreased, driven by the strong depreciation of gold by around 31% in 2013 (as measured in euro terms).

OWN FUNDS MANAGEMENT

The ECB's own funds portfolio consists of the invested counterpart of the ECB's paid-up capital, as well as amounts held in its general reserve fund and its provision against foreign exchange rate, interest rate, credit and gold price risks. The purpose of this portfolio is to provide the ECB with income to help cover its operating expenses.

The portfolio is invested in euro-denominated fixed income assets. The value of the portfolio at current market prices increased from €18.9 billion at end-2012 to €20.0 billion at end-2013. The increase in market value was mainly due to an increase in the provision against foreign exchange rate, interest rate, credit and gold price risks. Investment returns also contributed to this modest increase. Moreover, the ECB's paid-up capital also increased slightly, as Croatia joined the EU (and thus the Croatian central bank joined the ESCB) on 1 July.

The own funds portfolio continued to be managed in a largely passive way in 2013, in order to ensure that no inside information about central bank policy actions can have an impact on investment decisions.

I.4 RISK MANAGEMENT ISSUES RELATED TO INVESTMENT PORTFOLIOS AND SECURITIES HELD FOR MONETARY POLICY PURPOSES

The financial risks to which the Eurosystem is exposed through the ECB's investment activities and the Eurosystem's holdings of securities in monetary policy portfolios are closely monitored and measured. Regular reports ensure that all stakeholders are adequately informed about the level of such risks, so that appropriate actions can be taken to mitigate them. In particular, a risk control framework, mainly composed of eligibility criteria and a limit system, is in place to mitigate risks. Compliance with the risk control framework is monitored on a daily basis.

The Eurosystem's stock of securities held for monetary policy purposes declined over the course of 2013 owing to redemptions and the absence of additional purchases, as the SMP and the CBPP2 were terminated in 2012 and no OMTs were conducted. If OMTs were to be conducted, the financial risks entailed by potential purchases of securities would continue to be closely monitored and measured. Regarding the applicable risk control framework, the OMTs incorporate two additional risk-mitigating features compared with the SMP: first, the conditionality entailing that purchases of securities would only be conducted for limited periods, subject to a successful implementation of

⁸ Net foreign reserve assets are calculated as official reserve assets excluding the net, marked-to-market value of foreign currency swaps, plus deposits in foreign currency with residents, minus future predetermined net drains on foreign currency holdings owing to repurchase and forward transactions. For detailed information on the data sources, see the ECB's website.

economic policies; and, second, the focus of the purchases on instruments with a residual maturity of between one and three years.

2 PAYMENT AND SECURITIES SETTLEMENT SYSTEMS

The Eurosystem has the statutory task of promoting the smooth operation of payment systems. Payment systems and securities clearing and settlement systems are fundamental infrastructures that are necessary for the proper functioning of market economies. They are indispensable for the efficient flow of payments for goods, services and financial assets, and their smooth functioning is crucial for the implementation of a central bank's monetary policy and for maintaining the stability of and confidence in the currency, the financial system and the economy in general. For the performance of this task, the Eurosystem applies three approaches: it takes on an operational role, conducts oversight activities and acts as a catalyst (for further details on the second and third of these, see Sections 4 and 5 of Chapter 4). In terms of its operational role, the Eurosystem may, in accordance with the Statute of the ESCB, provide facilities to ensure efficient and sound clearing and payment systems.

2.1 THE TARGET2 SYSTEM

The Eurosystem operates the TARGET2 system for large-value and urgent payments in euro. TARGET2 offers a real-time settlement service in central bank money and broad market coverage. It processes large-value and urgent transactions without any upper or lower limit on the value of payments and has also attracted a variety of other payments. The system is based on a single technical infrastructure, the Single Shared Platform (SSP). Three NCBs – the Deutsche Bundesbank, the Banque de France and the Banca d'Italia – jointly provide the SSP and operate it on behalf of the Eurosystem. By December 2013 TARGET2 had 1,606 direct participants. The overall number of banks (including branches and subsidiaries) that can be addressed worldwide through TARGET2 reached some 55,000. In addition, TARGET2 settled the cash positions of 80 ancillary systems.

TARGET2 OPERATIONS

The TARGET2 system functioned smoothly in 2013 and settled a large number of euro payments. The system's market share remained stable, with 91% of the total value of payments in euro large-value payment systems being executed via TARGET2. In 2013 the system processed a total of 92,590,134 transactions, with a daily average of 363,099 transactions. The total value of TARGET2 traffic in 2013 was €493,442 billion, with an average daily value of €1,935 billion. Table 11 provides an overview of payment traffic in the TARGET2 system in 2013, comparing it with traffic in the previous year. In 2013 the overall availability⁹ of the SSP of TARGET2 reached 100%. Over the course of the year 100% of the payments in the SSP were processed within five minutes and the system's positive performance met with the satisfaction of participants.

COOPERATION WITH TARGET2 USERS

The Eurosystem maintains close relations with TARGET2 users. Regular meetings were held between the NCBs and national TARGET2 user groups in 2013. In addition, joint meetings of the Eurosystem's Working Group on TARGET2 and the TARGET Working Group of the European credit sector associations took place on a semi-annual basis to discuss TARGET2 business issues

⁹ The level of availability is the extent to which participants were able to use the TARGET2 system during their business hours without incident.

Table 11 Payment traffic in TARGET2

	Value (EUR billions)			Volume (number of transactions)		
	2012	2013	Change (%)	2012	2013	Change (%)
TARGET2 overall						
Total	634,132	493,442	-22.2	90,671,378	92,590,134	2.1
Daily average	2,477	1,935	-21.9	354,185	363,099	2.5

Source: ECB.

Notes: The sharp decrease in value compared with 2012 is due to changes in the statistical methodology used. There were 256 operating days in 2012 and 255 in 2013.

at the pan-European level. The ad hoc group composed of representatives from these two groups continued its work, addressing major changes that affect TARGET2, such as the connection of TARGET2-Securities (T2S) and the migration to the new industry standards (ISO 20022). Further strategic issues were addressed in the Contact Group on Euro Payments Strategy, a forum composed of senior representatives from commercial and central banks.

MANAGEMENT OF NEW SYSTEM RELEASES

The Eurosystem continues to develop TARGET2 in order to further increase the level of service offered and to meet the needs of its participants. The 2013 release of TARGET2 was a major one, encompassing the changes related to the adaptation to T2S and a number of minor improvements to the system. While the minor improvements – which mainly related to the implementation of a new version of cash management messages – went live on 18 November 2013, the T2S adaptations will only be activated with the launch of T2S, scheduled for June 2015. The T2S-related changes comprise all adaptations necessary to connect the two platforms, as well as a number of services that TARGET2 will offer to its participants to support their cash activities in T2S.

In 2013 two consultations were launched in order to obtain users' feedback on details relating to the migration of TARGET2 to ISO 20022 in November 2017.

COUNTRIES PARTICIPATING IN TARGET2

All euro area countries participate in TARGET2, as its use is mandatory for the settlement of all payment orders related to the Eurosystem's monetary policy operations. Non-euro area EU central banks may connect to the TARGET2 system on a voluntary basis in order to facilitate the settlement of euro-denominated transactions in these countries. From a legal and business point of view, each central bank is responsible for managing its system component and for maintaining relationships with its participants. In addition, some financial institutions located in other EEA countries participate in TARGET2 via remote access. 24 central banks of the EU and their respective user communities are currently connected to TARGET2: the 18 euro area NCBs (including Latvijas Banka), the ECB and five central banks of non-euro area countries.¹⁰

2.2 TARGET2-SECURITIES

TARGET2-Securities (T2S) is the future Eurosystem service for securities settlement in central bank money in Europe. The project is currently in the development phase and is due to go live in June 2015. Virtually all traded securities in Europe will be settled in T2S, leading to significant

¹⁰ Bulgaria, Denmark, Lithuania, Poland and Romania.

economies of scale and a reduction of settlement costs. By removing the distinction between cross-border and domestic settlement, T2S will constitute a major breakthrough in the creation of an integrated capital market for Europe, providing a solid basis for increasing efficiency and competition in the entire post-trading sector. T2S will enable significant savings in terms of collateral and liquidity, a particularly valuable feature at a time when the demand for high-quality collateral is ever-increasing as a result of the financial turmoil and new regulatory developments. It will harmonise market processes and thus facilitate back office streamlining.

In 2013 two further central securities depositories (CSDs) – BNY Mellon CSD, a newly formed CSD, and Latvijas Centrālais depozitārijs, the Latvian CSD belonging to the NASDAQ OMX Group – signed the T2S Framework Agreement.¹¹ This brought the total number of CSDs participating in T2S to 24 at the end of 2013. Considerable progress was made in 2013 in adapting the CSDs' infrastructure in view of their connection to T2S. The CSDs and their communities are now preparing for their user tests and migration.

In March 2013 the Governing Council of the ECB approved the plan for CSDs to migrate to T2S in four waves (see Table 12). At least 24 CSDs and 20 central banks will migrate to T2S between June 2015 and February 2017. Fixing the dates of the migration waves was an important achievement, as it provides participants with planning certainty with regard to their migration activities.

In May 2013 the T2S community reached a mutual agreement that the programme plan was comprehensive and adequately reflected any agreed additional specifications, deliverables and planning elements for CSDs or central banks. SIA/Colt¹² and SWIFT, the two licensed value-added network providers that will connect CSDs and market participants to T2S, passed the acceptance

Table 12 Migration waves and dates for the central securities depositories

First wave 22 June 2015	Second wave 28 March 2016	Third wave 12 September 2016	Fourth wave 6 February 2017
Bank of Greece Securities Settlement System – BOGS	Euroclear Belgium	Clearstream Banking (Germany)	BNY Mellon CSD (Belgium)
Depozitarul Central (Romania)	Euroclear France	KELER (Hungary)	Centrālais depozitāris cenných papīerov SR (Slovakia)
Malta Stock Exchange	Euroclear Nederland	LuxCSD (Luxembourg)	Eesti Väärtpaberikeskus (Estonia)
Monte Titoli (Italy)	Interbolsa (Portugal)	Oesterreichische Kontrollbank (Austria)	Euroclear Finland
SIX SIS (Switzerland)	National Bank of Belgium Securities Settlement System (NBB-SSS)	VP LUX (Luxembourg)	Iberclear (Spain)
		VP SECURITIES (Denmark)	KDD – Centralna klirinško depotna družba (Slovenia)
			Latvijas Centrālais depozitārijs (Latvia)
			Lietuvos centrinis vertybinių popierių depozitoriumas (Lithuania)

11 The T2S Framework Agreement is the contract stipulating the rights and obligations of the Eurosystem and of CSDs outsourcing their settlement function to the Eurosystem.

12 SIA/Colt is a joint venture between the Italian service provider SIA and the Italian subsidiary of the English network provider Colt.

procedure in 2013. The dedicated link solution offered by the Eurosystem was not taken up by any users, and there are therefore currently no plans to develop this service. In October 2013 the Eurosystem started its T2S user training programme based on a “train the trainer” approach. Work on developing the software for T2S was completed in 2013, and the Eurosystem is preparing the tools and resources for its acceptance tests for the T2S platform. The T2S project is thus moving forward according to plan.

T2S continued to be a driver of post-trade harmonisation in Europe in 2013. In March a conference on post-trade harmonisation and financial integration in Europe was hosted by the ECB and the European Commission. The T2S Advisory Group’s third harmonisation report, which highlights the progress made on the harmonisation agenda in the T2S markets¹³, was presented at the conference. The Advisory Group made substantial progress in 2013, in terms of both setting standards and monitoring compliance. All 21 T2S markets are now being monitored, and standards have been set for 16 of the 24 harmonisation activities that were identified. Work on the definition of standards will not be completed until the proposed regulation on improving securities settlement in the EU and on CSDs – which should strongly improve the legal and competitive environment in which T2S operates – has been adopted. On 18 December 2013 a political agreement was reached on this CSD regulation proposed by the European Commission, which is of key importance for T2S. The fourth T2S harmonisation progress report was prepared over the course of 2013 and is scheduled for publication in spring 2014. For further details on T2S harmonisation activities and their impact on European financial integration, see Section 5 of Chapter 4.

2.3 SETTLEMENT PROCEDURES FOR CROSS-BORDER COLLATERAL

Eligible assets may be used to collateralise all types of Eurosystem credit operation, not only at the domestic level but also across national borders. The cross-border mobilisation of collateral in the euro area is conducted mainly via the correspondent central banking model (CCBM) and through eligible links between euro area securities settlement systems (SSSs). Whereas the first solution is provided by the Eurosystem, the latter is a market-led initiative. In addition, cross-border collateral can be mobilised on the accounts of NCBs with a non-domestic (international) CSD on an exceptional basis.

At the end of 2013 the amount of cross-border collateral (including both marketable and non-marketable assets) held by the Eurosystem stood at €598 billion, down from €643 billion at the end of 2012. Overall, at the end of 2013 cross-border collateral represented 24.2% of the total collateral provided to the Eurosystem (compared with 22.8% in 2012).

COLLATERAL MANAGEMENT SERVICES

The CCBM remained the main channel for transferring cross-border collateral in Eurosystem monetary policy and intraday credit operations in 2013. Assets held in custody through the CCBM decreased from €354 billion at the end of 2012 to €328 billion at the end of 2013. Cross-border collateral held on accounts of NCBs with a non-domestic (international) CSD amounted to €95 billion at the end of 2013.

Initially set up in 1999 as an interim solution building upon the principle of minimum harmonisation, the CCBM remains an important channel for mobilising collateral across borders. Following market

¹³ T2S markets are those where at least one CSD has signed the T2S Framework Agreement.

participants' requests, the Eurosystem agreed to remove the requirement to repatriate (marketable) assets from investor CSDs to issuer CSDs before they are mobilised as collateral through the CCBM. In addition, preparations are under way to allow tri-party collateral management services which are currently only used domestically also to be used on a cross-border basis. The repatriation requirement is scheduled to be removed in May 2014, and the cross-border use of tri-party collateral management services will go live in September 2014.

Issues related to euro securities settlement and collateral mobilisation in Eurosystem credit operations were discussed in the Contact Group on Euro Securities Infrastructures, which is a forum for representatives of market infrastructures, market participants and central banks.

ELIGIBLE LINKS BETWEEN NATIONAL SECURITIES SETTLEMENT SYSTEMS

Cross-border collateral can also be mobilised by using links between national SSSs. However, such links are only eligible for use in Eurosystem credit operations if they have been positively assessed under the Eurosystem's user assessment framework.¹⁴ Once the securities have been transferred to another SSS via eligible links, they can be used through local procedures in the same way as domestic collateral. The amount of collateral mobilised through direct and relayed links increased from €156 billion at the end of 2012 to €174 billion at the end of 2013.

In 2013 8 new direct links and 15 new relayed links were added to the list of eligible links and 5 direct links were removed. In total, there were 55 direct and 23 relayed links available to counterparties at the end of 2013, of which only a limited number are actively used.

3 BANKNOTES AND COINS

In accordance with Article 128 of the Treaty, the Governing Council of the ECB has the exclusive right to authorise the issuance of euro banknotes within the EU. The ECB and the NCBs may issue these banknotes.

2013 saw the launch of the first denomination of the second series of euro banknotes, the €5 (as described in further detail at the end of Section 3.3 of this chapter).

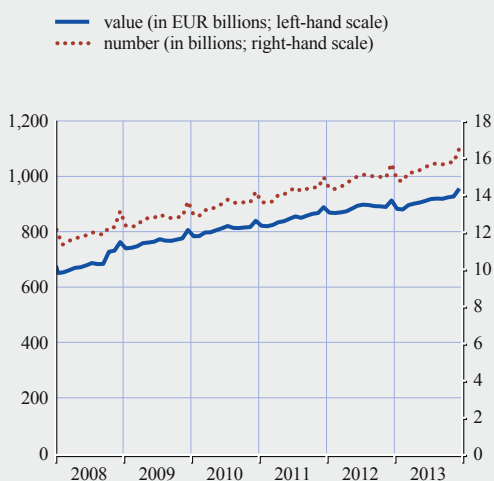
3.1 THE CIRCULATION OF BANKNOTES AND COINS

DEMAND FOR EURO BANKNOTES AND COINS

At the end of 2013 there were 16.5 billion euro banknotes in circulation, with a total value of €956.2 billion. This compares with 15.7 billion banknotes, with a total value of €912.6 billion, at the end of 2012 (see Chart 36). In terms of value, the €50 and the €500 banknotes accounted for the largest shares of the banknotes in circulation, standing at 36% and 30% respectively at the end of the year. The €50 banknote was the most-used denomination in terms of volume, accounting for 42% of all euro banknotes in circulation (see Chart 37). In 2013 the annual growth rate of banknotes in circulation was 4.8% in value terms and 5.3% in volume terms. The €100 banknotes showed the highest annual growth rate, at 8.4%, closely followed by the €50 and €200 banknotes, at 8.2% and 8.0% respectively, in terms of both volume and value. Circulation of

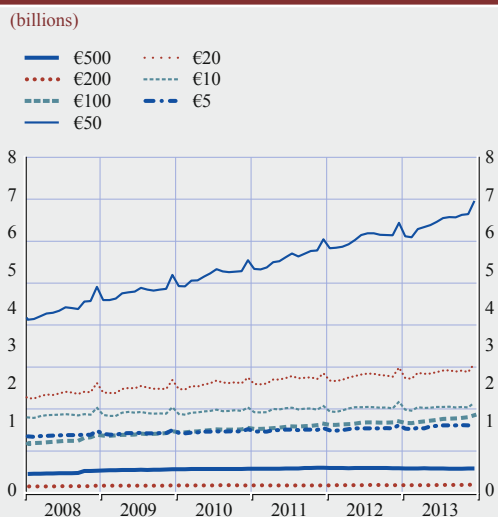
¹⁴ In September 2013 the Eurosystem established a new framework for the assessment of SSSs and links (see the press release of 27 September 2013 on the ECB's website).

Chart 36 Number and value of euro banknotes in circulation



Source: ECB.

Chart 37 Number of euro banknotes in circulation by denomination



Source: ECB.

the €500 banknote, which had shown considerable growth in the past, has been declining since the fourth quarter of 2012. The decline has been compensated for by an increased demand for €100 banknotes.

It is estimated that, in terms of value, 20-25% of the euro banknotes in circulation are held outside the euro area, predominantly in countries neighbouring the euro area. In 2013 net shipments of euro banknotes by financial institutions to regions outside the euro area were at the same level as in 2012. Euro banknotes, mainly high-value denominations, are held outside the euro area as a store of value and for settling transactions on international markets.

In 2013 the total number of euro coins in circulation (i.e. net circulation excluding stocks held by the euro area NCBs) increased by 3.8%, standing at 106.0 billion. At the end of 2013 the value of coins in circulation stood at €24.2 billion, 2.3% higher than at the end of 2012.

BANKNOTE HANDLING BY THE EUROSISTEM

In 2013 the euro area NCBs issued 32.7 billion banknotes worth €1,017.8 billion, while 31.6 billion banknotes worth €969.0 billion were returned to them. These figures were similar to those recorded in 2012. 33.7 billion banknotes were processed using fully automated banknote processing machines, which checked the banknotes for both authenticity and fitness for circulation in order to maintain the quality and integrity of the banknotes in circulation in accordance with the common minimum sorting standards established by the Eurosystem. In that process, some 6.1 billion banknotes were identified for destruction, largely because they were found to be unfit for circulation. The replacement rate¹⁵ of the banknotes in circulation was 45% for the denominations €5 to €50 and 8% for the remaining denominations. The overall replacement rate increased slightly from 38% in 2012 to 39% in 2013. This rise can largely be explained by the issuance scenario for

¹⁵ Defined as the number of banknotes identified for destruction in a year divided by the average number of banknotes in circulation during that year.

the new €5 banknote, which foresaw that NCBs would destroy all €5 banknotes of the first series that were returned to them. At the end of 2013 half of all €5 banknotes in circulation were of the second series.

The average return frequency¹⁶ of banknotes in circulation was 2.0 at end-2013, meaning that, on average, a banknote returned to a euro area NCB around every six months. The return frequencies were 0.3 for €500 banknotes, 0.4 for €200 banknotes and 0.7 for €100 banknotes, while the return frequencies of the denominations which are typically used for transactions were higher (1.4 for €50 banknotes, 3.2 for €20 banknotes, 4.0 for €10 banknotes and 2.3 for €5 banknotes).

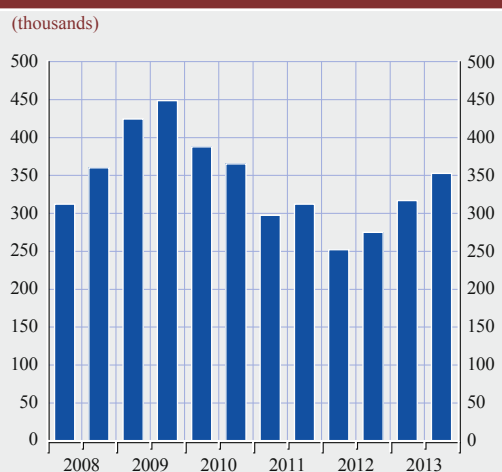
3.2 BANKNOTE COUNTERFEITING AND COUNTERFEIT DETERRENCE

COUNTERFEIT EURO BANKNOTES

In 2013 the National Analysis Centres¹⁷ received some 670,000 counterfeit euro banknotes. When compared with the number of genuine euro banknotes in circulation, the proportion of counterfeits remains at a very low level. Long-term developments in the quantity of counterfeits removed from circulation are shown in Chart 38. Counterfeiters tend to target the €20 and €50 banknotes, which in 2013 accounted for 40.4% and 39.6% of total counterfeits respectively. Further details of the denominational breakdown are shown in Chart 39.

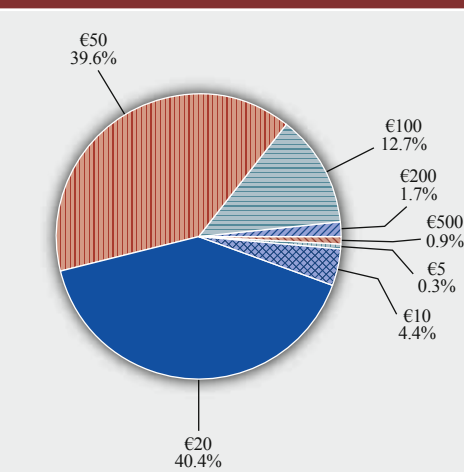
Although confidence in the security of the euro is fully justified by the ongoing anti-counterfeiting measures of European and international authorities, this should not give rise to complacency. The ECB continues to advise the public to remain alert to the possibility of fraud, to remember the “feel-look-tilt” test,¹⁸ and never to rely on just one security feature. In addition, training is offered

Chart 38 Number of counterfeit euro banknotes recovered from circulation



Source: ECB.

Chart 39 Breakdown of counterfeit euro banknotes by denomination in 2013



Source: ECB.

¹⁶ Defined as the total number of banknotes returned to euro area NCBs in a year divided by the average number of banknotes in circulation during that year.

¹⁷ Centres established in each EU Member State for the initial analysis of counterfeit euro banknotes at the national level.

¹⁸ See the “Security features” section of the ECB’s website under “The Euro”, then “Banknotes”.

to professional cash handlers on a continuous basis, both in Europe and beyond, and up-to-date information material is made available to support the Eurosystem's fight against counterfeiting. The ECB's well-established cooperation with Europol and the European Commission also serves this goal.

COUNTERFEIT DETERRENCE AT THE GLOBAL LEVEL

Cooperation on counterfeit deterrence goes beyond the European level. The Eurosystem participates actively in the work of the Central Bank Counterfeit Deterrence Group.¹⁹ The ECB hosts the International Counterfeit Deterrence Centre (ICDC), which acts as the technical centre for this group. The ICDC maintains a website²⁰ which provides information and guidance concerning the reproduction of banknote images, as well as links to country-specific websites.

3.3 BANKNOTE PRODUCTION AND ISSUANCE

PRODUCTION ARRANGEMENTS

In 2013 NCBs were responsible for the production of 8 billion euro banknotes, with the new €10 banknote, to be introduced in September 2014 (see below), accounting for 4.5 billion of that total (around 56% of the banknotes produced). The allocation of euro banknote production continued to be based on decentralised production with pooling, an arrangement initially established in 2002. Under this arrangement, each euro area NCB is responsible for the procurement of an allocated share of the total requirement for certain denominations (see Table 13).

RECIRCULATION OF BANKNOTES

When putting euro banknotes back into circulation, cash handlers (credit institutions, cash in transit companies and, under certain circumstances, other economic agents, such as retailers and casinos) must adhere to the rules laid down in Decision ECB/2010/14 on the authenticity and fitness checking and recirculation of euro banknotes.²¹ This Decision aims in particular to ensure that all banknotes distributed to the public via cash dispensers have been checked for both authenticity and fitness. According to data reported by cash handlers to the euro area NCBs, around one-third of the total number of euro banknotes that were put back into circulation in 2013 were recirculated via cash dispensers after having been processed by cash handlers using banknote handling machines.

The Eurosystem continued its efforts to help banknote equipment manufacturers to ensure that their machines meet the ECB's standards for machinery used by cash handlers to check euro banknotes prior to recirculation. It also supported third parties in adapting their banknote handling machines to the new series of banknotes.

Table 13 Allocation of euro banknote production in 2013

	Quantity (millions of banknotes)	NCB commissioning production
€5	0.00	-
€10	4,500.00	DE, CY, EE, GR, ES, FR, IE, IT, MT, LU, NL, AT, SI, SK, FI
€20	2,500.00	DE, CY, EE, GR, FR, IT, MT, LU, NL, PT, SI, SK, FI
€50	1,000.00	BE, DE, ES
€100	0.00	-
€200	0.00	-
€500	0.00	-
Total	8,000.00	

Source: ECB.

¹⁹ A group comprising 32 central banks and banknote printing authorities, working together under the auspices of the G10.

²⁰ See <http://www.rulesforuse.org>

²¹ OJ L 267, 9.10.2010, p. 1.

THE EXTENDED CUSTODIAL INVENTORY PROGRAMME

Following an open tender procedure among banknote wholesale banks in 2012, the contract for the operation of an Extended Custodial Inventory (ECI) for euro banknotes was awarded to Bank of America and Bank of China (Hong Kong) in 2013. Under the new contract, both banks started operating an ECI in Hong Kong. In addition, Bank of America began operations at its ECI in Miami. The ECI programme aims to ensure the smooth circulation of euro banknotes in geographically remote regions and to provide detailed statistical data on the international use of euro banknotes.

THE SECOND SERIES OF EURO BANKNOTES

The first denomination of the second series of euro banknotes, the €5, was launched on 2 May 2013. This second series is called the Europa series and features a portrait of Europa, a figure from Greek mythology, in the watermark and hologram. It will have the same denominations as the first series of banknotes and most of the same design elements.²² The Eurosystem's work on the new series in 2013 also focused on the large-scale production of the new €10 banknote and the ongoing development of the subsequent denominations of the new series. The Eurosystem also continued to help various stakeholders to prepare for the introduction of the new €10 banknote, providing extensive information and opportunities to conduct tests and adapt banknote handling machines and authentication devices to the new banknotes.

The Governing Council decided on 20 December 2013 that the new €10 banknote will be introduced on 23 September 2014. The exact timing of the issuance of the other denominations of the Europa series will be determined at a later stage. It is anticipated that the new banknotes will be introduced gradually over several years in ascending order. The Eurosystem will inform the public, cash handlers and banknote equipment manufacturers well in advance about the modalities of the introduction of the new banknotes. The banknotes of the first series will remain legal tender for a relatively long period and their withdrawal from circulation will be gradual and communicated to the public well in advance. Even after the banknotes of the first series have been withdrawn, it will be possible to exchange them at the euro area NCBs for an unlimited period of time.

4 STATISTICS

The ECB, assisted by the NCBs, develops, collects, compiles and disseminates a wide range of statistics which support the monetary policy of the euro area, various other tasks of the ESCB and the tasks of the European Systemic Risk Board (ESRB). These statistics are also used by public authorities, financial market participants, the media and the general public. In 2013 regular euro area statistics continued to be provided in a smooth and timely manner. In accordance with the annually reviewed statistical work programme, significant efforts were devoted to meeting the increasing demand for higher-frequency statistics providing broader coverage for the fulfilment of the mandates of the ECB and the ESRB (see Section 2 of Chapter 3).

Moreover, the ECB's statistical function has worked to meet the significant challenges posed by the need to establish a new collection framework for providing meaningful statistics and risk data as part of the preparatory work for the new Single Supervisory Mechanism (see Section 1 of Chapter 4).

²² For more details, see <http://www.newfaceoftheeuro.eu>

4.1 NEW AND ENHANCED EURO AREA STATISTICS

In April 2013 the results were published of the first wave of the Eurosystem Household Finance and Consumption Survey, a joint Eurosystem project carried out with the support of the national statistical institutes of three euro area countries. This survey provides micro-level data on, for example, households' real and financial assets, liabilities, consumption and saving, income and employment, and future pension entitlements. Its results contribute to the Eurosystem's knowledge of the euro area's economic and financial structure and to a better understanding of the monetary transmission mechanism and the impact of macroeconomic shocks on financial stability. The results of the survey were published with a report presenting the methodology.

Since August 2013 MFI interest rate statistics have been complemented by new composite cost-of-borrowing indicators for non-financial corporations and for households. These indicators make it easier to assess the retail bank interest rate pass-through in the euro area at times of financial fragmentation.

The dissemination and communication of statistics were also improved by publishing the ESRB risk dashboard in the Statistical Data Warehouse (SDW) and incorporating direct links to the SDW in press releases, beginning with the press release on euro area securities issues statistics in September 2013.

In addition, the ECB launched a new Statistics Paper Series, which provides a new channel for statisticians, economists and other staff to publish innovative work on statistics and related methodologies.

4.2 OTHER STATISTICAL DEVELOPMENTS

The ESCB continued its work on enhancing the availability and quality of statistics on the basis of micro-databases, as these provide more flexibility in meeting user needs and help to minimise the burden for reporting agents.

In May 2013 the ESCB deployed a register of all financial institutions in the EU, including large banking and insurance groups – the enhanced Register of Institutions and Affiliates Database (RIAD). Data on individual MFIs and other financial institutions are entered by statistics departments in the ESCB, and the updated lists are published on the ECB's website (refreshed daily for credit institutions and quarterly for investment funds and financial vehicle corporations). In addition to facilitating the classification of financial institutions for statistical reporting purposes, the enhanced RIAD helps the assessment of collateral in market operations and will also support the Single Supervisory Mechanism. To increase its usefulness, the RIAD will be interoperable with the EuroGroups Register of (mainly) non-financial enterprises in Europe, which is being developed and run in parallel by Eurostat.

With reference to banking statistics, the structural financial indicators and the consolidated banking data now provide the statistical basis for the Banking Structures Report, which was made possible in part by the substantially improved publication schedule for these statistical datasets in 2013.

The legislative process to align the European System of Accounts 1995 (ESA 95) with the System of National Accounts 2008 and the sixth edition of the IMF's "Balance of Payments and International

Investment Position Manual” was finalised in June 2013 with the publication of the European System of Accounts 2010 (ESA 2010). The revision of all related ECB and EU legal acts in order to ensure that the new standards are implemented as from September 2014 was conducted in parallel. In this context, the Governing Council approved a comprehensive revision of the legal acts in the field of monetary and financial statistics, also including further improvements in those statistics to meet essential new requirements for the purposes of, primarily, monetary policy and financial stability analysis. The revisions are contained in Regulation ECB/2013/33 concerning the balance sheet of the monetary financial institutions sector, Regulation ECB/2013/34 concerning statistics on interest rates applied by monetary financial institutions, Regulation ECB/2013/38 concerning statistics on the assets and liabilities of investment funds, Regulation ECB/2013/39 on statistical reporting requirements for post office giro institutions that receive deposits from non-monetary financial institution euro area residents, and Regulation ECB/2013/40 concerning statistics on the assets and liabilities of financial vehicle corporations engaged in securitisation transactions. Guideline ECB/2013/23 on government finance statistics and Guideline ECB/2013/24 on the statistical reporting requirements of the European Central Bank in the field of quarterly financial accounts were also updated in 2013.

In March 2013 the ECB adopted Guideline ECB/2013/7, which defines the procedures to be followed by NCBs when reporting to the ECB statistical information derived from the data collected under the new Regulation ECB/2012/24 concerning statistics on holdings of securities, covering both holdings by sectors of the economy and holdings by selected reporting banking groups. The requirements as regards holdings by sectors are for security-by-security data on holdings of securities by euro area (financial and non-financial) investors, as well as on holdings by non-euro area investors of securities issued by euro area residents which are kept in custody in the euro area. The data collection will start in March 2014 with reference to data for December 2013.

Payment statistics have been considerably enhanced by the new Regulation ECB/2013/43, which primarily covers developments relating to the Single Euro Payments Area, notably Regulation (EU) No 260/2012 of the European Parliament and of the Council of 14 March 2012 establishing technical and business requirements for credit transfers and direct debits in euro and amending Regulation (EC) No 924/2009 (see Section 4 of Chapter 4). The new ECB Regulation, which also enhances some existing indicators with amended methodology and/or deeper geographical breakdowns at counterparty level, is addressed to payment service providers, electronic money issuers and payment system operators resident in the euro area countries. It is accompanied by a recommendation addressed to national authorities in the non-euro area EU Member States to enable them to provide the same set of data.

In addition, other important datasets are under development. The ESCB is developing enhanced statistics for the insurance sector, which would to the extent possible reuse data to be collected using Solvency II quantitative reporting templates, as designed by the European Insurance and Occupational Pensions Authority. Work is also under way to harmonise a core set of data attributes and design a pilot area for data from credit registers or other similar loan-level datasets with a view to reusing information to meet various statistical and analytical needs.

The ECB continued its close working relationship with Eurostat and with other international organisations in 2013. At the European level, the Committee on Monetary, Financial and Balance of Payments Statistics (CMFB) has since 1991 been the main forum for coordinating the work of statisticians from the ESCB and the European Statistical System (ESS), which is composed of the

national statistical institutes of the EEA and Eurostat. In recent years, the CMFB has played an important advisory role as regards statistical issues related to excessive deficit procedure decisions. In April 2013, in order to further strengthen cooperation in areas of shared responsibility or common interest, the ESCB and the ESS signed a Memorandum of Understanding, which establishes a new structure alongside the CMFB, the European Statistical Forum, to enhance cooperation at the strategic level.

The ECB also contributes to the improvement of economic and financial statistics at the global level, notably via its participation in the Inter-Agency Group on Economic and Financial Statistics (IAG) and the Statistical Data and Metadata eXchange (SDMX), together with the BIS, Eurostat, the IMF, the OECD, the United Nations and the World Bank. The IAG coordinates and monitors the statistical initiatives supported by the finance ministers and central bank governors of the G20 to close global information gaps. The ECB continued to contribute to the Principal Global Indicators website, which presents quarterly main economic and financial indicators for countries that are members of the G20 and the Financial Stability Board. Moreover, in October 2013 the aggregate Consumer Price Index of the G20 economies was published for the first time by the ECB, Eurostat, the IMF and the OECD. It followed the first publication of the quarterly G20 GDP aggregate in spring 2012. To ensure the timely implementation of the statistical initiatives, the ECB advocates an enhanced institutional framework for the statistical work at the G20 level. The ECB also continued to contribute to the work of the Financial Stability Board Data Gaps Initiative on a common data template for systemically important global financial institutions. Together with the United Nations, the ECB published the “Handbook of National Accounting – Financial Production, Flows and Stocks in the System of National Accounts”, explaining how the activity of banks, other financial intermediaries, insurance corporations and pension funds is reflected in financial statistics. Moreover, the ECB continued to chair the Committee for the Coordination of Statistical Activities, which currently comprises 39 international organisations with a statistical mandate.

In order to maintain the public’s confidence in the statistics produced by the ESCB, upon which policy decisions are based, it is important for the ESCB to demonstrate that it adheres to the highest quality standards, and that the statistics are easily accessible. For this reason, in May 2013 the Governing Council approved the annual assessment of the availability and quality of the various statistics that are compiled by the Eurosystem on the basis of ECB legal acts. It also authorised the publication of the 2012 quality report on monetary and financial statistics,²³ produced in accordance with the ECB’s Statistics Quality Framework.

5 ECONOMIC RESEARCH

Consistent with the approach adopted throughout the Eurosystem, the purpose of research activities at the ECB is: (i) to provide research results relevant for monetary policy and other Eurosystem tasks, (ii) to maintain and use econometric models in order to construct economic forecasts and projections and compare the impact of alternative policy choices, and (iii) to communicate with the academic and central bank research community, for example through the publication of research results in peer-reviewed scientific journals and by participating in and organising research conferences. The following two sections analyse the main research areas and activities in 2013.

²³ Available on the ECB’s website.

5.1 RESEARCH ACTIVITIES AND ACHIEVEMENTS

Economic research at the ECB is performed in a decentralised manner by several business areas according to their needs and expertise. The Directorate General Research (DG/R) is charged with producing high-quality economic research, mainly in the areas of macroeconomics and financial economics. In order to maximise synergies among economists working in different fields and to enhance the contribution of research to policy work, DG/R economists are allocated to 11 thematic teams working on the following topics: (1) modelling and analysis of countries; (2) area-wide modelling and analysis; (3) forecasting and business cycle analysis; (4) international macroeconomics and finance; (5) micro-foundations and the transmission mechanism of monetary policy; (6) monetary policy strategy and fiscal policy; (7) monetary policy implementation; (8) monetary analysis; (9) macro-financial linkages and systemic risk policy; (10) financial stability indicators and asset pricing; and (11) financial institutions and structure.

DG/R is also responsible for coordinating the research work conducted across the ECB. Its Director General chairs the Research Coordination Committee (RCC), which aligns research activities at the ECB with the requirements of the institution and the needs of its policy processes.

In 2013 research work coordinated by the RCC was grouped into four broad areas: (i) the changing economic and financial structure and output growth; (ii) monetary policy transmission, including the changing operational framework and implementation; (iii) interaction between monetary and fiscal policies and financial stability amid a changing EU institutional framework; and (iv) forecasting, scenario analysis and country surveillance tools.

In the context of the first research area, special emphasis was given to price determination and growth enhancement drivers. This work benefited from new micro datasets that were either acquired from commercial providers or developed by two research networks, CompNet (which addresses issues related to competitiveness) and the Household Finance and Consumption Network. A further important area of work was the analysis of interlinkages between macro, fiscal and financial developments, particularly in the context of the segmentation of financial markets.

In the second area, several studies were conducted on the impact of standard and non-standard monetary policy measures, forward guidance and communication. Another set of studies dealt with real-financial linkages, transmission mechanisms, market segmentation, the role of the banking sector and monetary policy implementation.

The third area covers a number of distinct lines of research. Macro-prudential analyses and tools continued to be developed in the context of the Macro-prudential Research Network. In particular, considerable progress was made in developing theoretical and empirical tools which integrate financial instability into models of the aggregate economy. Other projects studied government bond yields and/or risk premia in the context of the euro area sovereign debt crisis, as well as the development of composite indicators of systemic stress. A number of research projects used new data from the TARGET2 system to study the euro area interbank market. Following the first wave of the Household Finance and Consumption Survey, a complete dataset (comprising 62,000 households in 15 countries) was made available for Eurosystem users and external researchers. Early results from the empirical analysis of these data were discussed at a conference held in Frankfurt in October 2013. Finally, against the background of ongoing changes in Europe, increased attention was devoted to institutional aspects of EU/euro area governance.

Fourth, in the area of forecasting, scenario analysis and country surveillance, the focus was on refining existing tools and extending their coverage to smaller euro area countries. Close attention was paid to enhancing the instruments that complement the forecasting process (supporting the analysis of, for example, the role of uncertainty and confidence), as well as the modelling of cross-country imbalances, spillovers and adjustment.

5.2 DISSEMINATION OF RESEARCH: PUBLICATIONS AND CONFERENCES

As in previous years, ECB staff research was published in the ECB's Working Paper Series and Occasional Paper Series. 123 Working Papers and 13 Occasional Papers were published in 2013. A total of 93 Working Papers were written or co-written by ECB staff, a large number together with other Eurosystem economists, with the remainder being written by external visitors attending conferences and workshops, participating in research networks or spending a prolonged period at the ECB for the completion of a research project.²⁴ As is now the established norm, most of the papers are eventually expected to be published in leading peer-reviewed academic journals. In 2013 ECB staff published 56 articles in academic journals.

Another regular ECB publication is the Research Bulletin,²⁵ which is used to disseminate research work of general interest to a wide audience. In 2013 two issues of the Research Bulletin were published. Articles covered a variety of topics, such as "Introducing systemic financial instability into macroeconomics: how to meet the challenge?", "Macroeconomic effects of large-scale asset purchase programs", "Wealth heterogeneity and the response of consumption to shocks" and "Heterogeneous transmission mechanism and the credit channel in the euro area".

The ECB organised or co-organised 29 conferences and workshops on research topics in 2013. Co-organised conferences involved central banks, both within and outside the Eurosystem. As in previous years, most of the conferences and workshops were related to specific research activities, as outlined above. The programmes for these events and the papers presented are available on the ECB's website.

Another long-standing mechanism for fostering interaction between the ECB and the broader community of economic researchers is the organisation of seminar series. Two are of particular relevance: the Joint Lunchtime Seminars, co-organised with the Deutsche Bundesbank and the Center for Financial Studies, and the Invited Speaker Seminars. These two series comprise weekly seminars at which external researchers are invited to present their recent work at the ECB. The ECB also organises research seminars outside the scope of these two series on a more ad hoc basis.

6 OTHER TASKS AND ACTIVITIES

6.1 COMPLIANCE WITH THE PROHIBITION OF MONETARY FINANCING AND PRIVILEGED ACCESS

Pursuant to Article 271(d) of the Treaty, the ECB is entrusted with the task of monitoring the compliance of the EU NCBs and the ECB with the prohibitions implied by Articles 123 and 124 of

²⁴ External researchers visit the ECB on an ad hoc basis or in the context of formal programmes such as the Wim Duisenberg Research Fellowship.

²⁵ All Research Bulletins can be found on the ECB's website under "Publications".

the Treaty and Council Regulations (EC) Nos 3603/93 and 3604/93. Article 123 prohibits the ECB and the NCBs from providing overdraft facilities or any other type of credit facility to governments and EU institutions or bodies, as well as from purchasing debt instruments directly from them. Article 124 prohibits any measure, not based on prudential considerations, which establishes privileged access by governments and EU institutions or bodies to financial institutions. In parallel with the Governing Council, the European Commission monitors Member States' compliance with the above provisions.

The ECB also monitors the EU central banks' secondary market purchases of debt instruments issued by the domestic public sector, the public sector of other Member States and EU institutions and bodies. According to the recitals of Council Regulation (EC) No 3603/93, the acquisition of public sector debt instruments in the secondary market must not be used to circumvent the objective of Article 123 of the Treaty. Such purchases should not become a form of indirect monetary financing of the public sector.

The monitoring exercise conducted for 2013 confirmed that the provisions of Articles 123 and 124 of the Treaty and the related Council Regulations were in general respected.

The liquidation of the Irish Bank Resolution Corporation (IBRC) raises serious monetary financing concerns. These concerns could be somewhat mitigated by the disposal strategy of the Central Bank of Ireland.

6.2 ADVISORY FUNCTIONS

Articles 127(4) and 282(5) of the Treaty require that the ECB be consulted on any proposed EU or draft national legislation falling within its fields of competence.²⁶ All ECB opinions are published on the ECB's website. ECB opinions on proposed EU legislation are also published in the Official Journal of the European Union.

In 2013 the ECB adopted 9 opinions on proposed EU legislation and 85 on draft national legislation falling within the ECB's fields of competence. A list of the opinions adopted in 2013 and early 2014 is annexed to this Annual Report (see Annex 1).

OPINIONS ON PROPOSED EU LEGISLATION

The ECB opinions issued at the request of the European Parliament, the EU Council and the European Commission concerned, among other things, the establishment of a Single Resolution Mechanism (SRM);²⁷ the facility for providing financial assistance for non-euro area EU Member States; the new regulatory regime for indices used as benchmarks in financial instruments and financial contracts; and the revision of the Payment Services Directive.

In an opinion on the establishment of a facility for providing assistance for Member States whose currency is not the euro,²⁸ the ECB welcomed the efforts to try to make, insofar as is possible, identical instruments available to both euro area and non-euro area countries, and the efforts to synchronise the procedures for granting such assistance. The ECB considered that granting

²⁶ The United Kingdom is exempt from the consultation obligation, pursuant to the Protocol on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland, which is annexed to the Treaty, OJ C 83, 30.3.2010, p. 284.

²⁷ CON/2013/76. This opinion is discussed in detail in Section 1.2 of Chapter 4.

²⁸ CON/2013/2.

credit lines for assistance to non-euro area countries whose economic and financial situation is fundamentally sound was compatible with the Treaty. At the same time, the ECB considered a close interpretation of the eligibility criteria when assessing access to the credit lines, and strict compliance with them over time, to be important. Regarding its own role in the administration of financial assistance, the ECB reiterated the fact that the accounts to be used for the management of this financial assistance at the NCBs and at the ECB would not provide for the possibility of an overdraft. Finally, the ECB noted that its role in the proposed regulation to cooperate with the European Commission regarding, among other things, the assessment of the sustainability of general government debt and current or potential financial needs, the preparation of macroeconomic adjustment programmes and the monitoring of their progress via regular missions would have to be organised within its mandate and with respect for its independence.

The ECB opinion on a proposal for a regulation on indices used as benchmarks in financial instruments and financial contracts²⁹ considered the regulatory measures to be justified and proportionate to the deficiencies that had been identified in the benchmark-setting process. The opinion supported the proposal's objectives to establish a common set of rules and regulations at the EU level for the benchmark-setting process for financial instruments and financial contracts in the interests of the integrity and reliability of financial benchmarks, the benchmark-setting process and the wider concern of protecting investors and consumers. As regards the reform of critical interest rate benchmarks, the ECB supported the move towards transaction-based benchmarks and the inclusion of rules on mandatory contribution. The opinion suggested that the new regulatory requirements should not inadvertently dissuade new benchmark contributors, nor discourage too strongly current contributors, especially during the period of transition to possible new reference rates. The ECB noted that the thresholds for mandatory contribution may need to be reviewed to deal with cases of gradual defections by panel banks. Generally, however, the ECB supported the attempts to facilitate market choice in a changing financial system as it would enable users to choose reference rates which better match their needs.

The ECB opinion on the proposed revision of the Payment Services Directive³⁰ expressed strong support for the objectives and the general content of the proposed directive and in particular for the expansion of the list of payment services to include payment initiation services. The ECB welcomed the harmonisation and enhancement of operational and security requirements for payment service providers, as well as the strengthening of the enforcement powers of the competent authorities. The ECB supported the limitation of Member States' discretion in certain areas such as payment service provider and payer liability, which had led to considerable divergence in the application of the rules across the EU and consequently to the fragmentation of retail payment markets. In addition, the ECB made a number of comments relating to topics such as definitions, the scope of application, consumer protection and operational security.

OPINIONS ON DRAFT NATIONAL LEGISLATION

There were a significant number of consultations by national authorities, many of which concerned measures relating to financial market stability.³¹

Several Member States consulted the ECB on measures for strengthening bank stability and on bank reorganisation and recapitalisation measures.³² In two opinions on measures to strengthen

²⁹ CON/2014/2.

³⁰ CON/2014/9.

³¹ For example, CON/2013/3, CON/2013/10, CON/2013/21, CON/2013/25, CON/2013/26, CON/2013/28, CON/2013/33, CON/2013/52, CON/2013/62, CON/2013/67 and CON/2013/73.

³² CON/2013/17, CON/2013/21, CON/2013/67, CON/2013/73, CON/2013/86 and CON/2013/87.

bank stability in Slovenia,³³ the ECB welcomed the efforts of the authorities to foster the Slovenian banking sector and noted that the envisaged measures should best be embedded in a comprehensive financial sector strategy. In this context, the ECB recommended conducting an independent system-wide asset quality review and a fresh stress test using appropriately severe assumptions.³⁴ With respect to the transfer of impaired assets to the Bank Asset Management Company (BAMC), primarily in exchange for bonds issued by the BAMC and guaranteed by the state, the ECB advocated implementing cash protocol arrangements³⁵ to ensure the timely repayment of such bonds. In a subsequent opinion on bank reorganisation, the ECB welcomed the strengthening of the tools and procedures available to Banka Slovenije for the effective reorganisation of distressed banks. However, the ECB also reminded the authorities of the need to ensure: (i) the ability of Banka Slovenije to perform its ESCB-related tasks; (ii) the appropriate separation of its tasks; (iii) the later review of the law in the light of the future directive establishing a framework for the recovery and resolution of credit institutions and investment firms³⁶ (BRRD), and the development of the SSM; and, where applicable, (iv) compliance of the measures with EU state aid rules.³⁷

In the context of the recapitalisation of credit institutions in Greece, the ECB supported the reinstatement of existing shareholders' pre-emption rights, enabling the efficient and effective participation of private investors in the recapitalisation of Greek banks.³⁸ In another opinion,³⁹ the ECB welcomed the draft provisions clarifying the ECB's observer status within the Hellenic Financial Stability Fund (HFSF), but at the same time considered that the competences and responsibilities of the HFSF's governing bodies should be clarified further to make the decision-making process more effective.

The ECB adopted opinions on bank reorganisation measures in Spain,⁴⁰ including one on the creation of the Asset Management Company for Assets Resulting from Bank Restructuring (SAREB),⁴¹ in relation to which an external Monitoring Commission was set up, in which the ECB assumed an observer role. The ECB was also consulted on a new role for the Spanish Deposit Guarantee Fund related to the purchase of shares not listed on an official market and issued by credit institutions in the context of the burden-sharing exercises.⁴² Furthermore, the ECB was consulted on several draft laws, specific to the Spanish jurisdiction, related, among other things, to improving the functioning of the mortgage market by reinforcing the independence of valuation agencies,⁴³ and to the reform of savings banks.⁴⁴

A number of Member States consulted the ECB on measures related to crisis planning, early intervention, and the recovery and resolution of credit and other institutions.⁴⁵ In these cases the draft laws were adopted ahead of the related EU acts. Although the ECB welcomed the introduction of a comprehensive bank resolution framework, it recommended that the relevant laws be reviewed in the light of the future BRRD and the development of the SSM.⁴⁶ The ECB noted that recovery

33 CON/2013/21 and CON/2013/67.

34 CON/2013/21.

35 The ECB provided more detailed guidance on the content of such cash protocol arrangements in CON/2013/86.

36 See the proposal for a directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms, COM (2012) 280 final.

37 CON/2013/73.

38 CON/2013/17.

39 CON/2013/38.

40 CON/2013/3, CON/2013/25, CON/2013/33 and CON/2013/52; see also CON/2012/108.

41 CON/2012/108.

42 CON/2013/25.

43 CON/2013/33.

44 CON/2013/52.

45 CON/2013/3, CON/2013/10, CON/2013/26 and CON/2013/28.

46 CON/2013/3, CON/2013/26 and CON/2013/28.

and resolution plans were a key element of preparation for possible crisis scenarios and for taking swift and effective remedial action, and that it was possible to extend the requirement to draw up such plans to all credit institutions, and not only to the “potentially systemic” ones.⁴⁷ In the context of the restructuring of systemic institutions, the ECB considered that restructuring a non-viable entity as a going concern (i.e. an “open bank scenario”) instead of resolving it as a gone concern (i.e. a “closed bank scenario”) should only be considered under exceptional circumstances, where the orderly resolution of a credit institution would have seriously damaging effects on the stability of the financial system, with a heightened risk of contagion across borders.⁴⁸ As regards the framework for the liquidation of credit institutions in Greece, the ECB welcomed the draft provisions increasing the protection of the value of assets in liquidation and, ultimately, of creditors’ interests, but raised concerns about the interaction with the special liquidation framework, possible conflicts of interest, the need to provide more guidance to liquidators, the control exercised over them and the safeguarding of central bank independence.⁴⁹

The ECB adopted opinions on draft legislation on public finances in Luxembourg and Estonia.⁵⁰ In this context, the ECB acknowledged that an NCB commonly monitors various types of information in order to properly assess current and prospective developments that are relevant for monetary policy. However, an NCB’s role should not go beyond monitoring activities that result from or are linked – directly or indirectly – to the discharge of its monetary policy mandate. If an NCB takes up the monitoring activities set out in Article 5 of Regulation (EU) No 473/2013 and Article 4 of Directive 2011/85/EU, the monetary policy mandate and the independence of the NCB risk being undermined. More generally, a formal mandate for an NCB to assess forecasts and fiscal developments implies a function for the NCB in the fiscal policy-making process. The ECB noted that, if an NCB were to be thus entrusted with a share of the responsibility for fiscal policy, the institutional separation between fiscal and monetary policy would become blurred.

The ECB considered several draft laws aimed at implementing Recommendation ESRB/2011/3 of the European Systemic Risk Board of 22 December 2011 on the macro-prudential mandate of national authorities.⁵¹ In this regard, it was recalled that the ECB and the NCBs should play a leading role in macro-prudential oversight, given their expertise and existing responsibilities in the area of financial stability. At the same time, the performance of macro-prudential tasks by an NCB should not affect: (i) the NCB’s institutional, functional and financial independence; or (ii) the ESCB’s performance of its tasks under the Treaty and the Statute of the ESCB.⁵²

In an opinion related to deposit-taking by the Hungarian Treasury, the ECB stated that deposit-taking placed the Treasury in direct competition with banks, and its deposit services to households should therefore be ring-fenced from the rest of its functions. Furthermore, the Treasury should therefore be subject to the same regulatory, supervisory and tax burden as commercial banks in order to avoid the Treasury having an advantage over commercial banks in attracting deposits.⁵³ In two opinions on the integrated Hungarian supervisory framework,⁵⁴ the ECB welcomed the integration of the supervisory authority into the Magyar Nemzeti Bank, but at the same time expressed serious concerns about the execution and timing of the integration. The opinions furthermore raised serious concerns as regards central bank independence and the prohibition of monetary financing as a result

47 CON/2013/28.

48 CON/2013/3, with reference also to CON/2012/99.

49 CON/2013/57.

50 CON/2013/90 and CON/2013/91, with reference also to CON/2012/105 regarding similar legislation in Lithuania.

51 OJ C 41, 14.2.2012, p. 1.

52 CON/2013/30, CON/2013/45, CON/2013/54, CON/2013/66, CON/2013/69, CON/2013/70 and CON/2013/82.

53 CON/2013/12.

54 CON/2013/56 and CON/2013/71.

of the Magyar Nemzeti Bank being obliged to hire all staff of the supervisory authority and being held liable for all obligations of the integrated supervisory authority.

The ECB underlined the importance of compliance with the monetary financing prohibition in an opinion⁵⁵ on the Statute of the Bank of Greece, which expressly enables the latter to transfer to the Greek state its income accruing from its Securities Markets Programme portfolio. Furthermore, the ECB reiterated the criteria which need to be satisfied to comply with the monetary financing prohibition where a state guarantee is used as collateral accepted by Narodowy Bank Polski for liquidity granted to individual credit unions.⁵⁶

Several Member States consulted the ECB on limitations on cash payments,⁵⁷ in the context of which the ECB stressed that such limitations, if established for public reasons, are not incompatible with the status of legal tender of euro banknotes and coins, provided that other lawful means for the settlement of monetary debts are available.⁵⁸ They should, however, be proportionate to the objectives pursued, such as preventing money laundering and the financing of terrorism,⁵⁹ and should not go beyond what is necessary to achieve these objectives, especially in view of the fact that the restrictive measures may also affect relatively low-value payments.⁶⁰

In an opinion on means of payment and payment systems in France,⁶¹ the ECB emphasised the general principle that the tasks assigned to the Eurosystem by the Treaty and the Statute of the ESCB have to be fulfilled exclusively by the ECB and the NCBs. The ECB furthermore elaborated that third parties may be entrusted by an NCB with the conduct of activities that offer limited room for discretion, provided that the activities are of an ancillary and preparatory nature, that the assessment of any discretionary elements remains with the commissioning NCB, and that certain additional conditions are fulfilled.

CASES OF NON-COMPLIANCE

In 2013 the ECB recorded 21 cases of non-compliance with the obligation to consult on draft national legislation.⁶² The following 14 cases were considered clear and important.⁶³

The Austrian authorities failed to consult the ECB on draft amendments establishing a new macro-prudential body and assigning new tasks to the Oesterreichische Nationalbank in connection with the preservation of financial stability and the reduction of systemic threats and pro-cyclical risks. The institutional set-up of macro-prudential oversight and the respective responsibilities of national authorities in an EU Member State are considered to be of general significance to the whole ESCB owing to their importance for the stability of the financial system.

55 CON/2013/15.

56 CON/2013/5.

57 CON/2013/9, CON/2013/11 and CON/2013/18.

58 In compliance with EU law, and in particular with recital 19 of Council Regulation (EC) No 974/98 of 3 May 1998 on the introduction of the euro (OJ L 139, 11.5.1998, p. 1).

59 CON/2013/9.

60 CON/2013/11.

61 CON/2013/84.

62 These include (i) cases where a national authority failed to submit draft legislative provisions within the ECB's field of competence for consultation to the ECB; and (ii) cases where a national authority formally consulted the ECB, but did not afford it sufficient time to examine the draft legislative provisions and to adopt its opinion prior to adoption of these provisions.

63 The ECB understands "clear" to mean cases where there is no legal doubt that the ECB should have been consulted, and "important" to mean cases: (i) where, if consultation had properly taken place, the ECB would have made significant critical comments on the substance of the legislative proposal, and/or (ii) which are of general significance to the ESCB.

The ECB was not consulted by the Cypriot authorities on amendments to the Resolution Law. The aim of the amendments was to replace the Central Bank of Cyprus as the single institution resolution authority with a three-member resolution authority, comprising the Minister of Finance, the Chairperson of the Cyprus Securities and Exchange Commission and the Central Bank of Cyprus. Draft amendments to the Restructuring of Financial Institutions Law, which aimed to lay down a two-pronged process for the conversion into equity of subordinated debt issued by credit institutions, were submitted to the ECB for consultation, but the draft was voted into law the following day. Both cases are considered important, because the ECB would have made significant critical comments, had it been consulted, and because the cases are of general significance to the ESCB.

There were two clear and important cases of non-compliance with the consultation obligation in relation to Greece. They concerned amendments aimed at strengthening the governance structure and independence of the Hellenic Financial Stability Fund and legislation on the special liquidation of credit institutions. Although the Greek Ministry of Finance submitted respective draft laws to the ECB for consultation, these were enacted shortly afterwards and, in any case, prior to the adoption of the related ECB opinions.⁶⁴ Both cases qualify as important, since they are of general significance to the ESCB owing to their importance for the stability of the financial system.

Although the ECB was formally consulted on amendments tabled in the parliamentary procedure for the draft new law on the Magyar Nemzeti Bank,⁶⁵ the legislation was adopted, including the amendments in question, very shortly afterwards. The ECB therefore discontinued the consultation procedure and did not issue an opinion. Likewise, the ECB received for consultation a draft law amending several legal acts in the area of financial regulation in connection with Law CXXXIX on the Magyar Nemzeti Bank facilitating the integration of the Hungarian Financial Supervisory Authority (HFSA) into the central bank, as well as later draft amendments. This request was followed by another one, namely for an opinion on a new draft decree amending several government decrees in connection with the integration of the HFSA into the Magyar Nemzeti Bank. Given that the request was also directly connected to the new integrated supervisory structure in Hungary, the ECB decided to issue a joint opinion on both consultation requests. The draft law, including draft amendments, as well as the draft decree were adopted prior to the adoption by the ECB of its opinion on the matter.⁶⁶ Both of the non-compliance cases mentioned are of general significance to the ESCB because they refer to central bank independence and because the ECB made significant critical comments in its opinions in this regard. In addition, the Hungarian authorities failed to consult the ECB on legislation defining the rules applicable to a new integrated system of cooperative credit institutions and on further easing the burden of foreign exchange mortgage holders, which are considered to be of general significance for the ESCB, given that they are important for the stability of the financial system.

The ECB was not consulted by the Irish authorities on a law for the purpose of allowing the immediate liquidation of the Irish Bank Resolution Corporation and safeguarding the position of the Central Bank of Ireland. It is understood that the reason for this was the urgent nature of the situation and, in particular, the need to enact the legislation before the disclosure of its content to prevent its aims being frustrated. The case is considered to be of general significance to the whole ESCB.

⁶⁴ See CON/2013/38 and CON/2013/57.

⁶⁵ The ECB adopted Opinion CON/2013/56 on the original draft of the new law on the Magyar Nemzeti Bank in July 2013. The amendments to this original draft were substantive in terms of their number and scope, affecting the essence of the legislation beyond an accommodation of the observations made in Opinion CON/2013/56.

⁶⁶ CON/2013/71.

The ECB was consulted by the Italian Ministry of Economy and Finance on a draft decree-law providing for a capital increase of the Banca d'Italia and laying down principles for amendments to the Statute of the Banca d'Italia. Since the draft decree-law was adopted only a few working days later, the national authority did not afford the ECB sufficient time to adopt its opinion.⁶⁷ The changes to the capital structure of the Banca d'Italia are of general significance to the ESCB.

The Luxembourg authorities failed to consult the ECB on a law on covered bonds amending the law on the financial sector. This law has introduced a new category of covered bonds which may be issued by credit institutions entitled to issue covered bonds and which are secured by loans granted to credit institutions taking part in a “system of institutional guarantee”. The case is considered to be of general significance to the ESCB because a new consultative role is assigned to the Banque centrale du Luxembourg in the context of the system of institutional guarantee. Moreover, the law gave rise to possible confusion with regard to the allocation of minimum reserves to specific sections of credit institutions issuing covered bonds, and also raised issues with regard to access to central bank funding through monetary policy operations or emergency liquidity assistance in the event of a stay of payment or liquidation of an institution issuing such covered bonds.

The ECB was formally consulted by the Slovenian authorities on a draft regulation on the implementation of measures to strengthen bank stability and on draft amendments to the adopted regulation. However, in both cases, the consultation request was sent to the ECB late in the legislative procedure, i.e. the draft regulation and subsequent draft amendments were adopted prior to the adoption by the ECB of the respective opinions.⁶⁸ The cases are considered important from a financial stability point of view and because they are of general significance to the ESCB.

In addition, the failures to consult the ECB by Greece, Hungary, Italy and Slovenia in 2013 were considered to be clear and repetitive cases.⁶⁹

6.3 ADMINISTRATION OF BORROWING AND LENDING OPERATIONS

In line with earlier requests, the ECB continued to administer and/or process several borrowing and lending operations in 2013.⁷⁰

The ECB is responsible for the administration of the borrowing and lending operations of the EU under the medium-term financial assistance facility, as set out in Decision ECB/2003/14 of 7 November 2003.⁷¹ Interest payments on 11 loans were processed by the ECB. The total amount of outstanding EU lending operations under this facility as at 31 December 2013 was €11.4 billion, the same amount as at 31 December 2012.

67 CON/2013/96.

68 CON/2013/21 and CON/2013/67.

69 Repetitive cases are those where the same Member State fails to consult the ECB at least three times in two consecutive years, with at least one case of non-compliance in each year under consideration.

70 In this context, it is important to recall that when acting as a fiscal agent for the EU's medium-term financial assistance facility, the European Financial Stabilisation Mechanism, the European Financial Stability Facility and the European Stability Mechanism (pursuant to Article 21.2 of the Statute of the ESCB), the ECB fully complies with the monetary financing prohibition under Article 123 of the Treaty. See Section 2.2.5 of *Convergence Report*, ECB, May 2010, p. 24 and point 9 of the ECB's opinion of 17 March 2011 on a draft European Council decision amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro (OJ C 140, 11.5.2011, p. 8).

71 In accordance with Article 141(2) of the Treaty, Articles 17, 21.2, 43.1 and 46.1 of the Statute of the ESCB and Article 9 of Council Regulation (EC) No 332/2002 of 18 February 2002.

The ECB is responsible for processing, on behalf of the lenders and the borrower, all payments related to the loan facility agreement for Greece.⁷² The original six loans were consolidated into a single loan in 2012, and in 2013 the ECB processed interest payments on that loan. The balance outstanding as at 31 December 2013 in respect of the pooled bilateral loans for the benefit of Greece was €52.9 billion, the same amount as at 31 December 2012.

The ECB is responsible for the administration of the borrowing and lending operations of the EU under the European Financial Stabilisation Mechanism (EFSM).⁷³ Interest payments on 18 loans were processed by the ECB in 2013. The total amount of outstanding EU lending operations under the EFSM as at 31 December 2013 was €43.8 billion, the same amount as at 31 December 2012.

The ECB is responsible for the administration of European Financial Stability Facility (EFSF) loans to Member States whose currency is the euro.⁷⁴ In 2013 the ECB processed 15 disbursement payments on behalf of the EFSF and transferred these amounts to the borrower countries (Ireland, Portugal and Greece). Interest and fee payments on 17 loans were processed by the ECB.

The ECB is responsible for the administration of European Stability Mechanism (ESM) loans to Member States whose currency is the euro.⁷⁵ In 2013 the ECB processed three disbursement payments on behalf of the ESM and transferred these amounts to the borrower country (Cyprus).

6.4 EUROSISTEM RESERVE MANAGEMENT SERVICES

In 2013 a comprehensive set of services continued to be offered within the framework established in 2005 for the management of Eurosystem customers' euro-denominated reserve assets. The complete set of services – which is available to central banks, monetary authorities and government agencies located outside the euro area, as well as to international organisations – is offered under harmonised terms and conditions in line with general market standards by individual Eurosystem central banks (the Eurosystem service providers). The ECB performs an overall coordinating role, ensuring the smooth functioning of the framework. The number of customers maintaining a business relationship with the Eurosystem increased slightly, from 299 in 2012 to 300 in 2013. With regard to the services themselves, in the course of 2013 there was a substantial decrease (-32%) in customers' total cash balances (including deposits), whereas securities holdings increased considerably (+9%).

In 2013 the ECB completed the work started in 2012 to examine possible ways of further improving the general operational efficiency and the range of services offered to customers of the Eurosystem Reserve Management Services. The changes came into effect on 1 July 2013 and offer customers, among other things, greater flexibility in managing overnight cash balances.

72 In the context of the loan facility agreement between the Member States whose currency is the euro (other than Greece and Germany) and Kreditanstalt für Wiederaufbau (acting in the public interest, subject to the instructions of and with the benefit of the guarantee of the Federal Republic of Germany) as lenders and the Hellenic Republic as borrower and the Bank of Greece as agent to the borrower, and pursuant to Articles 17 and 21.2 of the Statute of the ESCB and Article 2 of Decision ECB/2010/4 of 10 May 2010.

73 In accordance with Articles 122(2) and 132(1) of the Treaty, Articles 17 and 21 of the Statute of the ESCB, and Article 8 of Council Regulation (EU) No 407/2010 of 11 May 2010.

74 In accordance with Articles 17 and 21 of the Statute of the ESCB (in conjunction with Article 3(5) of the EFSF Framework Agreement).

75 In accordance with Articles 17 and 21 of the Statute of the ESCB (in conjunction with Article 5.12.1 of the ESM General Terms for Financial Assistance Facility Agreements).



Alongside the fitting of the facade panels, further headway was made on the installation of the technical infrastructure and fit-out for the offices and the interchange platforms in the atrium. In order to carry out the works on the four interchange platforms, the entire atrium was temporarily filled with internal scaffolding.

CHAPTER 3

ENTRY OF LATVIA INTO THE EURO AREA

I ECONOMIC AND MONETARY DEVELOPMENTS IN LATVIA

On 9 July 2013 the EU Council adopted a decision allowing Latvia to adopt the euro as its currency from 1 January 2014, increasing the number of euro area countries from 17 to 18. The Council's decision was based on the convergence reports published by the ECB and the European Commission in June 2013, and followed discussions by the European Council, an opinion of the European Parliament, a proposal from the European Commission and a recommendation by the Eurogroup. On the same day the Council also adopted a regulation fixing the irrevocable conversion rate between the Latvian lats and the euro. This conversion rate was set at LVL 0.702804 to the euro, which was equal to the central rate of the Latvian lats throughout Latvia's membership of the exchange rate mechanism II (ERM II).

Over the last 15 years the process of convergence towards a market economy and better living standards in Latvia has been accompanied by large swings in economic activity. In the early 2000s Latvia was one of Europe's fastest-growing economies, alongside Estonia and Lithuania. The accession to the EU in 2004 provided further stimulus to growth, thanks to enhanced trade and financial integration with the EU. A rapid sectoral transformation towards a more services-oriented economy took place. By 2006 and 2007 real GDP was growing at an annual rate of 10%, unit labour costs were increasing at almost twice that speed and the current account deficit had reached 20% of GDP (see Table 14).

The financial crisis that hit the world in 2008 intensified the adjustment of the Latvian economy after the overheating in previous years. Following the rescue of a private bank, Latvia requested financial assistance from the EU and the IMF in the autumn of 2008. Over the subsequent two years Latvia's output shrank by 20%, the unemployment rate rose to around 20%, and the current account deficit turned into a surplus owing mainly to the collapse in domestic demand.

A frontloaded and credible fiscal consolidation strategy, as well as structural reforms, laid the ground for a sustainable recovery. Devaluation fears in the markets receded and the country managed to stick to its fixed exchange rate against the euro. Economic growth turned positive, on a quarterly basis, towards the end of 2009. Significant downward adjustment in wages helped Latvia regain competitiveness and exports rebounded in the middle of 2009. Benefiting from strengthening world demand after the global recession, Latvia's share of world exports has been increasing since 2011. As a result, the trade deficit stood at 2.2% of GDP in the year up to the third quarter of 2013.

The EU-IMF financial assistance programme was successfully completed in January 2012. The loan from the IMF was fully repaid by the end of 2012, ahead of schedule. By the third quarter of 2013 Latvia had recovered almost half of the real GDP lost during the crisis.

Inflation developments in Latvia over the past decade have been very volatile. Following a downward trend between the mid-1990s and 2003, HICP inflation picked up noticeably in 2004, fluctuated between 6% and 7% until 2006, and peaked at 17.5% in the second quarter of 2008, reflecting demand pressures, the harmonisation of the indirect tax legislation with the rest of the EU, as well as increases in administered prices and global commodity prices. As the economy

Table I4 Main economic indicators for Latvia

(annual percentage changes, unless otherwise indicated; period averages, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Real GDP growth	2.9	5.7	7.3	7.1	7.7	8.8	10.1	11.0	10.0	-2.8	-17.7	-1.3	5.3	5.2	4.7 ¹⁾
<i>Contribution to real GDP growth (in percentage points)</i>															
Domestic demand (excluding inventories)	2.8	5.9	8.4	8.9	7.8	12.2	14.3	18.9	13.6	-7.7	-27.0	2.3	4.8	5.8	..
Net exports	0.1	3.3	-3.8	-0.2	-4.5	-5.3	0.4	-8.9	-6.4	7.4	12.3	-7.9	1.1	-0.2	..
HICP inflation	2.1	2.6	2.5	2.0	2.9	6.2	6.9	6.6	10.1	15.3	3.3	-1.2	4.2	2.3	0.0
Compensation per employee	..	..	4.3	2.8	11.0	14.5	25.1	23.2	35.1	15.7	-12.7	3.2	5.0	7.3	..
Nominal unit labour costs	..	..	-1.6	-1.2	5.2	6.5	15.4	16.5	27.2	20.1	-7.9	-9.9	1.2	3.5	..
GDP deflator	2.2	4.3	2.0	3.1	3.8	7.0	10.2	11.4	20.3	12.4	-1.3	-0.9	6.0	3.3	..
Import deflator	-4.2	6.0	0.9	4.4	6.2	8.5	11.3	9.9	6.8	10.4	-4.9	5.8	5.7	7.2	..
Unemployment rate (percentage of labour force)	14.1	14.3	13.5	12.5	11.6	11.7	10.0	7.0	6.1	7.7	17.5	19.5	16.2	15.0	..
Total employment ²⁾	1.2	2.9	1.9	1.2	1.6	4.9	3.6	-5.6	-14.3	-6.7	1.5	1.4	..
Current and capital account balance (percentage of GDP)	-8.7	-4.3	-7.2	-6.5	-7.6	-11.8	-11.2	-21.3	-20.4	-11.7	11.1	4.9	0.0	0.5	..
General government balance (percentage of GDP) ³⁾	-3.8	-2.8	-2.0	-2.3	-1.6	-1.0	-0.4	-0.5	-0.4	-4.2	-9.8	-8.1	-3.6	-1.3	-1.4
Public debt (percentage of GDP) ²⁾	12.4	12.4	14.1	13.6	14.7	15.0	12.5	10.7	9.0	19.8	36.9	44.4	41.9	40.6	42.5
Nominal three-month money market rate (percentage)	8.5	5.4	6.9	4.4	3.8	4.2	3.1	4.4	8.7	8.0	13.1	2.0	1.0	0.9	0.4
Nominal exchange rate against the euro ³⁾	0.6	0.6	0.6	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7

Sources: ECB, Eurostat and European Commission.

1) Flash estimate.

2) Value for 2013 refers to the European Commission's autumn 2013 forecast.

3) Latvian lats per euro.

entered a recession, inflation slowed significantly, partly affected by the downward adjustment of wages. With world food and energy prices rising and indirect taxes increasing (as one of the consolidation measures), inflation started to rise again towards the end of 2010. Over the last two years inflation developments have been more benign, however, partly reflecting the fading impact of past increases in global commodity prices, slower increases in administered prices and cuts in indirect tax rates. Owing to stable wage growth and an improvement in productivity, domestic cost pressures have also remained low.

Owing to a quite flexible labour market, the unemployment rate has declined markedly from the high levels reached during the crisis. Compared with the peak of 20.8% in the first quarter of 2010, the unemployment rate reached 12.1% in the third quarter of 2013. Over the last five years a large number of workers have emigrated to other EU countries and the labour force has shrunk significantly. However, the last couple of years have seen decreasing emigration, which suggests a stabilising outlook for labour force dynamics. At the same time, regional differences in employment and unemployment, as well as skill mismatches, persist. A tight labour market and a high natural rate of unemployment may create upward wage pressure and reduce Latvia's growth potential in the future. Therefore, further policies to improve the functioning of the labour market are crucial.

Pro-cyclical fiscal policies were observed during the boom period before the crisis. Over the period from 2000 to 2007 the headline deficit remained below 3% of GDP, but at the same time the underlying structural fiscal position deteriorated, a development masked by buoyant economic growth. According to European Commission estimates, fiscal policy was strongly expansionary

from 2005 to 2008 and revenue windfalls were used for additional spending instead of more rapid deficit reduction. When economic activity abruptly contracted in 2008, government revenues collapsed and the fiscal deficit increased, exceeding 4% of GDP in 2008 and reaching almost 10% of GDP in 2009 (see Table 14). In summer 2009 the ECOFIN Council decided to open an excessive deficit procedure for Latvia and set a deadline for correction by 2012. The magnitude of consolidation undertaken by Latvia under the supervision of the EU and the IMF was extraordinary. The level of nominal government consumption and investment declined by almost one-third in 2010 compared with 2008. On the expenditure side, consolidation primarily consisted of significant cuts in compensation of public employees and in intermediate consumption. On the revenue side, it consisted of increases in VAT rates and in the taxation of personal income and property, together with a broadening of the social security contribution base. In 2009 and 2010 capital injections into the ailing banking sector caused further strain on public finances. Nevertheless, the consolidation effort was successful in reducing the deficit-to-GDP ratio from 9.8% in 2009 to 1.3% in 2012. Government debt dynamics were relatively contained up to 2007; after that, the government debt quickly increased and peaked at 44.4% of GDP in 2010.

The latest developments in Latvia as regards the strengthening of fiscal governance have been positive. Latvia is a signatory of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, which entered into force in January 2013. In this context, the national fiscal framework was strengthened with the adoption of the Fiscal Discipline Law, which envisages a balanced budget over the economic cycle and from a medium-term perspective, as well as the creation of a Fiscal Council. According to the European Commission's autumn 2013 forecast, the government deficit-to-GDP ratio in Latvia is expected to remain contained, at around 1% in 2014, and the government debt-to-GDP ratio is expected to remain broadly unchanged at 39% in 2014.

Monetary policy has played an important role in shaping Latvia's convergence process over the past decade. The aim of Latvijas Banka has for a long time been price stability, enshrined in its law as of 1992. To achieve this aim, Latvijas Banka maintained a fixed exchange rate regime, while allowing for the free movement of capital. As of 1994 the Latvian lats was pegged to the special drawing rights (SDRs). After joining the EU in 2004, Latvia was expected to join Monetary Union as soon as sustainable convergence had been achieved. In view of its ERM II membership, Latvia pegged its currency to the euro on 30 December 2004 at the rate of LVL 0.702804. In May 2005 the country joined ERM II, unilaterally defining a fluctuation band of $\pm 1\%$ around the central parity rate equivalent to the rate fixed in December 2004. When the initial signs of overheating emerged in 2004, Latvijas Banka started to tighten monetary policy to mitigate the expansion of credit. This action, however, was not sufficient to prevent the build-up of excessive imbalances and the boom-bust cycle, in particular in the housing market. Once the adjustment started, Latvijas Banka started to loosen monetary policy. Following gradual reductions over the last few years, Latvijas Banka further reduced its refinancing rate to 0.25% in November 2013 to ensure a smooth transition to the ECB's monetary policy as of 1 January 2014.

The Latvian banking system is fairly small (as a share of GDP) in comparison with most other EU countries. However, several predominantly domestically owned banks rely on non-resident deposits as a source of funding. While domestic lending activity by these banks is rather limited, their holdings of non-resident deposits accounted for almost half of the total deposit base in the second half of 2013. High reliance on non-resident deposits implies risks to financial stability and creates contingent liabilities for the government. A business model based on non-resident financial

services may intensify a number of other risks, such as credit, concentration, liquidity, market and recapitalisation risk. To address potential risks, the Latvian authorities have adopted additional, much stricter, prudential requirements for banks with such a business model (additional capital and liquidity requirements within the Pillar 2 framework, as well as enhanced off-site and on-site inspections). The Latvian authorities should continue monitoring developments in this area and should implement a comprehensive policy toolkit of micro- and macro-prudential policies and enhance this toolkit, if necessary, in order to limit these risks.

In order to fully reap the advantages of the euro and to allow adjustment mechanisms to operate efficiently within the enlarged currency area, Latvia needs to maintain its reform efforts. It should conduct economic policies that are geared towards ensuring the sustainability of the convergence process and sustainable growth in the long term. Ensuring a low-inflation environment – in particular, keeping wage growth in line with productivity developments – is crucial in that respect. In addition, the functioning of the labour market should be improved to reach its full potential. It is imperative that policy areas other than monetary policy provide the Latvian economy with the ability to cope with potential country-specific shocks and avoid the reoccurrence of macroeconomic imbalances. The Latvian authorities have publicly underlined their key goal to avoid pro-cyclical policies and strengthen the quality of institutions, the business environment and governance to ensure the stability and competitiveness of the economy. In addition, the authorities have announced a commitment to full compliance with the Stability and Growth Pact and the fiscal compact on a permanent basis, further structural reforms and further strengthening of financial sector policies. The fulfilment of and long-term adherence to these commitments is essential to ensure that the economic environment is conducive to sustainable output and employment growth in the medium and long term, in the context of balanced macroeconomic conditions and price stability.

Box 8

STATISTICAL IMPLICATIONS OF THE ENLARGEMENT OF THE EURO AREA TO INCLUDE LATVIA

Latvia's entry into the euro area on 1 January 2014 has an impact on the compilation of statistics in Latvia as well as in the other euro area countries. This is the sixth time that statistical series for the euro area have had to be amended to include additional member countries. The preparation of statistics for the enlarged euro area has been coordinated, where necessary, with the European Commission. The entry of Latvia into the euro area means that Latvian residents, including legal entities, have become residents of the euro area. This affects statistics recording transactions (flows) and positions of euro area residents among themselves and vis-à-vis non-euro area residents, such as monetary, balance of payments and international investment position statistics, as well as financial accounts. In these cases, transactions and positions between residents of Latvia and other euro area residents must now be "consolidated" to ensure a proper definition of euro area residency in all statistics concerned.

As of January 2014 Latvia has to meet all the statistical requirements of the ECB, i.e. to provide fully harmonised and comparable national data.¹ Since the preparatory work for new statistics requires a long lead time, Latvijas Banka and the ECB started the statistical preparations before Latvia joined the EU. After becoming a member of the ESCB in 2004, Latvijas Banka

¹ The statistical requirements of the ECB are summarised in the document entitled *ECB statistics: an overview*, April 2010.

intensified its preparations to fulfil the requirements of the ECB in the fields of monetary and financial statistics, financial stability statistics, securities holdings statistics, external statistics, government finance statistics and financial accounts. It also had to prepare for the integration of Latvian credit institutions into the ECB's minimum reserve system and to fulfil the relevant statistical requirements in this area. Moreover, it had to carry out the necessary preparations to meet the statistical needs of the European Systemic Risk Board and to support the information needs of the new Single Supervisory Mechanism.

For the data reporters and NCBs of the other euro area countries, the enlargement of the euro area means that since January 2014 they have had to report transactions and positions with residents of Latvia as part of euro area data, instead of as non-euro area data.

In addition, Latvia and all other euro area countries provided backdata with sufficient geographical and sectoral detail, dating back as far as 2004, the year Latvia joined the EU. These historical data will enable the compilation of aggregates for the euro area in its new composition for some years before euro area enlargement.

Regarding the publication of euro area statistics, the ECB has granted users online access to different sets of time series, some of which contain data for the current euro area (i.e. including Latvia) as far back as available, and some of which link the various compositions of the euro area, starting with the initial 11 countries in 1999.

2 LEGAL ASPECTS OF THE INTEGRATION OF LATVIJAS BANKA INTO THE EUROSISTEM

Pursuant to Article 140 of the Treaty, the ECB reviewed the statute of Latvijas Banka and other relevant Latvian legislation for compliance with Article 131 of the Treaty. The ECB made a favourable assessment of the compatibility of Latvian legislation with the Treaty and with the Statute of the ESCB.¹

The ECB and Latvijas Banka put in place a number of legal instruments with a view to ensuring the integration of Latvijas Banka into the Eurosystem on 1 January 2014. The Eurosystem's legal framework was adapted as a consequence of the decision taken by the ECOFIN Council on 9 July 2013 to abrogate the derogation of Latvia.² The ECB adopted the necessary legal instruments to provide for the paying-up of the remaining capital and the transfer of foreign reserves to the ECB³ and established the banknote allocation key applicable from 1 January 2014⁴. Pursuant to Article 27.1 of the Statute of the ESCB, the Governing Council adopted a recommendation on Latvijas Banka's external auditors for the annual accounts starting from the financial year 2014.⁵ The ECB also reviewed its legal framework and introduced, where necessary, amendments resulting from Latvijas Banka's membership of the Eurosystem. This included a review of Latvian legislation

1 See *Convergence Report*, ECB, June 2013.

2 Council Decision 2013/387/EU of 9 July 2013 on the adoption by Latvia of the euro on 1 January 2014, OJ L 195, 18.7.2013, p. 24.

3 Decision ECB/2013/53 of 31 December 2013 on the paying-up of capital, transfer of foreign reserve assets and contributions by Latvijas Banka to the European Central Bank's reserves and provisions, OJ L 16, 21.1.2014, p. 65.

4 Decision ECB/2013/27 of 29 August 2013 amending Decision ECB/2010/29 on the issue of euro banknotes, OJ L 16, 21.1.2014, p. 51.

5 Recommendation ECB/2013/42 of 15 November 2013 to the Council of the European Union on the external auditors of Latvijas Banka, OJ C 342, 22.11.2013, p. 1.

implementing the Eurosystem's legal framework for monetary policy and TARGET2, which enabled Latvian counterparties to participate in the Eurosystem's open market operations from 2 January 2014. The ECB also adopted a Decision on transitional provisions for the application of minimum reserves by the ECB following the introduction of the euro in Latvia.⁶ Finally, the ERM II Agreement⁷ was terminated for Latvijas Banka.

The introduction of the euro in Latvia and the integration of its central bank into the Eurosystem also required changes to some Latvian legal instruments. The ECB was consulted on national legislation governing the euro changeover and the minimum reserves framework.⁸

The ECOFIN Council consulted the ECB on its proposals to amend the Council Regulations⁹ which enabled the introduction of the euro in Latvia and determined the irrevocably fixed exchange rate of the euro vis-à-vis the Latvian lats.¹⁰ The ECB welcomed the proposed regulations and noted that they would enable the introduction of the euro as the currency of Latvia following the abrogation of Latvia's derogation in accordance with the procedure set out in Article 140(2) of the Treaty.

3 OPERATIONAL ASPECTS OF THE INTEGRATION OF LATVIJAS BANKA INTO THE EUROSYS-TEM

Following the Decision of the EU Council of 9 July 2013 on the adoption of the euro by Latvia on 1 January 2014, the ECB conducted technical preparations with a view to fully integrating Latvijas Banka into the Eurosystem. In line with the provisions of the Treaty, Latvijas Banka joined the Eurosystem with exactly the same rights and obligations as the NCBs of the EU Member States that had already adopted the euro.

The technical preparations for the integration of Latvijas Banka into the Eurosystem covered a wide range of areas, notably financial reporting and accounting, monetary policy operations, foreign reserve management and foreign exchange operations, payment systems, statistics and banknote production. In the field of operations, preparations involved extensive testing of the instruments, procedures and technical systems for the implementation of monetary policy and foreign exchange operations.

MONETARY POLICY OPERATIONS

Following the adoption of the euro by Latvia on 1 January 2014, 61 Latvian credit institutions, a list of which is published on the ECB's website, became subject to the Eurosystem's reserve requirements as from that date. The entry of Latvia into the euro area changed the liquidity conditions in the Eurosystem only slightly. The aggregate reserve requirements of euro area credit institutions increased by less than 0.2% (€187 million). Net autonomous liquidity factors in Latvia

6 Decision ECB/2013/41 of 22 October 2013 on transitional provisions for the application of minimum reserves by the European Central Bank following the introduction of the euro in Latvia, OJ L 3, 8.1.2014, p. 9.

7 Agreement of 6 December 2013 between the ECB and the national central banks of the Member States outside the euro area amending the Agreement of 16 March 2006 between the ECB and the national central banks of the Member States outside the euro area laying down the operating procedures for an exchange rate mechanism in stage three of economic and monetary union, OJ C 17, 21.1.2014, p. 1.

8 CON/2012/97 and CON/2013/47.

9 Council Regulation (EU) No 870/2013 of 9 July 2013 amending Regulation (EC) No 2866/98 as regards the conversion rate to the euro for Latvia, OJ L 243, 12.9.2013, p. 1, and Council Regulation (EU) No 678/2013 of 9 July 2013 amending Regulation (EC) No 974/98 as regards the introduction of the euro in Latvia, OJ L 195, 18.7.2013, p. 2.

10 CON/2013/48.

for the period from 1 to 18 January 2014 were liquidity-absorbing, increasing the liquidity deficit of the entire euro area banking sector by 0.1% (€0.5 billion) on average.

CONTRIBUTION TO THE ECB'S CAPITAL AND FOREIGN RESERVE ASSETS

Latvijas Banka's total subscribed share in the ECB's capital amounts to €30.5 million, equivalent to 0.2821% of the ECB's subscribed capital of €10.825 billion as at 1 January 2014. Upon joining the ESCB on 1 May 2004, Latvijas Banka paid up 7% of its share of the subscribed capital of the ECB as a contribution to the ECB's operational costs; in conjunction with the ECB's capital increase on 29 December 2010 this contribution was reduced to 3.75%. In accordance with Article 48.1 of the Statute of the ESCB, Latvijas Banka paid up the remaining part of its subscription, equal to €29.4 million, on 1 January 2014.

With effect from 1 January 2014, and in accordance with Articles 30 and 48.1 of the Statute of the ESCB, Latvijas Banka, on the basis of its share of the ECB's subscribed capital, transferred to the ECB foreign reserve assets with a total value equivalent to €163.5 million (85% in Japanese yen-denominated assets and 15% in gold). Latvijas Banka has opted to conduct the operational activities related to the management of its share of the ECB's Japanese yen reserve assets in a pooled management arrangement with the Oesterreichische Nationalbank. As a result of the transfer of foreign reserve assets to the ECB, Latvijas Banka was credited with a euro-denominated claim on the ECB in accordance with Article 30.3 of the Statute of the ESCB.

4 THE CASH CHANGEOVER IN LATVIA

THE LOGISTICS OF THE CASH CHANGEOVER

On 1 January 2014 Latvia adopted the euro as its currency. The cash changeover went smoothly and, following a two-week period during which Latvian lats and euro cash circulated in parallel, the euro banknotes and coins became the sole legal tender in Latvia. Virtually all automated teller machines (ATMs) dispensed only euro banknotes as of 1 January 2014. The cash changeover modalities had been laid down in a changeover plan established jointly with stakeholders.

The Deutsche Bundesbank, which acted as the logistical counterpart, provided 110.3 million banknotes worth €3.12 billion. Latvijas Banka will repay that loan in the form of banknotes in 2015. The banknotes of the first series to be commissioned by Latvijas Banka will carry the letter "C" in their serial numbers. Latvijas Banka procured 400 million euro coins worth €98.8 million from the Staatliche Münzen Baden-Württemberg.

In terms of value, 8.0% of the borrowed euro banknotes and nearly 40.0% of the procured euro coins were distributed to banks before the changeover date so that they could fill ATMs and provide retailers and other professional cash handlers with euro cash. In addition, about 700,000 starter kits, each containing euro coins with a value of €14.23, were distributed to the general public in order to reduce the amount of change to be kept by retailers in the first few days of January.

In connection with the introduction of the euro in Latvia, NCBs exchanged, free of charge, Latvian lats for euro at par value from the first working day of 2014 until 28 February 2014.¹¹ The amount exchanged was limited to €1,000 for any given party and transaction on any one day.

¹¹ Article 49 of the Statute of the ESCB requires that the Governing Council of the ECB take the necessary measures to ensure that banknotes denominated in currencies with irrevocably fixed exchange rates to the euro are exchanged by the euro area NCBs at par value. Against this background, the Governing Council adopted a guideline on the exchange of such banknotes on 24 July 2006.

From 1 January 2014, for a period of six months, lats could be exchanged for euro at the fixed exchange rate free of charge at all bank branches providing cash services. Latvian post offices offered the same service until the end of March 2014.

Latvijas Banka will continue to redeem Latvian lats banknotes and coins for an unlimited period of time.

THE INFORMATION CAMPAIGN ON THE INTRODUCTION OF THE EURO

The ECB worked closely with Latvijas Banka to prepare a comprehensive information campaign in preparation for the introduction of the euro. The communication tools used in the campaign took into account the experience gained in past changeovers and included a mass media campaign involving two television commercials and print, outdoor and online advertising, public opinion surveys, different types of printed publication and dedicated internet pages. The euro information campaign organised by the ECB and Latvijas Banka aimed to familiarise the general public and cash handlers with the visual appearance and security features of the euro banknotes and coins, as well as with key facts and dates related to the cash changeover. Communication partners (mainly banks and public authorities) were given access to electronic material produced by the ECB, which they were able to adapt and use in their own communication activities.

As in previous changeovers, the ECB developed a “talking card” for the visually impaired (with an embedded MP3 file that reads out basic information requested on the changeover and the euro cash).

In addition to the measures targeted at the general public, a high-level conference aimed at representatives of government, civil society and the media was held on 12 September 2013 with the participation of the President of the ECB, the Governor of Latvijas Banka, the Prime Minister and Finance Minister of Latvia and the Vice-President of the European Commission.



The main principle of an English garden, i.e. that it should be in harmony with the surrounding landscape and present an idealised view of nature, formed the basis of the landscape concept for the new ECB premises developed by the Swiss company Vogt Landscape Architects. The idea is that of abstracting the typical terrain of natural flood plains. The continuous landscape design incorporates the Grossmarkthalle and the new high-rise, as well as essential functional equipment and structures, without losing its quality as a park and its landscape identity. It will also include over 700 trees of around 25 different types.

CHAPTER 4

FINANCIAL STABILITY, TASKS RELATED TO THE ESRB, AND FINANCIAL INTEGRATION

I FINANCIAL STABILITY

The Eurosystem contributes to the smooth conduct of policies pursued by the competent national authorities relating to the prudential supervision of credit institutions and the stability of the financial system. The ECB provides advice to the European Commission on the scope and implementation of EU legislation in the fields of prudential supervision and financial stability. Furthermore, the ECB provides administrative, analytical, statistical and logistical support to the European Systemic Risk Board (ESRB). From November 2014 onwards, the ECB will be responsible for the prudential supervision of the major banking groups in the euro area and will have important macro-prudential responsibilities. In this context, the ECB will make a major contribution to the financial stability of the euro area.

I.1 FINANCIAL STABILITY MONITORING

THE EURO AREA BANKING SECTOR

As part of its mandate, the ECB regularly monitors risks to financial stability and assesses the shock-absorbing capacity of the euro area financial system, in close collaboration with the ESCB's Financial Stability Committee.¹ Much of the focus of this important task is on banks, as they remain the primary financial intermediaries in the euro area. This notwithstanding, other financial institutions such as insurance corporations are also monitored closely. The related monitoring necessarily extends to non-financial sectors of the economy, which interact closely with the banking sector in its intermediation role. Moreover, owing to the importance of financial markets, financial infrastructures and other financial institutions, and their linkages with banks, vulnerabilities in these components of the financial system are also monitored by the ESCB. Analytical tools and models have been developed to assist in the performance of risk surveillance and risk assessment tasks, notably early warning signal models and macro-stress-testing tools to assess the overall resilience of the banking sector.²

Euro area financial sector stress remained moderate in 2013, despite some global financial market turbulence in the summer months mainly related to changes in expectations regarding the monetary policy stance in the United States. The developments in the euro area reflected continued adjustment in euro area countries, aimed at strengthening fiscal positions and addressing structural rigidities restraining economic growth. At the same time, advances made on the regulatory front contributed to building up higher capital and liquidity buffers in the banking sector, enhancing the banking system's shock-absorption capacity and establishing a more sustainable basis for bank profitability in the medium to long term. One element relates to the adoption in the EU of the Basel Committee on Banking Supervision's new global standards for capital and liquidity – the Capital Requirements Regulation and Directive (CRR/CRD IV) – which have been applicable since 1 January 2014.

¹ The ECB has published its Financial Stability Review, a semi-annual report on the stability of the euro area financial system, since 2004.

² See "A macro stress testing framework for assessing systemic risks in the banking sector", *Occasional Paper Series*, No 152, ECB, October 2013.

The financial performance of potentially significant banking groups³ in the euro area remained subdued in the first three quarters of 2013, hampered by still elevated loan loss provisioning charges and sluggish revenue growth. Euro area banks' net interest income continued to face headwinds from weak or negative lending growth as well as low interest rates. Fee, commission and trading income increased modestly as a percentage of total assets over the year. The cost-to-income ratios of significant banking groups declined in the first half of 2013, but increased again in the third quarter. The elevated loan loss provisioning appears to be closely linked to the economic cycle and was particularly pronounced for banks in stressed countries.

Despite relatively weak profitability, euro area banks have continued to steadily strengthen their capital positions. These improvements by euro area banks have been achieved through a combination of capital increases and reductions in risk-weighted assets, with the relative contribution of these two factors varying greatly across the significant banking groups.

Conditions in bank funding markets improved, but fragmentation nonetheless remains. Euro area banks' issuance of both senior unsecured and covered bonds remained below 2012 levels, even though average bank funding costs reached their lowest level for more than three years across all major debt instruments in early October. Smaller banks in stressed countries continued to pay higher spreads on their newly issued senior unsecured debt than their larger counterparts, whereas the difference in the spread between large and smaller banks in non-stressed countries was less marked. At the same time, the issuance of subordinated debt, in particular by large banks, picked up considerably, albeit from low levels. On the basis of survey data,⁴ price and non-price credit terms for wholesale counterparties remained unchanged after some improvement in the first half of 2013. Furthermore, banks' funding situation benefited from continued deposit inflows in most countries, including some reversal of the fragmentation that had previously exerted a negative effect on deposits in some countries under stress. Moreover, banks in most stressed countries continued to reduce their dependence on central bank funding by repaying funds borrowed through the three-year longer-term refinancing operations, although repayment rates varied across banking sectors.

OTHER FINANCIAL INSTITUTIONS

The reported profitability of large euro area insurers has so far been little affected by the financial and economic crisis or the prevailing low-yield environment, being on average roughly double that of the large and complex banking groups. Solid investment income and underwriting performance supported returns on equity. The observed resilience of these insurers appears to be linked to the extent of diversification that large insurers display, on the one hand, and to the long-term nature of insurance business, where assets are generally held to maturity and investment income is therefore less vulnerable to market volatility, on the other. However, profitability was dented by insured losses over the last months of 2013, mostly stemming from floods in central and eastern Europe. Investment income continued to be resilient to the low yields on highly rated government bonds, which constitute the lion's share of many euro area insurers' investment portfolios. Volatility in global debt markets through the summer had a stronger impact on the reported capital positions of large euro area insurers than on their profitability, demonstrating their vulnerability to the risk of a sudden increase in yields through its impact on asset valuations and therefore solvency.

³ This concept refers to the approximately 130 banking entities (including around 90 parent and stand-alone banks) that are currently estimated to fall under the direct supervision of the ECB as part of the Single Supervisory Mechanism (SSM).

⁴ "The survey on credit terms and conditions on euro-denominated securities financing and OTC derivatives markets" was launched by the ECB in 2013 and is conducted at a quarterly frequency.

1.2 FINANCIAL STABILITY ARRANGEMENTS

Important progress was made in the development of financial stability arrangements for the EU during 2013.

In June 2012 the European Commission issued a legislative proposal that aims to establish a harmonised EU-wide framework for the recovery and resolution of banks.⁵ The framework, which was broadly welcomed by the ECB in its opinion⁶, equips authorities with the powers and tools to inter alia manage bank failures, while keeping critical bank functions operational, protecting public finances, safeguarding financial stability and involving shareholders and creditors appropriately. In 2013 the ECB welcomed that the Council agreed on a compromise text in June.⁷ Since then, the “trialogue” negotiations between the European Parliament, the European Commission and the Council have been completed and an agreement between the co-legislators was reached on 12 December.

The forthcoming recovery and resolution framework will be a key element of banking union. In July 2013 the European Commission presented a legislative proposal⁸ for a Single Resolution Mechanism (SRM), which foresees a single European authority and fund for bank resolution for all EU Member States that participate in banking union. The Council agreed on a general approach regarding the SRM at the ECOFIN meeting on 18 December 2013, while the European Parliament’s Committee on Economic and Monetary Affairs adopted its negotiation position on 17 December. Triologue negotiations are now under way, with adoption expected in the current legislative period.

In its opinion⁹ on the proposed SRM regulation, the ECB fully supported the establishment of an SRM, which will contribute to strengthening the architecture and stability of EMU. The SRM is a necessary complement to the SSM. Such a mechanism therefore needs to be established by the time the ECB assumes its supervisory responsibility in full. Therefore, the ECB strongly supported the envisaged timeline for the SRM. Furthermore, the proposed regulation contains three essential elements for effective resolution, namely (i) a single European system, which encompasses all Member States participating in the SSM, (ii) a single European authority at the centre of the SRM, with sufficient decision-making authority to take resolution action in the interest of stability within the euro area and of the EU as a whole and (iii) a single European fund, which is financed by ex ante risk-based contributions from all banks subject to the SRM and complemented by ex post contributions where necessary.

The ECB considered that the SRM’s decision-making capacity and voting modalities must ensure timely and efficient decision-making. Furthermore, the tasks and responsibilities of the authorities involved in the resolution process should be precisely defined. Regarding the assessment of conditions triggering resolution, the ECB considered that the supervisory authority – namely the ECB or the relevant national supervisory authority – should be allocated sole responsibility for assessing whether the criteria have been met. Moreover, the ECB called for the bail-in tool to be implemented earlier than 2018 and for a joint and solid public backstop to be available upon

5 Proposal for a directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms (COM (2012) 280 final).

6 CON/2012/99. For further details on this opinion and other ECB opinions, see the ECB’s website.

7 For example, in the ECB President’s remarks at the hearing of the European Parliament’s Committee on Economic and Monetary Affairs on 8 July.

8 Proposal for a regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council (COM (2013) 520).

9 CON/2013/76.

the entry into force of the proposed regulation. Finally, regarding the composition of the single resolution board, the ECB recommended that the ECB should have an open invitation to observe in all meetings of the board in order to maintain the separation of institutional responsibilities between the supervisory and resolution functions.

A robust SRM is needed and it is expected that the co-legislators will achieve agreement on this in the trialogue process. The ECB considered that the Council's general approach will need to be amended in order for the governance framework to facilitate the fast and effective action that is required for effective bank resolution. An agreement is also necessary to establish access to a temporary joint public backstop to the SRM. This could take the form of a credit line to the single resolution fund, and should it be activated the credit extended would be fully recouped from the private sector. The forthcoming framework for the SRM should provide for close coordination between the SRM's resolution function and the SSM's supervisory function, while adhering to and respecting the respective institutional responsibilities. Both the SSM and the SRM are essential parts of the integrated financial framework of banking union, which will help to break the link between banks and sovereigns in the Member States concerned and reverse the current process of financial market fragmentation.

In the course of 2013 the ECB continued to support the Financial Stability Board (FSB) in its work to address the negative externalities related to systemic institutions and to address the "too big to fail" problem. In July 2013 the FSB issued additional guidance on effective resolution strategies, stress scenarios and recovery triggers, as well as on the identification of critical functions. This guidance assists authorities in developing and implementing the FSB recovery and resolution requirements. The ECB will support the FSB in the further policy development identified following the St Petersburg G20 summit in September 2013, in particular regarding the development of a proposal on gone-concern loss-absorbing capacity for global systemically important financial institutions for the Brisbane G20 summit in November 2014.

Moreover, in the context of the higher loss-absorbency requirements for global systemically important banks, the ECB continued to support the Basel Committee's work to further refine the assessment methodology. An updated framework including these refinements as well as reporting guidance was published in July 2013.

Finally, during 2013 the ECB also issued several other opinions related to financial stability arrangements.¹⁰

I.3 PROGRESS TOWARDS ESTABLISHING THE SINGLE SUPERVISORY MECHANISM

The Council Regulation establishing a Single Supervisory Mechanism ("SSM Regulation")¹¹ was adopted by the EU Council on 15 October 2013 and entered into force on 3 November 2013. In accordance with this Regulation, the ECB will assume new supervisory responsibilities on 4 November 2014, with the objective of protecting the safety and soundness of credit institutions and the stability of the financial system in Europe.

¹⁰ See, for example, CON/2013/2, CON/2013/3, CON/2013/21 and CON/2013/50, among others.

¹¹ Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

Following the entry into force of the Regulation, the Governing Council of the ECB proposed Danièle Nouy for the position of Chair of the Supervisory Board of the SSM. After the European Parliament had approved the Governing Council's proposal, the ECOFIN Council adopted the implementing decision in December. Sabine Lautenschläger was appointed Vice-Chair of the Supervisory Board in February 2014.

The preparatory work for the establishment of the SSM was launched during the summer of 2012 and was steered by a High-Level Group chaired by the President of the ECB. At the technical level, a Task Force on Supervision conducted the preparatory work. Both of these groups included representatives from each national competent authority (NCA). A project team, composed of managers from the supervisory and financial stability areas of the ECB and some of the national authorities, has also been created to foster communication and cooperation on specific issues.

The ECB also set up a structure to ensure the coordination of the preparatory work taking place internally. The Internal Group on Supervision is monitoring the ECB-wide master plan related to the SSM, and a dedicated human resources team has been established to support the preparatory work and the SSM-related recruitment process.

The technical work under the aegis of the Task Force on Supervision was organised in five work streams and conducted by representatives from both the ECB and the NCAs. The first work stream conducted a mapping of the euro area banking system, in the form of a catalogue comprising all supervised entities falling within the scope of the SSM, with details of the internal structure and composition of all euro area banking groups. The analytical work was supported by a newly developed reference database (see Section 4 of Chapter 2), and the data collected served as a basis for the ECB's selection of the institutions subject to the SSM comprehensive assessment.¹² The data are also being used in the classification of supervised entities as potentially significant or less significant banks prior to the start of SSM operations.

The second work stream, conducted by a group of legal experts from the ECB and the NCAs, developed a draft framework regulation which will govern the practical arrangements for implementing Article 6 of the SSM Regulation, and in particular the methodology for assessing the significance of credit institutions. The draft framework regulation also defines the procedures for cooperation between the ECB and the NCAs within the SSM. This work stream also covered the legal preparations for a public consultation on the draft regulation, which was launched in February 2014, and the provision of legal advice on various other legal acts of relevance for the development of the legal and institutional framework of the SSM (regarding administrative penalties, for example), as well as on various banking and supervisory legal matters of direct relevance to the SSM.

The third work stream focused on developing the supervisory model of the SSM, including all processes, procedures and the methodology for banking supervision. The processes under consideration aim to ensure harmonised and high-quality supervision for all credit institutions covered by the SSM. A risk assessment system was also developed, covering the scope and key principles of the risk assessment, the methodology, the data input and the back-testing. The methodology is based on a combination of quantitative indicators and qualitative inputs and is designed to apply to all banks that are supervised by the SSM. A further methodology was designed for the supervisory review and evaluation process to quantify capital and liquidity needs. This work stream also focused on the cooperation between the ECB and the NCAs within the SSM through the

¹² Note – comprehensive assessment, ECB, October 2013 (available on the ECB's website).

definition of processes and procedures for supervision. The day-to-day supervision of significant institutions will be conducted by joint supervisory teams led by the ECB and consisting of both ECB and NCA experts. An approach for on-site inspections has also been developed.

The fourth work stream reviewed the existing supervisory reporting models, with a specific focus on the granularity of information, the frequency of data and delivery lags, the coverage in terms of institutions, and the level of consolidation (i.e. group or individual level) of the available information. The availability of granular credit data for supervision was explored in cooperation with the statistics departments of the ECB and the NCAs. A particular focus was placed on the different accounting rules applicable in the various euro area jurisdictions. In the course of the year supervisory data to be used for the risk assessment system were collected in two pilot exercises.

The purpose of the fifth work stream was to propose a methodology to be used in the asset quality review, one of the three elements of the comprehensive assessment required by the SSM Regulation. The comprehensive assessment, to be conducted at least with respect to significant banks, comprises three complementary pillars: (i) a supervisory risk assessment, addressing key risks in banks' balance sheets, including liquidity, leverage and funding; (ii) the above-mentioned asset quality review, examining the assets side of bank balance sheets as at 31 December 2013; and (iii) a stress test, building on and complementing the asset quality review by providing a forward-looking view of banks' shock-absorption capacity under stress.

When the comprehensive assessment began in November 2013, a dedicated governance structure was established, at both the central and the national level, to ensure an efficient and rapid governance and decision-making process. The central structure is composed of a Comprehensive Assessment Steering Committee (chaired by the ECB and comprising four ECB representatives and eight high-level NCA representatives), which reports to the Supervisory Board; a Central Project Management Office located at the ECB; quality assurance and technical assistance country teams; and a stress-test team. Governance of the project at the national level consists of four main layers: a steering committee, a project management office, inspection teams with the responsibility for conducting balance sheet assessments, and a quality assurance and technical assistance team. The ECB has appointed Oliver Wyman to support the preparation and implementation of the comprehensive assessment of the significant banks that will be directly supervised by the ECB. Oliver Wyman will support the ECB's management and coordination and will provide financial advisory services for this project, notably in refining the methodology for the assessment. The Governing Council retains the ultimate responsibility for the comprehensive assessment.

Work in 2014 will cover areas such as human resources; the fee framework; the IT infrastructure of the SSM; data collection, quality management and analysis; and information management. In addition, the SSM governance and legal frameworks have been completed, while work is under way to ensure that sufficient office space is available. Various initiatives to provide the public with SSM-related information are ongoing. To enable the ECB to perform its new supervisory function, four new directorates general and a secretariat unit are in the process of being established. Recruitment for these business areas will be ongoing over the course of 2014.

Good progress has been made so far in the preparations for the SSM, and the ECB is on schedule to take up its new tasks in November 2014.

2 TASKS CONCERNING THE FUNCTIONING OF THE EUROPEAN SYSTEMIC RISK BOARD

2.1 INSTITUTIONAL FRAMEWORK

The European Systemic Risk Board (ESRB) is responsible for the macro-prudential oversight of the EU financial system and thus contributes to the prevention and mitigation of systemic risks to financial stability. It brings together representatives of the ECB, the NCBs and national supervisory authorities (NSAs) of the EU Member States, the European Supervisory Authorities (ESAs), the European Commission and the Economic and Financial Committee. These bodies are represented on the General Board and in some of the sub-structures of the ESRB.

The ESRB Secretariat is responsible for the day-to-day business of the ESRB. To this end, with 28 staff, it receives analytical, statistical, logistical and administrative support from the ECB. In addition, member institutions of the ESRB provide staff for secondment to ESRB strands of work. Cooperation with other EU institutions and the ESAs is an integral part of the ESRB's activities.

The ESRB identifies and monitors systemic risk throughout the EU financial system as a whole, analysing both cyclical threats and structural vulnerabilities. It focuses, in particular, on the linkages between deteriorating macroeconomic conditions and fragilities in the financial system. Specific areas include the relationship between sovereigns and the financial sector, interconnectedness and contagion risk (i.e. via interbank networks and counterparty risk as proxied by credit default swaps), sectoral exposures, shadow banking, securities financing transactions and infrastructures.

In 2013 the main focus of the ESRB's work was on macro-prudential instruments, creating a macro-prudential framework of objectives, tools and indicators. The main strands of work covered liquidity, real estate, and systemic and counter-cyclical buffers. On 15 June 2013 the ESRB published its Recommendation on intermediate objectives and instruments of macro-prudential policy (ESRB/2013/1)¹³. This Recommendation provided an indicative list of macro-prudential instruments to be applied by the Member States.

During the year the ESRB finalised the assessment of the implementation of its Recommendation on lending in foreign currencies (ESRB/2011/1)¹⁴. The results of the assessment showed that Member States had complied well with the Recommendation. The assessment will be repeated when credit conditions return to levels prevailing prior to the crisis. In 2013 the ESRB also initiated the assessment of the implementation of the Recommendation on the macro-prudential mandate of national authorities (ESRB/2011/3)¹⁵.

The ESRB uses various channels to ensure accountability, including hearings in the European Parliament. In 2013 the ESRB Chair appeared before the European Parliament's Committee on Economic and Monetary Affairs on three occasions.

The ESRB published its 2012 Annual Report on 8 July 2013. On the same date the Chair of the ESRB addressed a public letter to EU authorities on the forthcoming ESRB review, including

¹³ OJ C 170, 15.6.2013, p. 1.

¹⁴ OJ C 342, 22.11.2011, p. 1.

¹⁵ OJ C 41, 14.2.2012, p. 1.

the High-Level Group Report authored jointly by the ECB's Vice-President Vítor Constâncio, Governor Stefan Ingves (Chair of the ESRB's Advisory Technical Committee) and Professor André Sapir (Chair of the ESRB's Advisory Scientific Committee).

2.2 ANALYTICAL, STATISTICAL, LOGISTICAL AND ORGANISATIONAL SUPPORT TO THE ESRB

The ECB continued to ensure the ESRB Secretariat in 2013 and thereby provided analytical, statistical, logistical and organisational support to the ESRB. In the third year of ESRB operations, the ECB again contributed to the regular identification, monitoring and assessment of EU-wide systemic risks.

ANALYTICAL SUPPORT

As in previous years, the ECB provided analytical support to the ESRB in the form of contributions to the regular reports on the systemic risks faced by the EU financial system and the potential impact of those risks.

Contributions are based on both ECB expertise and information collected through market intelligence efforts, in particular to support the process of identifying systemic risk. Regular work on the surveillance and assessment of systemic risk also relies on, and benefits from, information received from the various member institutions of the ESRB. Systemic risk indicators and early warning systems are both important analytical tools that feed into the risk surveillance work of the ESRB. The risk assessment is supported, in particular, by macro-stress-testing tools and the analysis of propagation channels and contagion in order to assess and rank the potential severity of specific risks.

In addition, the ECB contributed to the various strands of work initiated by the ESRB to assess systemic risk, as well as to the preparation of recommendations on regulatory matters or legislative initiatives. More recently, the ECB has been involved in five new strands of work.¹⁶ These are related to macro-prudential tools and the corresponding tasks that the Capital Requirements Regulation and Directive (CRR/CRD IV) assign to the ESRB. These strands of work, established under the ESRB's Instruments Working Group (IWG), are expected to cover institutional aspects, the modalities of activation, adjustment and deactivation of macro-prudential tools (including indicators), as well as the prevention and mitigation of systemic risk. Moreover, the ECB chaired an IWG Expert Group on guidance on the setting of counter-cyclical buffer rates.

In cooperation with the NCBs, the NSAs and the ESAs – via the ESRB's Advisory Technical Committee and its sub-structures – the ECB regularly reviews the available tools, with a view to continuously improving the analytical framework and, where necessary, developing new tools to fill the analytical gaps identified.

The ESCB's Macro-prudential Research Network plays an important role in this regard.¹⁷ The work done so far can be grouped according to the Network's three main strands of work: (i) macro-financial models linking financial stability and the performance of the economy; (ii) early warning systems and systemic risk indicators; and (iii) the assessment of contagion risks.

¹⁶ These are: (i) tools addressing real estate; (ii) tools addressing liquidity; (iii) tools addressing systemic banks and systemic risks; (iv) the flexibility package; and (v) the setting-up of coordination packages for tools.

¹⁷ The establishment of the Network was approved by the General Council of the ECB in 2010. Its objective is to develop core conceptual frameworks, models and/or tools that support research into ways of improving macro-prudential supervision in the EU.

The ECB organised a workshop in November 2013 on early warning tools and other tools supporting macro-prudential policies. This workshop, attended by members of the ESCB Macro-prudential Research Network and the IWG Expert Group on guidance on the setting of counter-cyclical buffer rates, facilitated consolidation of the various insights from research and policy perspectives.

STATISTICAL SUPPORT

In 2013 the ECB, assisted by the NCBs, continued to provide statistical support to the ESRB through several channels, in full knowledge that the reliable collection and dissemination of data are key for the identification, assessment and mitigation of systemic risk.

The ECB, in accordance with Decision ESRB/2011/6¹⁸, continued to contribute by regularly providing the ESRB with a wide range of ESCB statistics and other information. In particular, through close cooperation between the ECB and the ESAs, steps were taken to enhance the quality of the aggregated supervisory information that the ESAs transmit to the ECB. The ECB also took important steps to ensure that the ESAs and the ESRB have access to non-published, non-confidential ESCB statistical information. This exchange of information among the ESCB, the ESRB and the ESAs also reflects the important work undertaken by the ESRB Contact Group on Data in fostering cooperation among institutions to enhance the relevance, reliability and timeliness of data.

Reflecting its expertise in statistical issues, the ECB continues to make an important contribution to the ESRB's risk surveillance and risk analysis work with a quarterly macro-prudential review that presents detailed statistical information on the different dimensions of systemic risks faced by the national and EU financial systems. In 2013 this quarterly macro-prudential review was complemented with a semi-annual summary assessment of risks faced by national EU banking systems, aimed at supporting a discussion on national differences and developments across the respective banking sectors.

The ECB was also involved in revising and developing further the ESRB risk dashboard so that it can address the evolving nature of risks in the EU financial sector. Providing statistical information on risks and vulnerabilities in the financial system, the ESRB risk dashboard is a key communication instrument of the ESRB and an important element in meeting the accountability requirements vis-à-vis the general public. Since March 2013 the ESRB risk dashboard has also been available via the ECB's Statistical Data Warehouse.¹⁹

3 FINANCIAL REGULATION AND SUPERVISION

3.1 BANKING

In 2013 the ECB continued to contribute to the work being carried out at the international and EU levels on financial regulation and supervision.

A major step towards enhancing the resilience of the financial system in the EU was taken in 2013, with the implementation of the new international standards of the Basel Committee on Banking Supervision (BCBS) on capital and liquidity (Basel III) in the EU through the Capital Requirements

¹⁸ OJ C 302, 13.10.2011, p. 3.

¹⁹ See the "Reports" section of the Statistical Data Warehouse (<http://sdw.ecb.europa.eu>).

Regulation and Directive (CRR/CRD IV)²⁰. The provisions of the Regulation are directly applicable in all Member States as of 1 January 2014. They form a “single rulebook” for financial regulation and supervision across the EU, thus ensuring equal regulatory treatment of institutions providing financial services in the Single Market and enhancing financial integration in Europe. The single rulebook also provides a sound basis for the uniform application of rules in the context of the Single Supervisory Mechanism, which will become fully operational in November 2014 (for more details, see Section 1 of this chapter).

From a central bank’s perspective, the appropriate design and calibration of the new liquidity rules are of particular importance, as the new requirements may have an influence on the conduct of monetary policy and the functioning of money markets. In the light of this, the ECB is conducting monitoring work to assess the likely impact of both the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). In particular, the ECB has contributed to the work of the BCBS to ensure that the LCR responds appropriately to the provision and withdrawal of central bank liquidity, and the revised LCR released by the BCBS in January 2013 reflects the views of the ECB.²¹ At the EU level, the CRR gives the European Banking Authority (EBA) a mandate to prepare guidelines and assessments on liquidity regulation. For example, the EBA is mandated to assess the economic impact of the LCR and to report on appropriate uniform definitions of liquid assets. In view of the need to carefully assess the interaction between liquidity regulation and monetary policy, the ECB is contributing to this work, which will also be reflected in a legal act to be developed in the course of 2014. With regard to the NSFR, the EBA is currently collecting data to monitor this ratio. Further work will be carried out in line with the progress being made by the BCBS.

3.2 SECURITIES

The ECB was very active in 2013 in the area of securities regulation.

Following the evidence of reference rate manipulation that emerged in 2012, the ECB has actively participated in the reform efforts on reference interest rates undertaken by the European Commission, the EBA and the European Securities and Markets Authority, as well as the International Organization of Securities Commissions.

While the choice of reference rates that better reflect end-user needs is ultimately the responsibility of the users themselves, the systemic relevance of reference rates justifies the active involvement of central banks in the reform process to uphold the reliability, integrity and representativeness of key euro area reference interest rates. The ECB’s involvement in this work has taken the following forms: (i) participation in public consultations conducted by regulators; (ii) public reminders to banks to act responsibly and assume collective responsibility to safeguard the functioning of key reference rates, thus preventing potential disruption to the functioning of financial markets while the regulatory framework is being refined; (iii) acting as a catalyst for market initiatives to assess the options for reforming the current reference rates, in particular EURIBOR, and collecting money market transaction data for the EURIBOR administrator (Euribor-EBF) to ascertain the feasibility

20 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012; Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

21 The Basel III liquidity rules foresee a phasing-in of the LCR, starting with 60% in 2015 and rising by 10 percentage points each year until 100% is reached in 2019. In the EU, the CRR envisages a more rapid phasing-in, with full implementation by 2018.

of a transaction-based unsecured money market reference rate; and (iv) participation in the work of the Official Sector Steering Group for benchmark reform set up by the Financial Stability Board (FSB).²² In 2013 the ECB also prepared an opinion on the European Commission's proposal for a regulation on indices used as benchmarks in financial instruments and financial contracts.²³

The ECB was also involved in international initiatives aimed at strengthening the regulation of shadow banking, participating in the policy and regulatory debate at the level of the FSB. In particular, the ECB contributed to the revised recommendations to strengthen the oversight and regulation of shadow banking published by the FSB on 29 August 2013.²⁴ The recommendations set out a framework to deal with the financial stability risks posed by shadow banking entities other than money market funds and by securities financing transactions. The FSB recommendations also stressed the need for more transparency with regard to repo and securities lending transactions in view of their relevance for monetary policy implementation and financial stability. In this context, the ECB is studying the possible establishment of a European aggregator of secured financing data, taking into account the need to leverage the existing market infrastructures and minimise the burden on the reporting entities.

3.3 ACCOUNTING

In 2013 the ECB continued to contribute to the accounting work carried out in various fora, including in sub-structures of the BCBS and the EBA.

Throughout the year the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) continued to work on aligning their respective accounting frameworks. Work predominantly related to the completion of the financial instruments project, including the classification and measurement of financial assets and liabilities, impairment and hedge accounting, and to leases.

Accounting for financial instruments is relevant from a financial stability perspective because of its potential to create volatility in banks' income statements, thereby increasing pro-cyclicality in the financial system. The current proposals on impairment aim to address the "too little too late" problem of accounting for expected credit losses. There is still a significant divergence of opinions on this topic between the IASB and the FASB, and this project is therefore not expected to be finalised until the first half of 2014.

The IASB issued its new standard on hedge accounting at the end of 2013. It aims to improve the ability of investors to understand risk management activities and to assess the amounts, timing and uncertainty of future cash flows, thereby contributing to greater financial stability.

Finally, accounting for leases is also important from a financial stability perspective, because it is likely to affect the calculation of banks' leverage ratios under the Basel III capital framework. The IASB and the FASB are both assessing this issue and the ECB is closely following the discussion.

²² For more details on the ECB's initiatives in the area of reference rate reform, see the article entitled "Reference interest rates: role, challenges and outlook", *Monthly Bulletin*, ECB, October 2013.

²³ CON/2014/2.

²⁴ The full documentation is available at <http://www.financialstabilityboard.org>

4 FINANCIAL INTEGRATION

The Eurosystem and the ESCB contribute to enhancing European financial integration by: (i) raising awareness of and monitoring financial integration; (ii) acting as a catalyst for private sector activities by facilitating collective action; (iii) giving advice on the legislative and regulatory framework for the financial system and direct rule-making; and (iv) providing central banking services that foster financial integration.

RAISING AWARENESS OF AND MONITORING FINANCIAL INTEGRATION

Since 2007 the ECB has published an annual report on “Financial integration in Europe”²⁵. The 2013 issue of the report included a new chapter on institutional reforms in the light of financial integration, regarding in particular the decision to establish a banking union and major developments towards the establishment of the Single Supervisory Mechanism (SSM). The report also focused on: (i) recent developments in financial integration in the euro area; (ii) Eurosystem activities in the area of financial integration; (iii) euro area money market segmentation in a low interest rate environment; (iv) the integration of the euro retail payments market; (v) sectoral accounts and rebalancing in the euro area; and (vi) a structural comparison of the EU and US money markets to demonstrate implications for financial integration.

On 25 April 2013 the ECB and the European Commission organised a joint conference on “Financial integration and stability: the impact of ongoing reforms on financial integration and stability”. This conference provided an opportunity for experts from both institutions, as well as external participants, to discuss ongoing developments in the area of financial integration and financial stability. One of the main conclusions was that despite the improvements in financial integration during 2012, the climate in the financial markets remains fragile. Therefore, further progress towards the establishment of banking union is needed.

The set of quantitative measures used to monitor financial integration was thoroughly reviewed and updated in 2013. The standard set of statistical indicators of integration is updated and published semi-annually on the ECB’s website.

ACTING AS A CATALYST FOR PRIVATE SECTOR ACTIVITIES

SEPA

The Single Euro Payments Area (SEPA) is an initiative aimed at achieving an integrated pan-European market for retail payment services in euro, with no distinction between cross-border and national payments. In 2013 the initiative moved towards a milestone: the replacement by 1 February 2014 of existing national credit transfer and direct debit schemes with SEPA-compliant alternatives.²⁶ To promote timely migration, the Eurosystem increased its monitoring and support activities in this field in 2013. The ECB published two SEPA migration reports, in March and October 2013, describing the progress made towards migration and providing guidance to the market. Communication efforts were increasingly undertaken to raise awareness of the migration, especially among citizens and smaller and medium-sized companies. Quantitative and qualitative information was collected to monitor the preparedness of national communities and their pace of migration. A “big bang” approach to migration was taken in several countries, and the Eurosystem issued warnings about the related risks for the wider supply chain, including “big billers”, public

²⁵ These reports are available on the ECB’s website.

²⁶ Regulation (EU) No 260/2012 of the European Parliament and of the Council of 14 March 2012 establishing technical and business requirements for credit transfers and direct debits in euro and amending Regulation (EC) No 924/2009.

administrations, businesses and citizens. In December 2013, according to ECB indicators for the euro area, SEPA credit transfers accounted for 73.8% of all credit transfers, while SEPA direct debits represented 41.0% of all direct debits.

The European Commission considered that, although the migration had accelerated, it was unlikely that it would be fully completed by 1 February 2014. Therefore, on 9 January the Commission published a proposal for an EU regulation allowing payment service providers to continue accepting payments in the national formats for an additional transitional period of six months. Although not challenging the Commission's proposal, in a press release on 9 January the ECB urged all market participants to complete the transition to the SEPA standards by the original deadline. The ECB opinion on the legal proposal was issued on 22 January 2014.²⁷ The draft regulation was submitted to the European Parliament and the Council for consideration in February 2014.

In 2013 the SEPA Council²⁸ met to discuss several issues related to SEPA migration, payment schemes, innovation and the related EU legal framework. Given that 1 February 2014 marked the start of a new phase in the integration process of European retail payments, governance issues also needed to be reviewed. The ECB, the European Commission and other stakeholders exchanged views on the way forward throughout the year. In December the ECB announced the creation of the Euro Retail Payments Board, which replaced the SEPA Council, with a wider mandate, a larger composition and a strong output-driven approach.

Progress is still needed in the field of SEPA for cards. In 2013 at the second Forum on SEPA Cards Standardisation the Eurosystem expressed the view that interoperability is needed. The Eurosystem monitored progress in building a SEPA framework for security evaluation and certification of payment terminals, and also undertook work on innovations related to card payments, in particular the use of smartphones as card payment acceptance devices.

The SEPA payment instruments are based on common business practices, technical standards and security requirements and lay the foundation for Europe-wide innovative payment solutions. In this context, the Eurosystem analysed the emergence of payment initiation services offered by non-account-servicing third-party providers and held meetings with stakeholders on the subject in March and April 2013. This helped to clarify the notion of access to payment accounts, which was taken up in the European Commission's proposal for a review of the Payment Services Directive²⁹.

Retail payment clearing and settlement infrastructures can play a role in the realisation of an integrated retail payments market. In September 2013 the Eurosystem released updated criteria for the SEPA-compliance of such infrastructures³⁰, taking into account the developments in the relevant market and regulatory framework since criteria were first published in 2008.

Finally, every two years the ECB organises a retail payments conference together with an ESCB central bank. In October 2013 this conference was jointly organised by the ECB and the Banque de France, and held in Paris. It brought together high-level policy-makers, academics and market

²⁷ CON/2014/3.

²⁸ This was a stakeholders' forum, co-chaired by the ECB and the European Commission, which aimed to promote an integrated euro retail payments market by ensuring the proper involvement of all parties and by fostering consensus on the next steps towards the realisation of SEPA.

²⁹ Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market amending Directives 97/7/EC, 2002/65/EC, 2005/60/EC and 2006/48/EC.

³⁰ Available on the ECB's website.

participants, and focused on the challenges and opportunities facing market players and public authorities in the area of retail payments integration and innovation.

SECURITIES MARKETS

With the aim of reviving the European structured finance market, given its role in the provision of loans to the economy and, consequently, its potential importance for long-term economic growth, the ECB acts as a catalyst with regard to a number of initiatives related to this market segment. In particular, the ECB supports the development of high-quality products that could attract investors from the private sector with a medium to long-term investment horizon. In 2013 the ECB played a role in certain such initiatives related to asset-backed securities (ABSs) and covered bonds.

With the aim of increasing transparency in the area of ABSs, loan-by-loan reporting became an eligibility criterion for ABSs in the Eurosystem collateral framework in 2013. Loan-level data reporting became mandatory for transactions backed by residential mortgages and by loans to small and medium-sized enterprises on 3 January 2013 and for those backed by commercial mortgages on 1 March. The same requirements were extended to four additional asset classes (assets backed by consumer finance, leases, auto loans and credit card debt) in early 2014. Loan-level data are handled via a market-led single loan-level data repository, the European Data Warehouse, and must be provided in accordance with the templates available on the ECB's website, at least on a quarterly basis. Furthermore, the ECB continued to monitor the Prime Collateralised Securities (PCS) initiative, which aims to enhance and promote quality, transparency, simplicity and standardisation throughout the ABS market in the EU. Assets that fully meet the criteria set by the PCS Association are awarded a PCS Label. The ECB acts as a permanent observer in the PCS Association.

The ECB also acted as an observer in the Covered Bond Label initiative, which was developed by the European Covered Bond Council with the aim of improving standards and increasing transparency in the European covered bond market. In 2013 the Covered Bond Label was brought into line with Article 129 of the Capital Requirements Regulation³¹ following input received from the ECB, the European Banking Authority and the investor community.

ADVICE ON THE LEGISLATIVE AND REGULATORY FRAMEWORK FOR THE FINANCIAL SYSTEM AND DIRECT RULE-MAKING

To enhance financial integration, the ECB and the Eurosystem, in line with their advisory and regulatory functions, monitor and actively contribute to the development of the EU regulatory framework. In addition to these activities, which are covered in other sections of this report,³² the following ECB activities contributed to increasing financial integration through regulatory initiatives.

The SEPA project and changes in the regulation of retail payments, along with the need to increase the quality, reliability and granularity of payment statistics, prompted the ECB to review its legal framework covering such statistics. This involved preparing a new regulation on payment statistics³³ which provides for consistent and harmonised reporting of payment statistics by reporting agents. Guideline ECB/2007/9 on monetary, financial institutions and markets statistics is also being revised in order to enhance the statistical information provided by the NCBs, including with regard to payment data.³⁴ The new legal framework for payment statistics will take effect from data

31 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

32 See in particular Section 3 of this chapter and Section 6.2 of Chapter 2.

33 Regulation (EU) No 1409/2013 of the European Central Bank of 28 November 2013 on payments statistics (ECB/2013/43).

34 Guideline ECB/2007/9 of 1 August 2007 on monetary, financial institutions and markets statistics.

referring to the second half of 2014. Further information on the legal texts regulating the enhanced payment statistics can be found in Section 4 of Chapter 2.

In September and October 2013 the ECB was consulted on the European Commission's proposals for three legal acts: a proposal for a directive on the transparency and comparability of payment account fees, payment account switching and access to a basic payment account, and a legislative package comprising a review of the Payment Services Directive and a regulation on interchange fees for card-based payment transactions. All three proposals are aimed at achieving more integrated, competitive and efficient payment services, in line with users' needs. The ECB's opinion on the first legal act was published in November.³⁵ The ECB opinions on the latter two legal acts were published in February 2014.^{36, 37}

The ECB participated in the UNIDROIT Study Group, which had the task of preparing draft principles regarding the enforceability of close-out netting provisions.³⁸ The UNIDROIT Governing Council, at its 92nd session held from 8 to 10 May 2013, adopted the Principles on the Operation of Close-out Netting Provisions. The ECB supports the objectives of the principles, which are designed to improve the enforceability of close-out netting, especially in cross-jurisdictional situations, in order to provide a sound basis, in commercial and insolvency law terms, for risk management and mitigation by financial institutions and for the application of regulatory policies in the international context.

At the EU level, the ECB participates in the European Commission's Securities Law Directive Member States Working Group, which is pursuing harmonisation of the legal framework for holdings and transfers of intermediated securities. The ECB's interest in this area relates in particular to collateral management rules, such as the regulation of collateral reuse.

Furthermore, the ECB contributes to the work of the European Post Trade Group, a joint initiative of the European Commission, the ECB, the European Securities and Markets Authority and the Association for Financial Markets in Europe. The group is mandated to contribute to the development of an efficient, safe and sound post-trade market in the EU and, as such, it builds on the work carried out in previous initiatives, i.e. by the Expert Group on Market Infrastructures and the Clearing and Settlement Advisory and Monitoring Expert Group II. The scope of the present work is limited to areas of financial harmonisation which are currently not covered by other existing regulatory or industry initiatives. This work is therefore complementary to the current regulatory initiatives of the Commission and to the implementation of the TARGET2-Securities (T2S) programme.

PROVIDING CENTRAL BANKING SERVICES WHICH FOSTER FINANCIAL INTEGRATION

TARGET2, the second generation of the Eurosystem's large-value payment system, is the first market infrastructure which is completely integrated and harmonised at the European level. The Eurosystem has continued to make enhancements to TARGET2 in collaboration with the banking industry (see Section 2.1 of Chapter 2).

T2S – the future single securities settlement engine of the Eurosystem – will have an important impact on the harmonisation and integration of the post-trading environment in Europe. T2S will

³⁵ CON/2013/77.

³⁶ CON/2014/9.

³⁷ CON/2014/10.

³⁸ See "Study LXXVIII C – Principles and rules on the netting of financial instruments" available on the UNIDROIT website (www.unidroit.org).

automatically remove many of the “Giovannini Barriers”³⁹ to cross-border clearing and settlement by, among other things: (i) providing a single IT platform with a common interface and a single messaging protocol; (ii) introducing a harmonised operational day for all connected markets; and (iii) extending a single harmonised settlement model comprising delivery versus payment in central bank money to all national and cross-border transactions.

Nevertheless, even with a single technical platform there are still significant barriers to cross-border settlement which must be removed in order for financial markets to reap the full benefits of financial integration in the post-trade environment. The T2S Advisory Group, which is part of the T2S governance, is responsible for, among other things, fostering the T2S post-trade harmonisation agenda and identifying where markets that will use T2S are lagging behind the rest of Europe in the implementation of commonly agreed harmonisation standards. The group publishes regular harmonisation progress reports (the fourth report will be published in March 2014) and constantly monitors the progress made by markets that will be connected to T2S. These reports are shared with the T2S Board and the ECB’s Governing Council and place the T2S Advisory Group at the core of the harmonisation agenda, giving a major boost to T2S and the broader post-trade harmonisation work in Europe conducted in cooperation with the European Commission and other relevant actors (see Section 2.2 of Chapter 2).

Finally, in the area of collateral management, the correspondent central banking model (CCBM) has fostered financial integration since its implementation in 1999, by enabling all euro area counterparties to use on a cross-border basis eligible assets as collateral in Eurosystem credit operations, regardless of the location of the counterparty or the country in which the asset has been issued. The Eurosystem is currently working on enhancements to the CCBM, which will be implemented in 2014 (see Section 2.3 of Chapter 2).

5 OVERSIGHT OF PAYMENT SYSTEMS AND MARKET INFRASTRUCTURES

Through its oversight function, the Eurosystem aims to ensure the safety and efficiency of payment, clearing and settlement systems processing the euro, as well as of payment instruments, major service providers and other critical infrastructures, by monitoring and assessing them against applicable oversight standards and, where necessary, inducing change.⁴⁰

The Eurosystem has translated its oversight objectives into specific standards and requirements that financial market infrastructures should meet. These standards and requirements are based on internationally accepted oversight standards. On 3 June 2013 the Governing Council adopted the Principles for Financial Market Infrastructures (PFMIs), introduced in April 2012 by the Committee on Payment and Settlement Systems (CPSS) of the BIS and the Technical Committee of the International Organization of Securities Commissions (IOSCO), for the conduct of Eurosystem oversight in relation to all types of financial market infrastructures. It also decided to launch a public consultation on a draft regulation on oversight requirements for systemically important

³⁹ These barriers are technical or market-practice barriers, legal barriers or barriers related to tax procedures (more information can be found on the official website of the European Union (<http://europa.eu>)).

⁴⁰ Detailed information on the Eurosystem’s oversight function and activities is also provided by the ECB on its website and through specific Eurosystem oversight reports, including the Eurosystem oversight policy framework published in July 2011 (available on the ECB’s website).

payment systems, which implements the PFMI in a legally binding way. The draft regulation, together with a press release, was published on the ECB's website on 7 June 2013.

The PFMI replace the previous CPSS Core Principles for Systemically Important Payment Systems (CPSIPS), the CPSS-IOSCO Recommendations for Securities Settlement Systems, as well as the CPSS-IOSCO Recommendations for Central Counterparties. They are designed to make financial market infrastructures more resilient to defaults by system participants and to financial crisis. The Eurosystem considers a timely and consistent implementation of the new principles by major economies to be important in order to strengthen global financial stability, enhance the ability of financial market infrastructures to manage various risks and avoid the risk of regulatory arbitrage.

5.1 LARGE-VALUE PAYMENT SYSTEMS AND INFRASTRUCTURE SERVICE PROVIDERS

Large-value payment systems form the backbone of the euro area market infrastructure and play an important role for the stability and efficiency of the financial sector and the overall economy. The Eurosystem applies a well-defined oversight policy framework to all large-value payment systems that settle euro-denominated transactions – both its own system and those that are privately operated.

TARGET2

The oversight of TARGET2 is led and coordinated by the ECB, acting in close cooperation with all euro area NCBs and other central banks connected to TARGET2. In 2013 the Eurosystem's oversight of TARGET2 focused on operational risk issues and a gap analysis of the system against the new PFMI. The new requirements introduced by the PFMI include the analysis of tiered participation arrangements, the establishment of a comprehensive risk management framework and the analysis of general business risks. The few areas for improvement identified in the gap analysis related to the new principles.

The Eurosystem also conducted an analysis of TARGET2 interdependencies, including system-based, institution-based and environmental interdependencies (including those which could arise from the connection with TARGET2-Securities), with the objective of increasing the overseer's and operator's awareness of risks stemming from such interdependencies. The need to address risks stemming from interdependencies is recognised by the PFMI. The analysis of TARGET2 interdependencies focuses on the risks that other entities pose to TARGET2 and contributes to the identification of entities which are critical for TARGET2's performance, as well as to the assessment of related risks and of the effectiveness of the risk management measures applied by the TARGET2 operator.

In addition, the Eurosystem continued its analysis of transaction-level TARGET2 data, using a dedicated simulator tool. This quantitative analysis supports and complements the standard-based oversight of TARGET2. Other work focused on the implementation of stress-testing for TARGET2, the definition and testing of risk or early warning indicators, and an analysis of the structure of indirect participation in TARGET2. Additionally, studies on the functioning of the interbank money market in the euro area were conducted, relying on a database for money market transactions identified on the basis of TARGET2 payments.

EURO1

EURO1 is a large-value payment system for transactions in euro between banks operating in the EU. It is operated by EBA CLEARING. EURO1 works on a multilateral net basis, while the

end-of-day positions of EURO1 participants are ultimately settled in central bank money via the TARGET2 system, with the ECB acting as the settlement agent.

The ECB is entrusted with primary oversight responsibility for EURO1, acting in close cooperation with all euro area NCBs. In 2013 EBA CLEARING changed the loss-sharing calculation method to be used in EURO1 in the event of more than three participants defaulting. The new approach is simpler than the previous one (as, in the event that multiple participants default, it applies the same regime regardless of the number of defaulted participants) and gives EURO1 participants an incentive to manage credit risk in the system more actively, as their loss share will depend on the bilateral limits granted to the defaulted participant(s). In the light of the systemic relevance of EURO1 in the euro area payment landscape, the Eurosystem assessed the impact that the change might have on EURO1's compliance with the applicable oversight standards. It concluded that the changed loss-sharing calculation method would not adversely affect the legal structure and risk profile of the EURO1 system.

The ECB is also closely monitoring the implementation of the recommendations that were made to the system operator following the comprehensive assessment of EURO1 against the CPSIPS in 2011.

CONTINUOUS LINKED SETTLEMENT SYSTEM

The Continuous Linked Settlement system (CLS) is operated by CLS Bank International (CLS Bank). It provides a multi-currency service for the synchronous – i.e. payment versus payment (PvP) – settlement of payment instructions relating to foreign exchange transactions. Through its PvP mechanism, CLS is designed to eliminate the principal risk associated with the settlement of foreign exchange transactions. CLS currently settles in 17 of the world's most traded currencies, including the euro. Given that CLS Bank is established in the United States, the Federal Reserve System accepts primary oversight responsibility for CLS under a cooperative oversight arrangement involving the G10 central banks and the central banks of issue of currencies settled by CLS. The ECB, in close cooperation with the euro area NCBs, is part of this cooperative oversight arrangement and has primary oversight responsibility for settlement in euro by CLS.

In 2013 the ECB's oversight activities with respect to CLS covered, among other things, the progress achieved on strategic initiatives and the review of additional risk mitigation services considered by CLS, including the launch of a same-day settlement session between the US dollar and the Canadian dollar. The ECB also organised a meeting of the Euro CLS Group, which serves as a euro area forum for exchanging views on CLS-related issues and developments, at which initial discussions were held on a possible European same-day settlement session.

SWIFT

SWIFT is important from a financial stability perspective, as it provides secure messaging services to the financial community in more than 210 countries. The central banks of the G10 have established a cooperative oversight arrangement for SWIFT. The ECB and some other euro area NCBs contribute to various oversight activities carried out by the cooperative oversight group, with the Nationale Bank van België/Banque Nationale de Belgique being the lead overseer. In addition, a SWIFT Oversight Forum was set up in order to expand to a larger group of central banks information-sharing and dialogue in relation to SWIFT oversight.

The SWIFT cooperative oversight activities are conducted in the framework of a yearly SWIFT oversight plan, which is prepared using a risk-based oversight planning approach. They focus on

those SWIFT services with a potential impact on systemic risk for the global financial infrastructure. In 2013 the oversight activities continued to focus on the implementation of the Distributed Architecture project, which improves SWIFT's resilience. Other major SWIFT projects being closely monitored included the renewal of the FIN software, which aims to mitigate technology risk and reduce costs, while ensuring strategic alignment of IT platforms. Furthermore, overseers also reviewed the enterprise risk management, business continuity, logical security features and the cyber defence of SWIFT operations, as well as the resilience tests conducted with the participation of the user community.

5.2 RETAIL PAYMENT SYSTEMS AND PAYMENT INSTRUMENTS

The Eurosystem also has oversight responsibility for retail payment systems and payment instruments. The oversight standards for retail payment systems, which draw on the CPSIPS, have been reviewed to take into account the implementation of the PFMI and also to reflect the increased integration of retail payment systems owing to the harmonisation of technical standards and procedures resulting from the Single Euro Payments Area (SEPA) project. SEPA gives incentives to an increasing number of retail payment systems either to establish cross-border links with other such systems or to offer services in more than one country. The revised oversight framework therefore includes a new classification for euro retail payment systems, reflecting the importance of a system from a European perspective. The revised framework also incorporates the oversight expectations for links between retail payment systems which were adopted by the ECB's Governing Council in 2012.

With respect to retail payment systems, the ECB is the lead overseer of the STEP2 system, which is a pan-European automated clearing house for retail payments in euro and is managed and operated by EBA CLEARING. STEP2 offers the processing of different kinds of retail payment, such as SEPA credit transfers and SEPA direct debits as well as "national" transactions within Italy and Ireland, which are processed according to domestic technical standards and limited to the national banking community. In 2013 important changes in the services of STEP2 were subject to an oversight assessment. The assessed changes included the introduction of an additional settlement cycle in the SEPA Credit Transfer (SCT) service, the implementation of the Electronic Banking Internet Communication Standard (EBICS) and the addition of a third data centre to the technical infrastructure. The changes did not affect the full compliance of the system with the applicable oversight standards.

Concerning payment instruments, in 2013 the focus of Eurosystem oversight remained on payment cards. The Eurosystem made further progress on the oversight assessments of international card payment schemes active in the euro area. Moreover, the ECB published the second Eurosystem report on card fraud with cards issued in SEPA. The second report included, for the first time, information on fraud at the level of each EU country and revealed that the overall levels of card fraud had decreased further between 2010 and 2011.

In January 2013 the European Forum on the Security of Retail Payments, which is composed of EU overseers and supervisors of payment service providers, launched a public consultation on a set of draft recommendations for "payment account access" services. Later in the year, the Forum took note of the European Commission proposal for a revised payment services directive, published in July 2013, which assigns to the European Banking Authority (EBA) the task of developing, in

close cooperation with the ECB, guidelines on the security aspects of payment services. This led the Forum to decide to transmit the final text of its recommendations to the EBA and not to publish it, as doing otherwise could have created confusion among market stakeholders. At the same time, however, the Forum agreed to prepare and make public a document in which it summarises the core elements of its work and how best to ensure security of payment account access services. This document also reflected how the Forum took on board the valuable feedback that it received from the market.

Furthermore, in November 2013 the Forum launched a public consultation on the recommendations that it developed for the security of mobile payments. The Forum also examined the possibilities for harmonising the reporting of major security incidents for retail payment systems, payment schemes and payment service providers within the EU. Finally, to ensure consistent assessments by overseers and supervisors, the Forum prepared an assessment guide for the implementation of its January 2013 final recommendations for the security of internet payments. This guide was made available on the ECB's website in February 2014.

5.3 SECURITIES AND DERIVATIVES CLEARING AND SETTLEMENT

The Eurosystem has a strong interest in the smooth functioning of securities clearing and settlement systems because failures in the clearing, settlement and custody of securities could jeopardise the implementation of monetary policy, the smooth functioning of payment systems and the maintenance of financial stability. In recent years, much of the work in this area has focused on contributing to major EU legislative initiatives aimed at establishing a common EU framework for financial market infrastructures.

CENTRAL COUNTERPARTIES AND TRADE REPOSITORIES

In 2013 efforts focused on ensuring the effective implementation of Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories – also known as the European Market Infrastructure Regulation (EMIR) – which entered into force in 2012, as well as of the respective regulatory and implementing technical standards.

Following the entry into force of most technical standards in March 2013, central counterparties (CCPs) and trade repositories had to submit an application for (re)authorisation under EMIR to the competent authorities. In the case of CCPs, the deadline for application was September 2013. The national competent authorities, supported by colleges of authorities, then began the process of deciding whether CCPs were compliant with the EMIR framework and should therefore be authorised. As envisaged by EMIR, the ECB and the Eurosystem NCBs are members of the colleges in their role as the central bank of issue for the euro. Therefore, the Eurosystem will be closely involved in the authorisation process for all EU CCPs with a high volume of euro-denominated central clearing business.

In November 2013 the European Securities and Markets Authority, which is responsible for the authorisation of trade repositories, took over supervisory responsibility for trade repositories authorised in the EU. The ECB participated in 2013 in the cooperative oversight arrangement for the trade depository DDRL UK, which was led by the UK's Financial Conduct Authority.

CENTRAL SECURITIES DEPOSITORIES

In 2013 the ECB contributed to the discussions on primary legislation as well as on the drafting of technical standards under the proposed regulation on improving securities settlement in the EU and on central securities depositories (CSDs). This regulation will establish a common EU framework for the authorisation and supervision of CSDs. The ECB strongly supports the European Commission's proposal to strengthen the legal framework applicable to CSDs, also in the context of the future TARGET2-Securities environment. Political agreement on the regulation between the European Parliament, the European Commission and the EU Council was reached in December 2013, paving the way for its entry into force in 2014.

TARGET2-SECURITIES

TARGET2-Securities (T2S) is an infrastructure project that aims to provide European CSDs with a single, pan-European platform for securities settlement in central bank money. The Eurosystem will oversee T2S services and cooperate with the competent supervisors and overseers of participating CSDs, as well as with central banks of issue for eligible non-euro currencies, in order to share with them comprehensive T2S-related information so that they can perform their statutory duties under their respective legal framework.

Work on the Eurosystem oversight framework for T2S, as well as the cooperative arrangement with other authorities, progressed in 2013. Furthermore, the pre-assessment of the T2S design was updated. Since T2S is still in the development phase, a final assessment is not yet possible and will have to be conducted closer to the launch of the platform.



The distinctive entrance building (in the foreground of the double office tower) and the long horizontal expanse of the Grossmarkthalle round off the building ensemble and define the look of the ECB.

The entrance building not only projects out of the Grossmarkthalle, but also rises above it by a few metres. To enable its construction, three of the 15 concrete shells forming the roof of the Grossmarkthalle were removed. These were not original shells, but replacements for those destroyed during the Second World War. As they therefore were not part of the original substance of the building, it was possible – in agreement with the historic preservation authorities – to remove them to make way for the entrance building.

The northern facade of the entrance building, behind which the press centre is located, is particularly striking: in contrast to that of the double office tower, it is a three-dimensionally curved surface consisting of hyperbolic glass panels. Below it, panels of glass break up the concrete grid facade of the Grossmarkthalle, clearly marking the main entrance to the ECB.

CHAPTER 5

EUROPEAN ISSUES

I POLICY AND INSTITUTIONAL ISSUES

As Europe pursued its policy efforts to cope with the consequences of the economic and financial crisis, 2013 saw a continuation of intense cooperation among EU institutions and bodies, in particular the European Council, the ECOFIN Council, the Eurogroup, the European Commission, the European Parliament and the ECB.

The President of the ECB participated regularly in Eurogroup and ECOFIN Council meetings when matters related to the objectives and tasks of the ESCB were discussed. Moreover, the President of the ECB was invited to take part in European Council meetings, when issues related to the EU's policy response to the economic and financial crisis were addressed, as well as in euro summit meetings. The President of the Eurogroup and the Commissioner for Economic and Monetary Affairs and the Euro participated in meetings of the Governing Council of the ECB, when considered appropriate.

PROGRESS TOWARDS DEEPER ECONOMIC AND MONETARY UNION

In 2012 the Heads of State or Government of the EU agreed on the objective of breaking the negative feedback loops between banks and their sovereigns, putting a stop to the increasing fragmentation of European financial markets and promoting their integration. Important steps were taken in this area in 2013, in particular as regards the establishment of the Single Supervisory Mechanism (SSM). In addition, in December 2013 a general approach was adopted by the ECOFIN Council with regard to the establishment of a Single Resolution Mechanism, and final agreement was reached in the “trialogue” between the European Parliament, the EU Council and the European Commission on the proposed deposit guarantee scheme directive and the proposed bank recovery and resolution directive. Further information regarding the establishment of the SSM can be found in Section 1.3 of Chapter 4.

On 20 March 2013 the European Commission issued a communication on the ex ante coordination of major economic reforms, following up on the European Council conclusions of December 2012. The December 2013 European Council invited the President of the European Council, in close cooperation with the President of the European Commission, to carry work forward on a system of mutually agreed contractual arrangements and associated solidarity mechanisms and to report to the October 2014 European Council with a view to reaching overall agreement on both of these elements. As stressed by the European Council, concrete new steps towards strengthening economic governance will need to be accompanied by further steps towards stronger democratic legitimacy and accountability at the level at which decisions are taken and implemented.

THE EUROPEAN SEMESTER

In November 2012 the European Commission presented its 2013 Annual Growth Survey, which reviews progress towards Europe 2020 targets, sets out the key measures for recovery and growth for the EU as a whole and marks the start of the European Semester. The 2013 survey stressed the need for Member States to (i) pursue differentiated, growth-friendly fiscal consolidation, (ii) restore normal lending to the economy, (iii) promote growth and competitiveness, (iv) tackle unemployment and the social consequences of the crisis, and (v) modernise public administration. The Annual Growth Survey for 2014, presented by the European Commission on 13 November 2013, reiterates these priorities.

At its meeting in March 2013 the European Council endorsed the above five priorities for 2013, which Member States incorporated into their stability or convergence programmes and national reform programmes. Following a review of these programmes, including the implementation of the voluntary commitments under the Euro Plus Pact, the ECOFIN Council issued policy recommendations to each Member State in July 2013, ahead of the adoption of national budgets and other economic reforms which takes place in the second half of the year.

In the context of the macroeconomic imbalance procedure, which aims to prevent and correct macroeconomic imbalances, the European Commission published the second Alert Mechanism Report in November 2012. On the basis of 11 macroeconomic indicators and economic analysis, the report identified 14 Member States whose macroeconomic situation was scrutinised more closely. In April 2013 the Commission published in-depth reviews examining the origin, nature and severity of possible macroeconomic imbalances in 13 of the countries identified in the report.¹ These countries received policy recommendations under the preventive arm of the macroeconomic imbalance procedure. The third Alert Mechanism Report was published in November 2013. It found that EU economies had continued to make progress in correcting their external and internal imbalances but that further progress was needed. It concluded that it was therefore necessary to analyse in further detail the accumulation and unwinding of imbalances, and the related risks, in 16 Member States.

The 2013 European Semester saw the first round of implementation of the “two-pack” regulations, which entered into force in May 2013. The two-pack further strengthens surveillance of euro area countries, building on and complementing the Stability and Growth Pact. Under these new rules, euro area countries submit their draft budgetary plans to the European Commission and the Eurogroup in the autumn so as to ensure ex ante coordination of Member States’ budgets as well as of the fiscal stance in the euro area as a whole. The two-pack also puts in place enhanced surveillance for countries under financial stress and post-programme surveillance for countries which have completed a macroeconomic assistance programme.

The experience with the 2013 European Semester showed that the implementation of policy recommendations, in particular with regard to structural reforms, is still an issue that warrants stronger monitoring throughout the year. In this context, the European Council in June 2013 concluded that the EU Council and the European Commission should closely monitor the implementation of the country-specific recommendations provided to Member States in the context of the European Semester. A first interim overview of the recommendations was provided by the Commission in the 2014 issue of the Annual Growth Survey, which concluded that progress had been made in the area of fiscal consolidation, but that financial market fragmentation had led to very divergent interest rates for loans to businesses and households across the EU, and that in several Member States further progress was needed in the implementation of structural reforms.

THE STABILITY AND GROWTH PACT

In 2013 the majority of EU countries, most of them from the euro area, were still subject to excessive deficit procedures (EDPs). Nevertheless, as a result of consolidation efforts, the total number of countries subject to an EDP declined to 16, compared with 20 at the end of 2012.

In June 2013 the ECOFIN Council issued new recommendations for half of the countries under EDPs, namely Belgium, Spain, France, Cyprus, the Netherlands, Portugal, Slovenia and Poland,

¹ The in-depth review did not cover Cyprus, which was about to implement a macroeconomic adjustment programme.

and re-opened an EDP for Malta, only half a year after abrogating the previous EDP. The recommendations proposed deadline extensions for correcting the excessive deficit, which in most cases exceeded the “one year as a rule” extension foreseen under the Stability and Growth Pact. Spain, France, Slovenia and Poland were granted a two-year extension, with the deadline being moved to 2014 for Poland, to 2015 for France and Slovenia and to 2016 for Spain. The deadline for Cyprus was extended by four years, to 2016. A one-year extension was granted only to the Netherlands, to 2014, and Portugal, to 2015. Under its renewed EDP, Malta was given a deadline of 2014. The ECOFIN Council gave notice to Belgium as it had not taken effective action to correct its excessive deficit by the 2012 deadline. The country was granted an extension of the deadline by the ECOFIN Council and has to ensure a sustainable correction of the excessive deficit from 2013 onwards and sufficient progress towards its medium-term objective in 2014. In December 2013 the ECOFIN Council adopted a new recommendation for Poland, extending the deadline for the correction of the excessive deficit by one year, to 2015. For most countries, the new EDP recommendations also implied a substantial reduction of the recommended corrective effort by comparison with previous EDP recommendations.

Five EU Member States, namely Italy, Latvia, Lithuania, Hungary and Romania, had their EDPs abrogated by ECOFIN Council decisions in June 2013. These decisions were based on Eurostat data confirming that the deficits of these countries had fallen below 3% of GDP and the European Commission’s projections that the deficits would remain below this threshold in 2013 and 2014.²

One milestone of the fiscal governance framework was the fiscal compact, which entered into force on 1 January 2013 as part of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. Participating Member States were obliged to transpose into their national legislation by 1 January 2014 the commitment to maintain a balanced budget throughout the cycle and to introduce an automatic correction mechanism for potential deviations.³

Overall, the concrete transposition of the fiscal compact into national law differs widely across countries. For example, countries have different formulations in terms of the balanced budget rule and underlying legal instruments. For countries that have not yet achieved their medium-term objective, the convergence path towards it is generally defined as annual adjustment of the structural balance towards the objective of 0.5% of GDP. However, the underlying definitions of the “escape clauses” for temporary deviations from the medium-term objective or the adjustment path towards it range widely. There are also differences regarding the automaticity of the correction mechanism in the event of significant deviations from the medium-term objective or the adjustment path towards it, while only a few countries have followed the common principles set out by the European Commission on the nature, size and time frame of corrective action. Finally, regarding the monitoring institutions, independent fiscal councils are currently being set up in a number of countries, while the existing councils appear to fulfil most of the criteria specified by the European Commission. The success of the monitoring institutions will, however, ultimately depend on their impact on the relevant policy debates.

CONVERGENCE REPORT

At the request of the Latvian authorities, the ECB published on 5 June 2013 its assessment of the economic and legal convergence of Latvia in line with Article 140 of the Treaty. The ECB’s

² In Lithuania, the general government deficit stood at 3.2% of GDP in 2012. However, when the direct net costs of a pension reform are accounted for, the deficit threshold was met in 2012.

³ 24 of the 25 countries that signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union have thus far ratified the treaty.

Convergence Report examined whether a high degree of sustainable economic convergence had been achieved in Latvia and gauged Latvijas Banka's compliance with the statutory requirements that an NCB has to fulfil in order to become an integral part of the Eurosystem. The report noted that, while the longer-term sustainability of its economic convergence remained a concern, all in all Latvia was within the reference values of the convergence criteria (see also Chapter 3).

2 EU ENLARGEMENT AND RELATIONS WITH EU CANDIDATE COUNTRIES AND POTENTIAL CANDIDATES

Further progress was made in the EU enlargement agenda over 2013. On 1 July Croatia became the 28th EU Member State, making it the second country of former Yugoslavia to join the EU after Slovenia in 2004.

Moreover, the EU opened accession negotiations with Serbia in January 2014 and started discussions with Kosovo⁴ on a Stabilisation and Association Agreement in October 2013, following a European Council decision in June. This decision recognised the agreement reached by Serbia and Kosovo on the normalisation of their bilateral relations.

In October the European Commission recommended opening negotiations with the former Yugoslav Republic of Macedonia, for the fifth time since 2009. The European Commission recommended for the second time that Albania's status be upgraded from a potential candidate to a candidate country.

Accession negotiations with Montenegro, which started in June 2012, continued; two negotiation chapters have been provisionally closed. In October 2013 the European Council decided to open a new negotiation chapter with Turkey; accession negotiations with the country have been ongoing since 2005, with one negotiation chapter provisionally closed. Accession negotiations with Iceland (opened in 2010) were put on hold by the Icelandic government following the general elections in April 2013.

On the basis of its analysis of economic and financial developments in EU candidate countries, the ECB continued its policy dialogue with the central banks of these countries in 2013 through bilateral meetings and within the overall institutional framework for the enlargement process set up by the EU. The ECB held its annual high-level policy dialogue with the Central Bank of the Republic of Turkey in June in Ankara. A high-level policy dialogue was held for the first time with the Central Bank of Montenegro in July in Podgorica. Moreover, close relations with the central banks of candidate countries and potential candidates, as well as those of other countries, have been maintained through technical cooperation programmes (see Section 2 of Chapter 6).

⁴ This designation is without prejudice to positions on status, and is in line with United Nations Security Council Resolution 1244 and the International Court of Justice's opinion on Kosovo's declaration of independence.



The eastern interior facade of the entrance building, which separates the press centre from the main lobby, consists of translucent glass panels mounted on a customised steel grid. The translucency of the glass panels is created by sandblasting the glass.

CHAPTER 6

INTERNATIONAL ISSUES

I KEY DEVELOPMENTS IN THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM

SURVEILLANCE OF MACROECONOMIC POLICIES IN THE GLOBAL ECONOMY

Given the high degree of global economic and financial integration, a good understanding of the international environment through monitoring and analysis is essential to policy-making in the euro area. The ECB also plays an important role in the process of international multilateral surveillance of macroeconomic policies and financial stability, which at the central banking level is mainly coordinated by the BIS. Moreover, the ECB participates in working groups and meetings of international organisations such as the IMF and the OECD, as well as fora such as the G20 and G7 finance ministers and central bank governors.

In 2013 the international economic environment was characterised by a restrained economic recovery, with GDP growth projected to have declined to 1.3% for advanced economies (compared with 1.4% in 2012) and to 4.7% for emerging market and developing economies (compared with 4.9% in 2012), according to the latest IMF projections. Amid this subdued global economic recovery, discussions in international institutions and fora stressed the need to increase the momentum of the global recovery and to tackle near-term risks to the economic outlook, while at the same time strengthening the foundations for strong, sustainable and balanced growth. In that context, the G20 leaders at their St Petersburg summit agreed on a set of actions designed to boost economic activity and job creation and to support the medium-term recovery. In particular, they agreed on a new framework to safeguard fiscal sustainability, on boosting investment, on increasing productivity and labour force participation by stepping up structural reform efforts and on addressing internal and external demand rebalancing. The international community also stressed the importance of a more inclusive pattern of growth as unemployment, particularly among young people, remained persistently high.

As regards central banks' actions, discussions at the global level showed broad consensus that the accommodative monetary policies in advanced economies, including unconventional monetary policy measures, had been supportive of the global recovery. At the same time, there was recognition of the need to remain mindful of unintended consequences and potential spillover effects on other countries.

The ECB continued to play an active role in the G20 and its various work streams. Under the Russian presidency in 2013 these work streams focused on: (i) improving the foundations for strong, sustainable and balanced growth (including an agreement on the post-Toronto fiscal consolidation strategies); (ii) advancing the global financial regulatory agenda (including progress in the fields of Basel III implementation, over-the-counter derivatives, global systemically important financial institutions and shadow banking); (iii) strengthening the international financial architecture, with a particular focus on IMF quota and governance reform; (iv) addressing tax base erosion and profit-shifting; and (v) improving the availability of long-term investment financing. In September 2013 the G20 leaders adopted the St Petersburg Action Plan, which focuses on policy actions to support the near-term recovery and improve the medium-term foundations for global growth, and on strengthening financial stability. In addition, the G20 members endorsed their Accountability Assessment, in which they took stock of previous policy commitments.

Finally, the euro area itself is subject to international policy surveillance exercises by the IMF and the OECD. In 2013 the IMF conducted its regular review of the monetary, financial and economic policies of the euro area, as a complement to its reviews of the individual euro area countries. The ECB also participated in discussions related to the IMF's Financial Sector Assessment Program for the EU.

REFORMS IN INTERNATIONAL INSTITUTIONAL PROCESSES AND PRACTICES

Following standard practice, the ECB continued to monitor and to help shape developments in the international monetary system in 2013. While progress was made in implementing reforms related to increasing IMF resources and improving IMF surveillance and governance, the completion of the 2010 IMF quota and governance reform is being held up by delays in ratification by a sufficient majority of the membership.

As part of the efforts to overcome the global financial crisis, it was decided that the optimal way to further augment IMF resources in the short term was through new temporary bilateral loans and note purchase agreements with its members. During the Spring Meetings of the IMF and World Bank in 2012 38 countries (including 18 EU Member States) committed to increase IMF resources by USD 461 billion through bilateral borrowing agreements. By the end of December 2013 agreements with 30 of these countries (15 of which were EU Member States) had come into effect for a total amount of USD 424 billion.

Following the 2011 Triennial Surveillance Review, the IMF has undertaken major initiatives to strengthen surveillance to respond to a more globalised and interconnected world. These initiatives include revising the legal framework for surveillance, deepening the analysis of risks and financial systems, stepping up assessments of members' external positions, responding more promptly to membership concerns, and better addressing the possible effects of spillovers from members' policies on global stability.

On the operational side, a Spillover Report has been published since 2011, assessing the impact of economic policies in the world's five largest economies on partner economies. The 2013 report examined in particular potential spillovers arising from the euro area crisis, US fiscal and monetary policy, structural and fiscal reforms in Japan, and a possible slowdown in China. Similarly, a Pilot External Sector Report was produced in 2012 and 2013, providing an assessment of the external positions of 29 systemic advanced and emerging market economies, including the euro area as a whole and several euro area members individually.

In May 2013 the IMF strengthened its debt sustainability analysis by updating its Staff Guidance Note for Public Debt Sustainability Analysis in Market-Access Countries, which will lead in particular to more in-depth analysis with respect to the underlying assumptions and macro-fiscal risks.

The effectiveness and credibility of the IMF hinges on its broad membership, which should be reflected in its governance. A comprehensive review of the current quota formula was completed in January 2013, when the IMF Executive Board submitted its report to the Board of Governors. The outcome of this review will form the basis for Executive Board discussions as part of the 15th General Review of Quotas. Originally brought forward by about two years to January 2014, the deadline for the completion of the 15th General Review of Quotas has been put back to January 2015, owing to delays in implementing the 2010 IMF quota and governance reform. European countries have already taken actions that will lead to a reduction of advanced European country representation in the IMF Executive Board by 1.64 seats.

2 COOPERATION WITH COUNTRIES OUTSIDE THE EU

In 2013 the ECB actively participated alongside the European Commission in the EU's macroeconomic dialogue with key emerging market economies (e.g. China, India, Israel and Russia). As in previous years, the Eurosystem organised seminars and workshops with non-EU central banks in order to foster policy dialogue. A high-level seminar with the Bank of Russia was held on 15 February in Moscow. The topics of the seminar were economic developments in Russia and the euro area and the changing role of central banks in terms of both monetary policy and financial stability and supervision.

TECHNICAL COOPERATION

The technical cooperation provided by the Eurosystem remained an important tool for strengthening the institutional capacity of central banks outside the EU, especially in EU candidate and potential candidate countries, and for enhancing compliance with European and international standards.

The ECB commemorated ten years of ECB-coordinated technical cooperation with a conference held on 3-4 December 2013 in Frankfurt. Since 2003 the ECB, together with the NCBs, has implemented several EU-funded technical cooperation programmes for the benefit of central banks and banking supervisors in various countries. In addition, the ECB has strengthened its long-term cooperation with a number of central banks through memoranda of understanding.

In December 2013 the ECB and 21 NCBs completed an EU-funded technical cooperation programme with the National Bank of Serbia. This programme, which was launched in February 2011, helped the National Bank of Serbia to strengthen its institutional capacities and align its processes and regulations with EU and international standards.

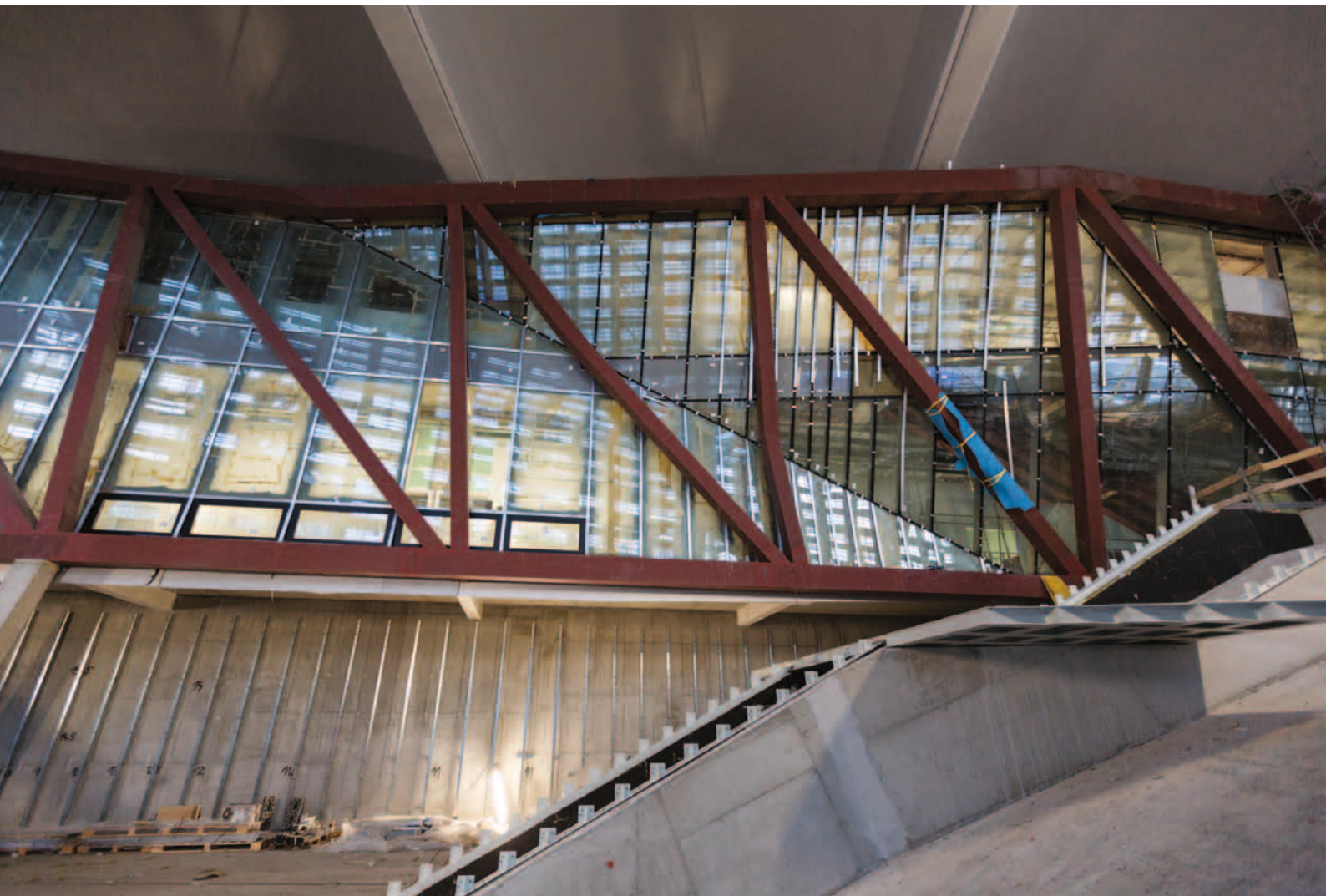
In July 2013 the Eurosystem completed a technical cooperation programme with the National Bank of the Republic of Macedonia. The ECB and 11 NCBs participating in the programme presented a needs analysis report to the Governor of the National Bank of the Republic of Macedonia, which covered ten areas of central banking. The report contained an assessment of the central bank's current institutional and operational framework, as well as recommendations to further strengthen its institutional capacity to bring it closer to EU central banking standards.

On 19 December 2013 the ECB signed a contract with the European Commission to carry out technical cooperation with the Bank of Albania and the Central Bank of the Republic of Kosovo. The ECB will implement the programme in partnership with 11 NCBs. The programme will assess the current institutional and operational frameworks of the central banks and compare them with EU central banking standards. The Bank of Albania and the Central Bank of the Republic of Kosovo will each receive a needs analysis report with recommendations on how to reinforce their institutional capacity and bring their practices more in line with EU central banking standards. The programme will also take stock of priorities for further strengthening the institutional capacity of the National Bank of the Republic of Macedonia and possibly of other central banks in the region.

The ECB and the Central Bank of the Republic of Turkey continued their cooperation and regular policy dialogue based on a memorandum of understanding signed in July 2012. In 2013 cooperation included a joint conference on international linkages and spillovers in Izmir, a seminar on financial statistics in Ankara and a six-month secondment of a staff member from the Central Bank of the Republic of Turkey to the ECB.

Cooperation also continued under the memorandum of understanding with the Bank of Russia that was signed in October 2012, which covers cooperation at the technical level as well as policy discussions. In 2013 activities focused mainly on monetary policy and financial stability and took place in the form of seminars; a member of staff from the Bank of Russia was also seconded to the ECB. Events on the topic of banking supervision were also held in the course of the year, with the involvement of several euro area NCBs, as well as the European Systemic Risk Board and the European Banking Authority.

In 2013 the ECB and the People's Bank of China continued implementing their memorandum of understanding through meetings of their bilateral working group and information exchanges at staff level. The memorandum, which was signed in 2008, aims to strengthen cooperation between the two institutions and foster information-sharing. As part of the EU-China Trade Project, the ECB received three groups of staff from the People's Bank of China to discuss monetary policy, market operations and IT security.



In line with the “house-in-house” concept designed by the Viennese architects COOP HIMMELB(L)AU, the conference area and staff restaurant have been integrated into the Grossmarkthalle as separate building elements. These have a structural framework of steel posts and beams, and individual facades consisting of thermal insulation glass. While the new building elements are enclosed units with their own temperature regulation system, the open areas of the Grossmarkthalle surrounding them will be affected by the seasonal air temperatures outside.

CHAPTER 7

EXTERNAL COMMUNICATION AND ACCOUNTABILITY

I ACCOUNTABILITY AND COMMUNICATION POLICY

Central bank independence has established itself over the past few decades as an indispensable element of the monetary policy regimes of both advanced and emerging market economies. The decision to grant central banks independence has long been firmly supported by economic theory and empirical evidence, both of which show that such a set-up is conducive to maintaining price stability. At the same time, it is a founding principle of democratic societies that any independent institution bestowed with a public function must be accountable to citizens and their representatives. Accountability is therefore an important counterpart of central bank independence.

The ECB's commitment to accountability and transparency is illustrated by its reporting to European citizens and their elected representatives, the European Parliament. The Treaty lays down precise reporting requirements for the ECB, which include the publication of a weekly financial statement, a quarterly report and an annual report. The ECB goes far beyond these statutory obligations in its regular reporting, for instance by publishing a Monthly Bulletin, rather than the required quarterly report. The ECB's commitment to accountability and transparency is also illustrated by the numerous speeches delivered by the members of the Governing Council, which deal with a broad variety of topics of relevance to the ECB's tasks. In addition, the President of the ECB appears four times a year before the European Parliament. The ECB also replies to written questions from Members of the European Parliament (MEPs) and publishes these questions and answers on its website.

On 3 November 2013 the Council Regulation conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions entered into force. From 4 November 2014 onwards the ECB will assume its full role as single supervisor and in particular will directly supervise significant banks in the countries participating in the Single Supervisory Mechanism (SSM). Supervisory tasks will be carried out by the ECB separately from its tasks relating to monetary policy and from its other tasks. Banking supervision therefore requires a different form of accountability from the other tasks conferred on the ECB by the Treaties. Pursuant to the relevant provisions in the above-mentioned SSM Regulation, the ECB and the European Parliament signed an inter-institutional agreement in November 2013 to ensure an appropriate framework of accountability for the ECB's supervisory tasks. In addition, the ECB and the EU Council signed a Memorandum of Understanding (MoU) laying down in more detail the provisions of the SSM Regulation on cooperation between the two institutions and the accountability obligations related to the ECB's supervisory tasks. The MoU entered into force on 11 December 2013.

External communication at the ECB aims to enhance the public's understanding of the ECB's policies and decisions and, as such, is an integral part of the ECB's monetary policy and its other tasks. Two key elements – openness and transparency – guide the ECB's communication activities. Both contribute to the effectiveness, efficiency and credibility of the ECB's monetary policy and its other statutory tasks. They also support the ECB's efforts to give a full account of its actions.

The ECB's concept of real-time, regular and comprehensive explanations of its monetary policy assessment and decisions, which was introduced in 1999, represents a uniquely open and transparent approach to central bank communication. Monetary policy decisions are explained at a press conference immediately after the Governing Council has taken them. The President delivers

a detailed introductory statement at the press conference, explaining the Governing Council's decisions. The President and Vice-President are then at the media's disposal to answer questions. Since December 2004 decisions taken by the Governing Council other than those setting interest rates have also been published every month on the websites of the Eurosystem central banks.

ECB legal acts are made available in all the official languages of the EU, as are the Governing Council's monetary policy decisions, the decisions taken by the Governing Council in addition to decisions setting interest rates, and the consolidated financial statements of the Eurosystem.¹ The ECB's Annual Report is also made available in full in all official EU languages.² The Convergence Report and the quarterly issues of the ECB's Monthly Bulletin are made available either in full or in summary form in all official EU languages.³ For the purposes of public accountability and transparency, the ECB also publishes other documentation – in addition to the statutory publications – in some or all official languages, in particular press releases announcing staff macroeconomic projections, policy positions and information of relevance to the general public. The preparation, publication and distribution of the national language versions of the ECB's key publications are undertaken in close collaboration with the NCBs.

2 ACCOUNTABILITY TO THE EUROPEAN PARLIAMENT

The European Parliament, as the only EU institution whose members are directly elected by the citizens of the EU, plays a key role in holding the ECB to account. In 2013 the two institutions continued their close and fruitful dialogue.

The President of the ECB appeared four times in 2013 before the European Parliament's Committee on Economic and Monetary Affairs to inform MEPs about recent economic and monetary developments and to answer their questions. Furthermore, he participated in the two plenary sessions of the European Parliament at which the ECB's Annual Reports for 2011 and 2012 were discussed and in a meeting of the Parliament's Conference of Presidents in December 2013.

Other members of the ECB's Executive Board also appeared before the European Parliament. The Vice-President presented the ECB's Annual Report for 2012 to the Committee on Economic and Monetary Affairs. Jörg Asmussen participated in an exchange of views in the same committee alongside Commissioner Rehn to give the ECB's assessment of the situation in Cyprus and to answer questions from members. Peter Praet participated in the European Parliamentary Week on the European Semester for Economic Policy Coordination. In addition, ECB staff provided technical expertise to the European Parliament on issues related to the ECB's field of competence, such as the SSM and the economic situation in countries under an EU-IMF adjustment programme. Furthermore, the ECB answered 42 written questions by MEPs and published the replies on its website in 2013.

BANKING UNION

The preparations for the SSM figured prominently in the exchanges between the ECB and the European Parliament. Discussions mainly focused on the separation between supervision and monetary policy-making and on the accountability framework for the SSM. The latter was formalised in the inter-institutional agreement that entered into force in November 2013. The two

1 With the exception of Irish, for which a derogation is in effect at the EU level.

2 With the exception of Irish (by EU derogation) and Maltese (by agreement with the Central Bank of Malta, following the lifting of the temporary EU derogation in May 2007).

3 See footnote 2.

institutions agreed on the need for the Supervisory Board of the SSM to be set up swiftly so that rapid progress might be made in selecting the Chair of the Supervisory Board. The European Parliament was involved in this selection process as foreseen in the provisions of the SSM Regulation. MEPs also asked about the modalities of the comprehensive assessment being conducted by the ECB in preparation for the SSM. In his regular hearings the President of the ECB stressed the importance of this exercise for the credibility of banking union and for long-term growth prospects.

Another key issue was the work towards establishing a Single Resolution Mechanism and the finalisation of the single rulebook. The President of the ECB repeatedly stressed to the Committee on Economic and Monetary Affairs the importance of having uniform rules for banking resolution as soon as possible. He also emphasised on numerous occasions how vital it was that banking union be completed with a Single Resolution Mechanism as a necessary complement to the SSM.

FINANCING CONDITIONS OF THE REAL ECONOMY

During the committee hearings of the President of the ECB, a number of MEPs voiced concerns about the financing conditions of the real economy, in particular of small and medium-sized enterprises. They inquired about possible measures to reduce the significant divergences prevailing across euro area countries.

The President underlined the importance of completing banking union to rein in fragmentation and to improve financing conditions for the private sector across the euro area. He also stressed the role of Outright Monetary Transactions in this respect and explained on various occasions the non-standard measures of the ECB.

At the same time, the President and other ECB representatives also made it clear that national governments and the legislators at both the national and the European level had to undertake the necessary steps to decrease fragmentation in a sustainable fashion for the benefit of the real economy.

3 COMMUNICATION ACTIVITIES

The ECB addresses a variety of audiences – the media, financial experts, academia, parliaments and public institutions, as well as the general public – with varying levels of knowledge regarding finance and economics. Its mandate and decisions are therefore explained through a range of communication tools and activities which are constantly being refined in order to make them as effective as possible, taking into account the different audiences and the relevant communication environments and needs.

In 2013 the Executive Board confirmed that strengthening communication remained one of the medium-term strategic priorities of the ECB. The ECB's communication activities continued to focus on the ECB's accommodative monetary policy, efforts to maintain ample liquidity conditions for the banking sector and the strengthening of the governance and functioning of the euro area. The vast majority of public speeches delivered by members of the Executive Board were related to these issues. In addition, communication activities were conducted in the countries under EU-IMF financial assistance programmes. These topics also dominated the questions and requests for information received from the media, the public and visitors to the ECB.

The ECB publishes a number of regular and periodic studies and reports. These include the Annual Report, which presents a review of the ECB's activities in the previous year, and the Monthly Bulletin, which provides regular updates on the ECB's assessment of economic and monetary developments and detailed information underlying its decisions. The ECB issued 201 press releases in 2013, covering all aspects of the ECB's policies and activities, as well as additional information related to the implementation of monetary policy. The ECB also provides a wide range of statistical data, primarily by means of the Statistical Data Warehouse and interactive charts on the ECB's website.

All members of the ECB's Executive Board continued to contribute directly to enhancing public knowledge and understanding of the Eurosystem's tasks and policies by giving testimonies before the European Parliament, delivering public speeches and granting interviews to the media. Over the course of 2013 the members of the Executive Board delivered more than 150 speeches to a variety of audiences and granted over 140 interviews to the media. Some of the speeches were translated into several official EU languages to make them accessible to a wider audience.

In 2013 the ECB organised 20 seminars for journalists at its premises, as well as one in Amsterdam and one in Brussels. They were all aimed at enhancing the knowledge and understanding of the media as regards the ECB's mandate, tasks and activities. Some of these seminars were organised in cooperation with the NCBs, the European Commission, the European Journalism Centre and other public authorities. In addition to the monthly press conference following the meetings of the Governing Council, the ECB organised numerous press briefings aimed at fostering a greater understanding of other ECB policies and actions.

The ECB welcomed 587 groups of visitors to its current and future premises in Frankfurt in 2013. Some 16,312 visitors received first-hand information in the form of presentations given by ECB staff and tours of the site of the new ECB premises.

A number of high-level international conferences, workshops and seminars were organised in 2013, including an ECB workshop on "Non-standard monetary policy measures", a conference entitled "The future of banking regulation and supervision in the EU", and several events organised in cooperation with other institutions, such as "Financial integration and stability: the impact of ongoing reforms on financial integration" with the European Commission. As in previous years, in May 2013 the ECB had an information stand at the open day events hosted by the EU Council in Brussels and the European Parliament in Strasbourg. For the first time, the ECB also joined the EU delegation to the United States at their open days, informing US citizens and other visitors about the ECB and the euro banknotes and coins.

All documents published by the ECB and other information about its various activities are available on the ECB's website. In 2013 the website received 27 million visits; 517 million pages were viewed and 75 million documents were downloaded. In 2013 the ECB replied to around 80,000 enquiries from the public requesting information on issues related to the ECB's activities, policies and decisions. The ECB has further expanded its presence in social media. Its Twitter account has around 100,000 followers and is used to highlight publications and speeches. In 2013 the ECB opened a Google+ page which relays the ECB's RSS information and is actively followed in particular by other EU institutions and economists. A Facebook page is maintained for the Generation Euro Students' Award competition. In addition, the ECB uses its YouTube channel to publish videos of its monthly press conferences and other films.

In an effort to strengthen its educational outreach activities the ECB and the euro area NCBs released a new web-based educational game called “Top Floor – Make Your Way Up!” in April and an animation entitled “The ECB and the Eurosystem explained in three minutes” in September 2013. Both are available in the “Educational” section of the ECB’s website.

On 17 April 2013 Mario Draghi and the governors of the respective euro area NCBs presented the Europe-level prizes to the teams that had won the national contests of the Generation Euro Students’ Award 2012/13. This competition, which is held each year, aims to enhance the understanding of teenagers of the central bank’s role in the economy. More than 3,500 students from the euro area, aged between 16 and 19, entered the competition. The following year’s competition was launched on 1 October 2013.

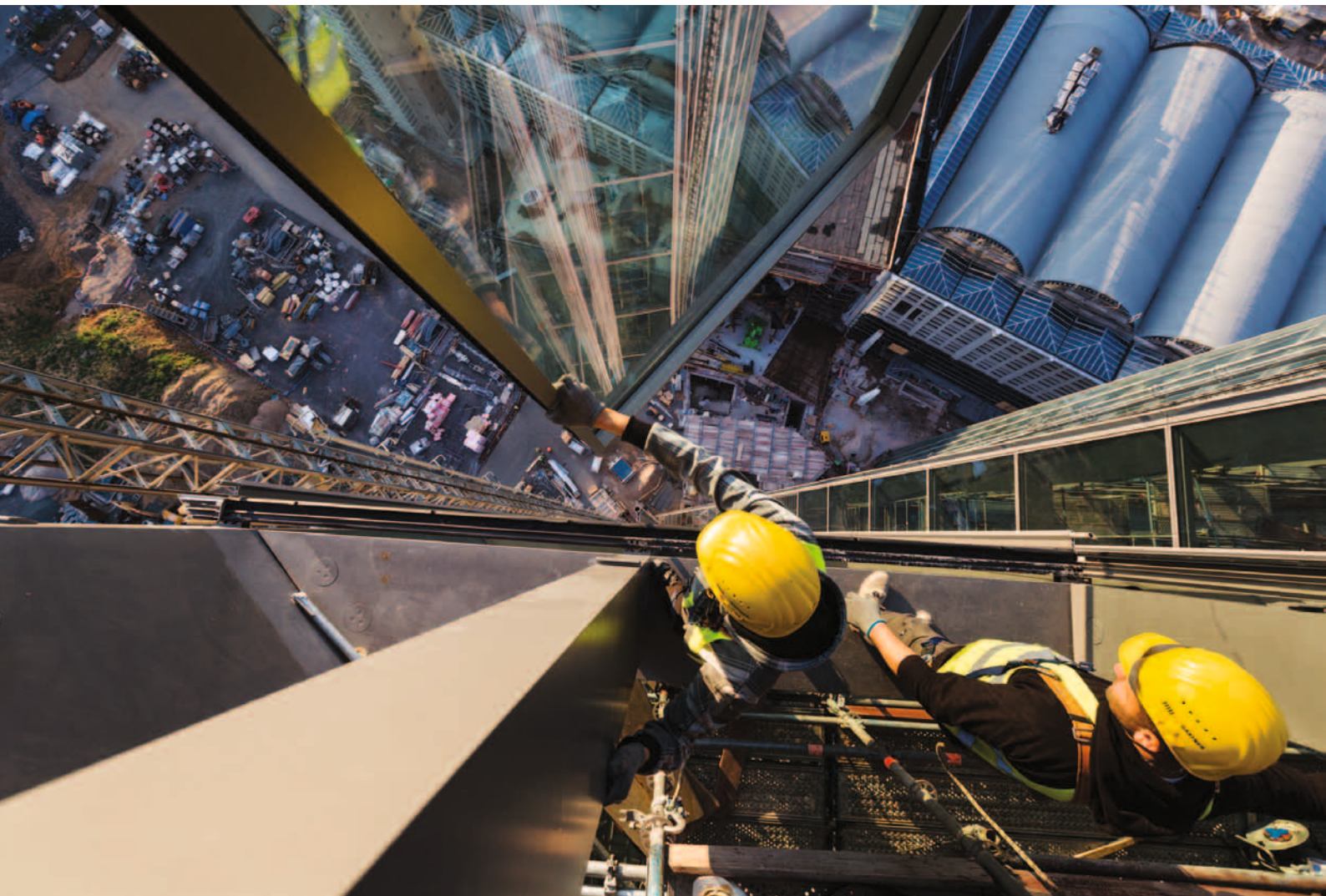
With regard to communication activities concerning the SSM, the ECB created a new “Banking Supervision” section on its website in September 2013. This section provides information about key features of the SSM and important milestones in its development. These web pages will be developed further as the ECB prepares to assume full responsibility for supervision in November 2014. In October 2013 the ECB communicated the details of the comprehensive assessment being conducted in preparation for the SSM. The list of banks subject to the assessment was also published. The details can be found in the “Banking Supervision” section of the ECB’s website.

Communication activities in 2013 also focused on euro banknotes, in particular in relation to the preparations for the changeover in Latvia⁴ and the issuance on 2 May of the new €5 banknote, which was the first denomination of the new series of euro banknotes. The ECB implemented a number of communication measures aimed at informing the general public and cash handlers about the new banknote and its updated security features. These measures included over 3 million leaflets sent to businesses which handle cash on a day-to-day basis in April 2013, a set of videos produced for the internet for the launch in May 2013, a digital marketing campaign in the months following the issuance to direct people searching for information on the new banknote online to the ECB’s dedicated banknote website,⁵ and a travelling exhibition on the euro banknotes and coins, which visited Frankfurt, Madrid, Bratislava and Riga over the course of 2013. To help key stakeholders such as banknote equipment manufacturers, commercial banks and major retailers prepare for the issuance of future denominations, the ECB organised a major partnership event in Brussels in November 2013.

In 2013 the EUROPEAN CULTURAL DAYS of the ECB were dedicated to Latvia and organised in close cooperation with Latvijas Banka. From 16 October to 15 November 2013 a wide variety of events were held at various locations in Frankfurt, featuring some of the most characteristic aspects of Latvian culture. The programme included classical music, avant-garde pop music, literature readings, film screenings, a theatre project, exhibitions focusing on architecture and photography, and several special events for children. The EUROPEAN CULTURAL DAYS were launched in 2003 and have become a fixture in the cultural life of Frankfurt and the surrounding area. The initiative aims to raise awareness of the EU’s cultural diversity and foster mutual understanding among Europeans.

⁴ For more details, see Section 4 of Chapter 3.

⁵ www.new-euro-banknotes.eu



The panes of glass for the facade of the atrium – which connects the two polygonal towers – are mounted on a customised steel grid. The grid is strong enough to bear the weight of the glass panels along the full height of the atrium and is therefore clearly visible through them. In line with the design concept, the glazing of the atrium is neutral in colour and transparent. This enables people to see straight through the atrium and clearly distinguish the two separate towers of the high-rise. This impression of a transparent atrium is enhanced by its roof, which is also made of glass. The glass is coated in such a way that it absorbs less than 10% of the energy from the sun, though the sky can still be seen through it.

CHAPTER 8

INSTITUTIONAL FRAMEWORK AND ORGANISATION

I DECISION-MAKING BODIES AND CORPORATE GOVERNANCE OF THE ECB

I.1 THE EUROSISTEM AND THE EUROPEAN SYSTEM OF CENTRAL BANKS

The Eurosystem is the central banking system of the euro area. It comprises the ECB and the NCBs of the EU Member States whose currency is the euro (18 since 1 January 2014). The ESCB is composed of the ECB and the NCBs of all EU Member States (28 since 1 July 2013), i.e. it also includes the NCBs of the Member States which have not yet adopted the euro.

The ECB is the core of the Eurosystem and the ESCB and ensures that the operations which form part of the tasks of the ESCB are carried out either through its own activities or via the NCBs, to which the ECB shall have recourse to the extent deemed possible and appropriate. The ECB is an EU institution and has legal personality under public international law.

Each NCB has legal personality according to the law of its respective Member State. The euro area NCBs, which form an integral part of the Eurosystem, carry out the tasks conferred upon the



Eurosystem in accordance with the rules established by the ECB's decision-making bodies. The NCBs also contribute to the work of the Eurosystem and the ESCB through their participation in the Eurosystem/ESCB committees (see Section 1.5 of this chapter). They may perform non-Eurosystem functions on their own responsibility, unless the Governing Council finds that such functions interfere with the objectives and tasks of the Eurosystem.

The Eurosystem and the ESCB are governed by the decision-making bodies of the ECB: the Governing Council and the Executive Board. The General Council is constituted as a third decision-making body of the ECB, for as long as there are EU Member States which have not yet adopted the euro. The functioning of the decision-making bodies is governed by the Treaty, the Statute of the ESCB and the relevant Rules of Procedure.¹ Decision-making within the Eurosystem and the ESCB is centralised. However, the ECB and the euro area NCBs jointly contribute, strategically and operationally, to attaining the common goals of the Eurosystem, with due respect to the principle of decentralisation in accordance with the Statute of the ESCB.

1.2 THE GOVERNING COUNCIL

The Governing Council comprises the members of the Executive Board of the ECB and the governors of the NCBs of the Member States which have adopted the euro. In view of Latvia's adoption of the euro as of January 2014, the Governor of Latvijas Banka, the central bank of Latvia, was invited to attend the meetings of the Governing Council in an observer capacity between July and December 2013.

The Governing Council's main responsibilities, as laid down in the Treaty, are:

- to adopt the guidelines and take the decisions necessary to ensure the performance of the tasks entrusted to the Eurosystem;
- to formulate the monetary policy of the euro area, including, as appropriate, decisions relating to intermediate monetary objectives, key interest rates and the supply of reserves in the Eurosystem, and to establish the necessary guidelines for their implementation.

In the context of the ECB's new responsibilities relating to the prudential supervision of credit institutions, the Governing Council also has the competence to adopt decisions related to the general framework under which supervisory decisions will be taken. Furthermore, it will adopt decisions relating to the micro-prudential and macro-prudential supervisory tasks conferred on the ECB, in accordance with the SSM Regulation and the ECB's Rules of Procedure.

The Governing Council meets, as a rule, twice a month at the ECB's premises in Frankfurt am Main, Germany. It conducts, *inter alia*, an in-depth assessment of monetary and economic developments and takes related decisions specifically at its first meeting of the month, while the second meeting usually focuses on issues related to other tasks and responsibilities of the ECB and the Eurosystem.

¹ For the ECB's Rules of Procedure, see: Decision ECB/2014/1 of 22 January 2014 amending Decision ECB/2004/2 of 19 February 2004 adopting the Rules of Procedure of the European Central Bank; Decision ECB/2004/2 of 19 February 2004 adopting the Rules of Procedure of the European Central Bank, OJ L 80, 18.3.2004, p. 33; Decision ECB/2004/12 of 17 June 2004 adopting the Rules of Procedure of the General Council of the ECB, OJ L 230, 30.6.2004, p. 61; and Decision ECB/1999/7 of 12 October 1999 concerning the Rules of Procedure of the Executive Board of the ECB, OJ L 314, 8.12.1999, p. 34. These rules are also available on the ECB's website.

In 2013 two meetings were held outside Frankfurt, one hosted by Národná banka Slovenska in Bratislava and the other hosted by the Banque de France in Paris. In addition to these meetings, the Governing Council may also hold meetings by means of teleconference or take decisions by written procedure.

When taking decisions on monetary policy and on other tasks of the ECB and the Eurosystem, the members of the Governing Council do not act as national representatives, but in a fully independent personal capacity. This is reflected by the principle of “one member, one vote” applied within the Governing Council. In 2008 the Governing Council decided to continue its existing voting regime – as provided for by Article 10.2 of the Statute of the ESCB – and to introduce a rotation system only when the number of governors in the Governing Council exceeds 18.

The Governing Council is assisted by the ECB Audit Committee with regard to matters related to the corporate governance of the ECB and the Eurosystem.

THE GOVERNING COUNCIL

Front row (from left to right):

Patrick Honohan, Benoît Cœuré,
Sabine Lautenschläger, Mario Draghi,
Vitor Constâncio, Yves Mersch

Middle row (from left to right):

Carlos Costa, Luc Coene,
Christian Noyer, Jens Weidmann,
Jozef Makúch, Josef Bonnici

Back row (from left to right):

Boštjan Jazbec, Erkki Liikanen,
Ardo Hansson, George A. Provopoulos,
Gaston Reinesch, Ilmārs Rimšēvičs,
Klaas Knot, Peter Praet



Note: Panicos O. Demetriades,
Luis M. Linde, Ewald Nowotny and
Ignazio Visco were not available at the
time the photograph was taken.

Mario Draghi

President of the ECB

Vitor Constâncio

Vice-President of the ECB

Jörg Asmussen

Member of the Executive Board of the ECB
(until 7 January 2014)

Josef Bonnici

Governor of the Central Bank of Malta

Luc Coene

Governor of the Nationale Bank van België/
Banque Nationale de Belgique

Benoît Cœuré

Member of the Executive Board of the ECB

Carlos Costa

Governor of the Banco de Portugal

Panicos O. Demetriades

Governor of the Central Bank of Cyprus

Ardo Hansson

Governor of Eesti Pank

Patrick Honohan

Governor of the Central Bank of Ireland

Boštjan Jazbec

Governor of Banka Slovenije
(from 17 July 2013)

Klaas Knot

President of De Nederlandsche Bank

Marko Kranjec

Governor of Banka Slovenije
(until 16 July 2013)

Sabine Lautenschläger

Member of the Executive Board of the ECB
(from 27 January 2014)

Erkki Liikanen

Governor of Suomen Pankki – Finlands Bank

Luis M. Linde

Governor of the Banco de España

Jozef Makúch

Governor of Národná banka Slovenska

Yves Mersch

Member of the Executive Board of the ECB

Ewald Nowotny

Governor of the Oesterreichische Nationalbank

Christian Noyer

Governor of the Banque de France

Peter Praet

Member of the Executive Board of the ECB

George A. Provopoulos

Governor of the Bank of Greece

Gaston Reinesch

Governor of the Banque centrale du
Luxembourg

Ilmārs Rimšēvičs

Governor of Latvijas Banka
(from 1 January 2014)

Ignazio Visco

Governor of the Banca d'Italia

Jens Weidmann

President of the Deutsche Bundesbank

I.3 THE EXECUTIVE BOARD

The Executive Board comprises the President and the Vice-President of the ECB and four other members appointed by the European Council, acting by qualified majority, after consultation of the European Parliament and of the ECB. The main responsibilities of the Executive Board, which as a rule meets once a week, are:

- to prepare the meetings of the Governing Council;
- to implement the monetary policy of the euro area in accordance with the guidelines and decisions laid down by the Governing Council and, in doing so, to give the necessary instructions to the euro area NCBs;
- to manage the current business of the ECB;
- to exercise certain powers delegated to it by the Governing Council, including some of a regulatory nature.

The Executive Board is assisted by a Management Committee in matters relating to the ECB's management, business planning and annual budget process. The Management Committee is chaired by one Executive Board member and comprises a number of senior managers.

THE EXECUTIVE BOARD

Front row (left to right):
Sabine Lautenschläger,
Mario Draghi (President),
Vitor Constâncio (Vice-President)

Back row (left to right):
Yves Mersch, Peter Praet,
Benoît Cœuré



Mario Draghi

President of the ECB

Vitor Constâncio

Vice-President of the ECB

Jörg Asmussen

Member of the Executive Board of the ECB
(until 7 January 2014)

Benoît Cœuré

Member of the Executive Board of the ECB

Sabine Lautenschläger

Member of the Executive Board of the ECB
(from 27 January 2014)

Yves Mersch

Member of the Executive Board of the ECB

Peter Praet

Member of the Executive Board of the ECB

I.4 THE GENERAL COUNCIL

The General Council is composed of the President and the Vice-President of the ECB and the governors of the NCBs of all 28 EU Member States. When Croatia joined the EU in July 2013, the Governor of Hrvatska narodna banka became a member of the General Council.² The General Council mainly carries out those tasks taken over from the European Monetary Institute which still have to be performed because not all the Member States have adopted the euro. These tasks include strengthening cooperation between the NCBs, supporting the coordination of the monetary policies of the Member States with the aim of ensuring price stability, and monitoring the functioning of ERM II. Moreover, it reports – in the form of the ECB’s Convergence Report – to the EU Council on the progress made by Member States which have not yet adopted the euro in fulfilling their obligations regarding the achievement of EMU. It also contributes to the advisory functions of the ECB. In 2013 the General Council had its four quarterly meetings, as well as one meeting for the adoption of the ECB’s Convergence Report.

² The Governor of Hrvatska narodna banka was invited to attend the meetings of the General Council in an observer capacity from December 2011, in preparation for Croatia’s accession to the EU.

THE GENERAL COUNCIL

Front row (left to right):

Luis M. Linde, Carlos Costa,
Stefan Ingves, Vítor Constâncio,
Mario Draghi, Mark Carney,
Josef Bonnici, Ignazio Visco,
György Matolcsy

Middle row (left to right):

Ewald Nowotny, Marek Belka,
Christian Noyer, Jozef Makúch,
Panicos O. Demetriades, Luc Coene,
Patrick Honohan, Boris Vujčić,
Gaston Reinesch

Back row (left to right):

Erkki Liikanen, Ardo Hansson,
Ivan Iskrov, Ilmārs Rimšēvičs,
Klaas Knot, Lars Rohde,
Vitas Vasiliauskas, Jens Weidmann,
Miroslav Singer, Boštjan Jazbec

Note: Mugur Constantin Isărescu
and George A. Provopoulos
were not available at the time
the photograph was taken.



Mario Draghi

President of the ECB

Vítor Constâncio

Vice-President of the ECB

Marek Belka

President of Narodowy Bank Polski

Nils Bernstein

Governor of Danmarks Nationalbank
(until 31 January 2013)

Josef Bonnici

Governor of the Central Bank of Malta

Mark Carney

Governor of the Bank of England
(from 1 July 2013)

Luc Coene

Governor of the Nationale Bank van België/
Banque Nationale de Belgique

Carlos Costa

Governor of the Banco de Portugal

Panicos O. Demetriades

Governor of the Central Bank of Cyprus

Ardo Hansson

Governor of Eesti Pank

Patrick Honohan

Governor of the Central Bank of Ireland

Stefan Ingves

Governor of Sveriges Riksbank

Mugur Constantin Isărescu

Governor of Banca Națională a României

Ivan Iskrov

Governor of Българска народна банка
(Bulgarian National Bank)

Boštjan Jazbec

Governor of Banka Slovenije
(from 17 July 2013)

Mervyn King

Governor of the Bank of England
(until 30 June 2013)

Klaas Knot

President of De Nederlandsche Bank

Marko Kranjec

Governor of Banka Slovenije
(until 16 July 2013)

Erkki Liikanen

Governor of Suomen Pankki – Finlands Bank

Luis M. Linde

Governor of the Banco de España

Jozef Makúch

Governor of Národná banka Slovenska

György Matolcsy

Governor of the Magyar Nemzeti Bank
(from 4 March 2013)

Ewald Nowotny

Governor of the Oesterreichische Nationalbank

Christian Noyer

Governor of the Banque de France

George A. Provopoulos

Governor of the Bank of Greece

Gaston Reinesch

Governor of the Banque centrale du Luxembourg

Ilmārs Rimšēvičs

Governor of Latvijas Banka

Lars Rohde

Governor of Danmarks Nationalbank
(from 1 February 2013)

András Simor

Governor of the Magyar Nemzeti Bank
(until 3 March 2013)

Miroslav Singer

Governor of Česká národní banka

Vitas Vasiliauskas

Chairman of the Board of Lietuvos bankas

Ignazio Visco

Governor of the Banca d'Italia

Boris Vujčić

Governor of Hrvatska narodna banka
(from 1 July 2013)

Jens Weidmann

President of the Deutsche Bundesbank

I.5 EUROSISTEM/ESCB COMMITTEES, THE BUDGET COMMITTEE, THE HUMAN RESOURCES CONFERENCE AND THE EUROSISTEM IT STEERING COMMITTEE

The Eurosystem/ESCB committees have continued to play an important role in assisting the ECB's decision-making bodies in the performance of their tasks. At the request of both the Governing Council and the Executive Board, the committees have provided expertise in their fields of competence and have facilitated the decision-making process. Membership of the committees is usually restricted to staff of the Eurosystem central banks. However, the NCBs of the Member States which have not yet adopted the euro take part in the meetings of a committee whenever it deals with matters that fall within the field of competence of the General Council. Where appropriate, other competent bodies may also be invited.

On 17 July 2013 the Governing Council established an Organisational Development Committee to advise on planning issues related to the Eurosystem, the SSM and their functions and to steer the activities of the Eurosystem Procurement Coordination Office (EPCO) and the framework for Eurosystem/ESCB operational risk and business continuity management. As at 31 December 2013 15 Eurosystem/ESCB committees had been established under Article 9.1 of the Rules of Procedure of the ECB. To support the preparatory work related to the establishment of the SSM, some of these committees started to meet in an SSM composition, i.e. including staff from national competent authorities which are not NCBs.

EUROSISTEM/ESCB COMMITTEES, EUROSISTEM IT STEERING COMMITTEE, BUDGET COMMITTEE, HUMAN RESOURCES CONFERENCE AND THEIR CHAIRPERSONS ¹⁾	
Accounting and Monetary Income Committee (AMICO) Werner Studener	International Relations Committee (IRC) Frank Moss
Banknote Committee (BANCO) Ton Roos	Legal Committee (LEGCO) N.N.
Committee on Controlling (COMCO) Pentti Hakkarainen	Market Operations Committee (MOC) Ulrich Bindseil
Eurosystem/ESCB Communications Committee (ECCO) Christine Graeff	Monetary Policy Committee (MPC) Wolfgang Schill
Financial Stability Committee (FSC) Ignazio Angeloni	Organisational Development Committee (ODC) Steven Keuning
Information Technology Committee (ITC) Koenraad de Geest	Payment and Settlement Systems Committee (PSSC) Daniela Russo
Internal Auditors Committee (IAC) Klaus Gressenbauer	Risk Management Committee (RMC) Carlos Bernadell
Budget Committee (BUCOM) José Luis Malo de Molina	Statistics Committee (STC) Aurel Schubert
Eurosystem IT Steering Committee (EISC) Yves Mersch	Human Resources Conference (HRC) Steven Keuning

1) As at 1 January 2014.

Three further committees exist. The Budget Committee, which was established under Article 15 of the Rules of Procedure, assists the Governing Council in matters related to the ECB's budget. The Human Resources Conference was established in 2005 under Article 9a of the Rules of Procedure as a forum for the exchange of experience, expertise and information among Eurosystem/ESCB central banks in the field of human resources management. The Eurosystem IT Steering Committee was established in 2007 by the Governing Council, with a mandate to steer continuous improvement in the use of IT within the Eurosystem.

I.6 CORPORATE GOVERNANCE

In addition to the decision-making bodies, the corporate governance of the ECB encompasses a high-level ECB Audit Committee as well as a number of external and internal control layers, two codes of conduct, an Ethics Framework and rules concerning public access to ECB documents.

ECB AUDIT COMMITTEE

The ECB Audit Committee enhances the corporate governance of the ECB and of the Eurosystem as a whole. It supports the Governing Council by providing advice and/or opinions regarding its responsibilities in respect of (i) the integrity of financial information, (ii) the oversight of internal controls, (iii) compliance with applicable laws, regulations and codes of conduct, and (iv) the performance of audit functions. The ECB Audit Committee is chaired by Erkki Liikanen (Governor of Suomen Pankki – Finlands Bank) and comprises two other Governing Council members (Vítor Constâncio and Christian Noyer) as well as two external members (Hans Tietmeyer and Jean-Claude Trichet). Its mandate is available on the ECB's website.

EXTERNAL CONTROL LAYERS

The Statute of the ESCB provides for two control layers, namely the external auditor, which is appointed to audit the annual accounts of the ECB (in accordance with Article 27.1 of the Statute of the ESCB), and the European Court of Auditors, which examines the operational efficiency of the management of the ECB (in accordance with Article 27.2). The annual report of the European Court of Auditors, together with the ECB's reply, is published on the ECB's website and in the Official Journal of the European Union. In order to reinforce public assurance as to the independence of the ECB's external auditor, the principle of audit firm rotation is applied.³ Good practices for the selection and mandate of external auditors, published on the ECB's website, provide high-level guidance for each Eurosystem central bank when selecting their external auditors and determining their mandate. They also enable the Governing Council to formulate its recommendations to the EU Council on the basis of harmonised, consistent and transparent selection criteria.

INTERNAL CONTROL LAYERS

The internal control structure of the ECB is based on an approach in which each organisational unit (section, division, directorate or directorate general) has primary responsibility for managing its own risks, as well as for ensuring the effectiveness and efficiency of its operations. Each organisational unit implements operational control procedures within its area of responsibility in accordance with the risk tolerance set in advance by the Executive Board.

Within the ECB, budgetary responsibility and accountability lies first with the individual business areas, which are also responsible for the first level of control. The Budget, Controlling and

³ Following the conclusion of a tender procedure, Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft was appointed as the ECB's external auditor for the financial years 2013-17.

Organisation Division is responsible for planning, coordinating, steering and executing all related centralised processes as well as for preparing the relevant documentation. It also serves as a second level of control and reports to the Executive Board on a regular basis, alerting it to issues where necessary.

In accordance with its mandate, the Budget Committee assesses the ECB budget planning and monitoring reports submitted by the Executive Board and reports on them to the Governing Council. It assists the Governing Council in the evaluation of the Executive Board's annual budget proposal before the latter is adopted, and assesses budget monitoring reports and reports on them to the Governing Council.

As far as the operational risks of the ECB are concerned, the Operational Risk Committee, an internal ECB committee, is responsible for stimulating and overseeing the development, implementation and maintenance of operational risk management by the business areas that own the risks. It also supports the Executive Board in the execution of its role in overseeing the management of the operational risks of the ECB.

In 2013 the ECB continued, together with the euro area NCBs, to update the operational risk assessments of its tasks and processes. It also continued to regularly test and review the business continuity arrangements for its critical operations. Furthermore, in cooperation with the NCBs, the ECB finalised a business impact analysis to identify the time criticality of Eurosystem functions.

As regards financial risks, the ECB's Directorate Risk Management is responsible for the risk management framework applicable to all of the ECB's financial market operations and for monitoring, assessing and proposing improvements to the Eurosystem's operational framework for monetary policy and foreign exchange policy from a risk management perspective.

The Risk Management Committee, comprising experts from Eurosystem central banks, assists the decision-making bodies in ensuring an appropriate level of protection for the Eurosystem by managing and controlling the financial risks originating from its market operations, in the context of both the Eurosystem's monetary policy operations and the ECB's foreign reserve portfolio. With regard to these activities, the Risk Management Committee contributes to, among other things, the monitoring, measuring and reporting of financial risks and the definition and review of the associated methodologies and frameworks.

Independently from the internal control structure and risk monitoring of the ECB, audit missions are performed by the Directorate Internal Audit under the direct responsibility of the Executive Board. In accordance with the mandate defined in the ECB Audit Charter⁴, the ECB's internal auditors provide independent and objective assurance and consulting services, bringing a systematic approach to evaluating and improving the effectiveness of risk management, control and governance processes. The ECB's internal audit activities conform with the International Standards for the Professional Practice of Internal Auditing of the Institute of Internal Auditors.

A Eurosystem/ESCB committee, the Internal Auditors Committee, which is composed of internal audit experts from the ECB and the NCBs, assists in the achievement of Eurosystem/ESCB objectives by providing independent, objective assurance and consulting services designed to add value and to improve the Eurosystem/ESCB.

4 This charter is published on the ECB's website to foster the transparency of audit arrangements in place at the ECB.

CODES OF CONDUCT

Two codes of conduct are applicable to the members of the ECB's decision-making bodies. The first code of conduct gives guidance to, and sets ethical standards for, the members of the Governing Council and their alternates when exercising their functions as members of the Governing Council.⁵ It reflects their responsibility to safeguard the integrity and reputation of the Eurosystem and to maintain the effectiveness of its operations. An Ethics Adviser has been appointed by the Governing Council to provide guidance to its members on aspects of professional conduct. The second code is the Supplementary Code of Ethics Criteria for the members of the Executive Board.⁶ It complements the other code of conduct by further detailing the ethical regime applicable to members of the Executive Board.

The Ethics Framework for members of staff of the ECB⁷ provides guidance and sets ethics conventions, standards and benchmarks. All staff are expected to maintain high standards of professional ethical behaviour in the performance of their duties, as well as in their relations with NCBs, public authorities, market participants, media representatives and the public in general. An Ethics Officer appointed by the Executive Board ensures a consistent interpretation of the rules.

ANTI-FRAUD MEASURES

In 1999 the European Parliament and the EU Council adopted a Regulation⁸ to step up the fight against fraud, corruption and any other illegal activity detrimental to the Communities' financial interests. The Regulation provides, inter alia, for the internal investigation of suspected fraud by the European Anti-Fraud Office (OLAF) within the EU institutions, bodies, offices and agencies. The OLAF Regulation foresees that each of the latter adopt decisions in order for OLAF to be able to carry out its investigations within each of them. In 2004 the Governing Council adopted a Decision⁹ concerning the terms and conditions for investigations by OLAF of the ECB, which entered into force on 1 July 2004.

ANTI-MONEY LAUNDERING/COUNTER-TERRORIST FINANCING PROGRAMME

In 2007 the ECB established its internal anti-money laundering (AML) and counter-terrorist financing (CTF) schemes. The design of the AML/CTF provisions is in line with the Recommendations of the Financial Action Task Force (FATF), to the extent that they are applicable to the ECB's operations. A compliance function within the ECB identifies, analyses and addresses the risks associated with money laundering and terrorist financing for all relevant activities of the ECB. In particular, ensuring compliance with applicable AML/CTF legislation is part of the process of assessing and monitoring the eligibility of the ECB's counterparties. In this context, particular attention is paid to restrictive measures adopted by the EU and public statements issued by the FATF. An internal reporting system complements the ECB's AML/CTF framework to ensure that all relevant information is systematically collected and duly communicated to the Executive Board.

5 See the Code of Conduct for the members of the Governing Council, OJ C 123, 24.5.2002, p. 9, its amendment, OJ C 10, 16.1.2007, p. 6, and the ECB's website.

6 See the Supplementary Code of Ethics Criteria for the members of the Executive Board of the ECB, OJ C 104, 23.4.2010, p. 8, and the ECB's website.

7 See Part 0 of the ECB Staff Rules containing the Ethics Framework, OJ C 104, 23.4.2010, p. 3, and the ECB's website.

8 Regulation (EC) No 1073/1999 of the European Parliament and of the Council of 25 May 1999 concerning investigations conducted by the European Anti-Fraud Office (OLAF), OJ L 136, 31.5.1999, p. 1.

9 Decision ECB/2004/11 of 3 June 2004 concerning the terms and conditions for European Anti-Fraud Office investigations of the European Central Bank, in relation to the prevention of fraud, corruption and any other illegal activities detrimental to the European Communities' financial interests and amending the Conditions of Employment for Staff of the European Central Bank, OJ L 230, 30.6.2004, p. 56.

PUBLIC ACCESS TO ECB DOCUMENTS

The ECB's Decision on public access to ECB documents,¹⁰ adopted in 2004, is in line with the objectives and standards applied by other EU institutions and bodies with regard to public access to their documents. It enhances transparency, while at the same time taking into account the independence of the ECB and of the NCBs and ensuring the confidentiality of certain matters specific to the performance of the ECB's tasks.¹¹ In 2013 the number of public access requests remained limited.

10 Decision ECB/2004/3 of 4 March 2004 on public access to European Central Bank documents, OJ L 80, 18.3.2004, p. 42 and Decision ECB/2011/6 of 9 May 2011 amending Decision ECB/2004/3 on public access to ECB documents, OJ L 158, 16.6.2011, p. 37.

11 In line with the ECB's commitment to openness and transparency, the "Archives" section of the ECB's website provides access to historical documentation.

THE ORGANISATION CHART OF THE ECB

(as at 1 January 2014)



¹ Reports to the President of the ECB in his capacity as Chair of the ESRB.

² Includes the data protection function.

³ Secretary to the Executive Board, the Governing Council and the General Council.

2 ORGANISATIONAL DEVELOPMENTS

2.1 HUMAN RESOURCES MANAGEMENT

In 2013 human resources management activities at the ECB centred on working culture, gender diversity, recruitment, professional development and employment conditions. Throughout 2013 the Directorate General Human Resources, Budget and Organisation was heavily involved in organisational preparations for the Single Supervisory Mechanism (SSM), as described in more detail in Section 1.3 of Chapter 4.

WORKING CULTURE

In 2013 developments related to the working culture of the ECB continued to focus on professional ethics and performance management. With regard to professional ethics, additional provisions to prevent and address any possible conflicts of interest were prepared. The rules concerning private financial activities, and the monitoring thereof, were also further reviewed in order to maintain an effective regulatory ethics framework. With respect to performance management, the ECB implemented an “underperformance procedure” which supports staff members who are required to restore their performance to at least a satisfactory level in order to further foster and maintain the ECB’s status as a high-performing organisation.

DIVERSITY

With the aim of doubling the share of women in high-ranking positions over the medium term, the ECB decided in 2013 to introduce gender targets. By the end of 2019 35% of positions at management level (heads of division, deputy heads of division, heads of section, senior advisers and advisers) as well as at senior management level (directors general, deputy directors general, directors and principal advisers) should be held by women. For senior management-level positions taken alone, the target is 28%. At the end of 2013 the overall share of women in management-level positions was 18%, while women held 15% of positions at senior management level. In order to reach the gender targets, the ECB is implementing a gender diversity action plan.

RECRUITMENT

The ECB had 1,907 full-time equivalent permanent positions at the end of 2013, compared with 1,450.5 positions at the end of 2012. The increase was mainly due to positions approved in 2013 in relation to the establishment of the SSM. On 31 December 2013 recruitment was under way to fill the recently approved positions and the actual full-time equivalent number of staff holding employment contracts with the ECB was 1,790 (1,638 on 31 December 2012).¹² A total of 111 new fixed-term contracts (limited in nature or convertible to permanent contracts) were offered in 2013. By contrast, 28 members of staff employed on a fixed-term or permanent basis left the ECB in 2013 (34 in 2012), following resignation or retirement. Furthermore, to cover for absences of less than one year, 175 short-term contracts were issued during 2013 (in addition to a number of contract extensions), while 156 short-term contracts expired in the course of the year.

Throughout 2013 the ECB continued to offer short-term contracts for periods of up to 36 months to staff from NCBs and international organisations. In particular, many colleagues joined the ECB in this context to assist in preparations for the SSM. On 31 December 2013 205 employees from NCBs and international organisations were working at the ECB on various assignments, 44% more than at the end of 2012.

¹² In addition to contracts based on full-time equivalent positions, this figure includes short-term contracts awarded to staff seconded from NCBs and international organisations and contracts awarded to Graduate Programme participants.

In September 2013 the ECB welcomed ten participants in the eighth intake of its Graduate Programme. These participants have various academic backgrounds and are each assigned to two different business areas for consecutive periods of one year each.

As in previous years, traineeship opportunities were offered throughout the year to students and graduates with backgrounds in economics, statistics, business administration, law or translation. On 31 December 2013 145 trainees were hosted by the ECB (19% more than in 2012). The ECB also awarded five fellowships as part of the Wim Duisenberg Research Fellowship Programme, which is open to leading economists, and five fellowships to young researchers under its Lamfalussy Fellowship Programme.

PROFESSIONAL DEVELOPMENT

In 2013 ECB employees continued to benefit from internal mobility opportunities within the organisation. In the course of 2013 308 staff members, including 77 managers and advisers, moved internally to other positions, on either a temporary or a longer-term basis.

The ECB, like all ESCB central banks, actively participates in the external mobility schemes promoted by the Human Resources Conference, which enables the ECB to second staff to the 28 NCBs in the EU or to relevant international organisations (e.g. the IMF and the BIS) for periods of two to twelve months. A total of 12 members of staff were seconded under this scheme in 2013 (new cases). The total number of staff members on unpaid leave at the end of December 2013 was 62 (compared with 56 in 2012). The ECB also launched a two-year career transition support programme in January 2013, so as to support staff members who have served the ECB in the same or similar positions for a prolonged period and who are interested in pursuing their career outside the ECB. It is foreseen that up to 50 staff members can be accepted for the programme by the end of 2014. By the end of 2013 26 staff members had registered.

The ECB continued to promote the acquisition and development of relevant skills and the further enhancement of the required competencies of management and staff. In addition to a range of in-house training opportunities, management and staff continued to follow external training courses, including those offered under the ESCB training programme. In preparation for the SSM, several national competent authorities invited ECB staff to participate in “hands-on” study visits or dedicated training in the field of micro-prudential supervision.

In 2013 22 deputy heads of division and 39 heads of section participated in a multi-source feedback exercise, in which their staff, peers and external counterparts completed a questionnaire on their managerial and leadership skills. Overall, the feedback was very positive. As a follow-up, these managers devised individual action plans to further enhance their performance.

THE HUMAN RESOURCES CONFERENCE

The activities of the Human Resources Conference covered various aspects of human resources management in 2013, including the organisation of a broad range of ESCB training activities as well as intra-ESCB mobility. In 2013 there were 44 sessions of ESCB training activities, hosted by 22 central banks.

EMPLOYMENT CONDITIONS

The ECB’s employment conditions have been fine-tuned so as to continue offering an attractive package to staff, also in view of their generally high workload, and to balance the needs of staff with those of the organisation.

At the end of 2013 228 staff members were working part time, 13% less than in 2012. The number of staff on unpaid parental leave as at 31 December 2013 was 26 (compared with 25 in 2012). In 2013, on average, around 491 staff members teleworked each month. In 2013 as a whole, 1,280 staff members teleworked at least once.

2.2 STAFF RELATIONS AND SOCIAL DIALOGUE

The ECB fully recognises the importance of a constructive dialogue with its staff. In 2013 the ECB consulted and exchanged information with the elected Staff Committee and the recognised trade union IPSO¹³ on changes related to remuneration, staffing provisions, staff development, performance management, working conditions, health and safety conditions and pension governance. In this context, 175 letters were exchanged. In addition, the ECB continued to have a frequent dialogue through regular meetings with the Staff Committee and IPSO on employment and social matters, and also ensured that staff were kept abreast of developments related to the establishment of the SSM.

2.3 ESCB SOCIAL DIALOGUE

The ESCB Social Dialogue is a consultative forum involving the ECB, employee representatives from the central banks of the ESCB and representatives from European trade union federations.¹⁴ Its purpose is to provide information and foster exchanges of views on issues that may have a major impact on employment conditions at the central banks of the ESCB. This information is provided in a biannual newsletter and at meetings held in Frankfurt.

The first ESCB Social Dialogue meeting of 2013 took place in April in an extended format, with emphasis placed on topics linked to the SSM. Issues relating to banknote production and circulation, ESCB/Eurosystem training and mobility and market operations were also discussed.

The second regular ESCB Social Dialogue meeting was held in November and focused on the main developments in the area of banking supervision. In this context, the adaptation of the ESCB Social Dialogue to adequately cater, in terms of employer and employee representation, for the establishment of the SSM was also addressed. Other issues discussed were ESCB/Eurosystem training and mobility, payment systems and banknotes.

The ad hoc working group on banknote production and circulation continued to address technical issues, complementing the discussions held in the plenary meeting of the ESCB Social Dialogue. The working group on the ESCB Social Dialogue met in March and October 2013 and, among other things, identified possible items to be included in the agenda of the ESCB Social Dialogue meetings.

2.4 THE EUROSISTEM PROCUREMENT COORDINATION OFFICE

The objective of the Eurosystem Procurement Coordination Office (EPCO) is to ensure the efficient coordination of joint procurements of goods and services by those ESCB central banks that have

¹³ IPSO stands for "International and European Public Services Organisation".

¹⁴ The Standing Committee of European Central Bank Unions (SCECBU), Union Network International – Europa (UNI-Europa Finance) and the European Federation of Public Service Unions (EPSU).

committed to participating in EPCO's activities, as well as to further improve the best procurement practices of these central banks. The network of central bank procurement experts, coordinated by EPCO, met six times in 2013.

The 2013 update of the rolling EPCO Procurement Plan was implemented over the course of the year. The joint procedures on air transport for ESCB meetings and global hotel agreements were renewed. Several joint procurement procedures were finalised and new contracts implemented during 2013, in areas including market data services, audit services, banknote-related items and stationery products. In addition, EPCO progressed on five other joint procurement procedures in different domains, including market data services, information technology and banknote-related products. Progress also continued to be made on studies to identify the potential for joint procurement in various areas such as insurance services, airlines and information technology.

EPCO also prepared a handbook of best procurement practices and made it available to the EPCO central banks.

EPCO's activities during its first mandate were evaluated in 2013 in preparation for a decision on the possible extension of its mandate and its future operational set-up.

2.5 NEW ECB PREMISES

Construction works for the new ECB premises continued in 2013, with the completion of the structural works for the 45 floors of the north tower and 43 floors of the south tower. The double office tower reached its final height of 185 m when the steel structures to house the technical areas were completed in March 2013. The antenna was installed shortly before Easter.

The facade elements of the double office tower and of the atrium connecting the two towers were mounted in the course of 2013. The cranes were removed in January 2014, soon after the large air conditioning units had been installed in the technical areas located on the upper floors of the towers. By the end of 2013 work on the technical infrastructure and fit-out of the standard office floors had been partially completed. Some of the lifts became operational and were able to be used to transport materials and workers.

Works also continued on the entrance building which will create a visual link between the Grossmarkthalle and the high-rise and clearly mark the main entrance to the ECB. The renovation of the concrete roof shells of the Grossmarkthalle was completed, while the restoration works in and around the western wing building continued. In parallel with the restoration works, the installation of the technical infrastructure and interior fit-out was carried out.

The facades of the new internal structures for the conference area and the staff restaurant were completed. Considerable headway was also made on fitting out these areas, with the different interior spaces clearly taking shape. Meanwhile, the landscaping of the area surrounding the building ensemble progressed.

The relocation of ECB staff is planned for the second half of 2014.

2.6 ENVIRONMENTAL ISSUES

Throughout 2013 the ECB continued to strive to improve its environmental performance. Its environmental policy was updated to better reflect the evolution and context of the organisation, while maintaining the emphasis on the minimisation of its ecological footprint and carbon emissions. In 2013 the ECB was re-awarded its environmental certification in accordance with ISO 14001 and was re-registered under the EU's Eco-Management and Audit Scheme (EMAS). The ECB continues to look for further ways in which to reduce its carbon footprint. It has also increased the scope of reporting and monitoring of its carbon emissions.

The Governing Council decided to end the large-scale printing of the ECB's Annual Report, and a similar print-run reduction was applied to all of the ECB's official publications. The production of hard copies has been adjusted to the number of recipients who register online. Stocks of publications have also been drastically reduced and responsibly disposed of.

The sustainable procurement guideline adopted in 2012 is increasing the number of products and services purchased with reference to sustainability criteria. In addition, in order to raise the environmental awareness of all staff, the ECB again organised a car-free day in 2013 during European Mobility Week.

Finally, special attention is being paid to the establishment of state-of-the-art sustainability features in the operation and maintenance plans for the ECB's new premises.

2.7 INFORMATION TECHNOLOGY SERVICE MANAGEMENT

In 2013 the Directorate General Information Systems (DG/IS) supported the ECB's core business with the provision of new Eurosystem solutions in the areas of statistics and market operations. Several application releases were provided for the management of the ECB's foreign reserve assets, own funds, monetary policy operations and collateral. New initiatives were launched to strengthen the risk management framework and the ECB's analytical capabilities, including new applications for supervisory data collection and reporting. In parallel, transversal systems for information, human resources and financial management underwent regular maintenance to improve the efficiency of the ECB's administration.

Work intensified in preparation for moving the IT infrastructure to the new ECB premises, and the ECB invested in both hardware (network and storage) and software (facility and data centre management). Additional workplaces and enhanced mobility services have been set up in preparation for the SSM.

The IT infrastructure was reviewed in terms of operational stability and business continuity in 2013, and initiatives were planned to simplify the existing infrastructure and strengthen technical and organisational resilience in the period 2014-16. These initiatives will also require further optimisation and additional controls with regard to DG/IS internal processes, the definition and implementation of which began in 2013.



The exterior surface of the two office towers consists of a state-of-the-art “shield hybrid facade”, which comprises three layers and is a refined synthesis of classic facade constructions, combining the functions of box windows, double-glazed windows and double facades. In order to meet various requirements relating to fire prevention, the reduction of radar reflection, the cleaning of the facades and sun protection, a special type of glazing was chosen, consisting of sun protection glass on the outside and thermal insulation glass on the inside. Aluminium blinds are also fitted between the two panes of glass to enhance the level of sun protection.

ANNUAL ACCOUNTS

MANAGEMENT REPORT FOR THE YEAR ENDING 31 DECEMBER 2013

1 NATURE OF THE BUSINESS

The ECB's activities in 2013 are described in detail in the relevant chapters of the Annual Report.

2 OBJECTIVES AND TASKS

The ECB's objectives and tasks are described in the Statute of the ESCB (Articles 2 and 3). An overview of performance against these objectives is included in the President's foreword to the Annual Report.

3 KEY RESOURCES AND PROCESSES

GOVERNANCE OF THE ECB

The Executive Board, the Governing Council and the General Council are the decision-making bodies of the ECB. In addition, the corporate governance of the ECB encompasses a high-level Audit Committee and a number of layers of internal and external controls, as well as two codes of conduct and an Ethics Framework.

In order to further strengthen the corporate governance of the ECB and the Eurosystem, the Audit Committee provides assistance to the Governing Council as regards its responsibilities in respect of the integrity of financial information, the oversight of internal controls, compliance with applicable laws, regulations and codes of conduct, and the performance of the audit functions of the ECB and the Eurosystem.

The Statute of the ESCB provides for two layers of external controls, namely the external auditors appointed to audit the annual accounts of the ECB (Article 27.1) and the European Court of Auditors, which examines the operational efficiency of the management of the ECB (Article 27.2). In order to reinforce public assurance as to the independence of the ECB's external auditors, the principle of audit firm rotation every five years is applied. In 2013 Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft was appointed as the external auditors of the ECB for the period to the end of the financial year 2017.

In the context of the internal control structure of the ECB, an operational risk management framework is in place, whereby each organisational unit is responsible for managing its own operational risks and implementing its own controls, as well as for the effectiveness and efficiency of its operations. The Operational Risk Committee (ORC) supports the Executive Board in their oversight role regarding the management of the ECB's operational risks.

The ECB's Directorate Risk Management is responsible for the risk management framework applicable to all of the ECB's financial market operations and for monitoring, assessing and

proposing improvements to the Eurosystem's operational framework for monetary policy and foreign reserves policy from a risk management perspective.

Within the ECB's internal control structure, responsibility and accountability for budget matters lies primarily with the individual business areas. The Budget, Controlling and Organisation Division (BCO) of the Directorate General HR, Budget and Organisation develops the framework for and prepares and monitors strategic planning in respect of the ECB's resources, as well as the related operational budget, in cooperation with the business areas. BCO also provides planning and resource controlling, cost-benefit analysis and investment analysis for ECB and ESCB projects. Spending against agreed budgets is monitored regularly by the Executive Board, taking into account the advice of BCO, and by the Governing Council with the assistance of the Budget Committee (BUCOM), which is composed of ECB and euro area NCB experts. In accordance with Article 15 of the ECB's Rules of Procedure, BUCOM supports the Governing Council by providing a detailed evaluation of the ECB's annual budget proposals and of requests for supplementary budget funding by the Executive Board, prior to their submission to the Governing Council for approval.

In addition, independent audit missions are performed by the Directorate Internal Audit under the direct responsibility of the Executive Board.

A comprehensive Ethics Framework for the staff of the ECB provides guidance and sets ethics conventions, standards and benchmarks. All staff are expected to maintain high standards of professional ethical behaviour in the performance of their duties, as well as in their relations with NCBs, public authorities, market participants, media representatives and the general public. Two additional codes of conduct deal exclusively with the ethical regime applicable to the members of the ECB's decision-making bodies. The Ethics Officer appointed by the Executive Board ensures that the rules applicable to Executive Board members and staff are interpreted consistently. An Ethics Adviser has been appointed by the Governing Council to provide guidance to its members on aspects of professional conduct.

Further information relating to the governance of the ECB is provided in Section 1 of Chapter 8 of the Annual Report.

MEMBERS OF THE EXECUTIVE BOARD

The members of the Executive Board are appointed from among persons of recognised standing and professional experience in monetary or banking matters by the European Council, upon a recommendation from the EU Council after it has consulted the European Parliament and the Governing Council.

The terms and conditions of members' employment are determined by the Governing Council, based on a proposal from a committee comprising three members appointed by the Governing Council and three members appointed by the EU Council.

Salaries, allowances and other benefits of the members of the Executive Board are set out in note 30, "Staff costs", of the Annual Accounts.

EMPLOYEES

In 2013 human resources management policies at the ECB focused on working culture, gender diversity, recruitment, professional development and employment conditions. Developments related to the working culture of the ECB continued to focus on professional ethics and performance management. With respect to the latter, the ECB implemented an “underperformance procedure” which supports staff members who are required to restore their performance to at least a satisfactory level. Furthermore, the bank decided in 2013 to introduce gender targets and has put in place a gender diversity action plan, aimed at significantly increasing the proportion of women in high-ranking positions over the medium term.

The ECB continued to promote the acquisition and development of relevant skills and the further enhancement of the required competencies of management and staff. In January 2013 the ECB launched a two-year career transition support programme for staff members who have served the bank in the same or similar positions for a prolonged period and are interested in pursuing careers outside the ECB. Throughout 2013 intensive organisational preparations for the Single Supervisory Mechanism were under way. In this context, ECB staff participated in study visits and training courses offered by several national competent authorities.

The average number of staff (full-time equivalents) holding contracts with the ECB¹ rose from 1,615 in 2012 to 1,683 in 2013. At the end of 2013 1,790 staff were employed. For further information, see note 30, “Staff costs”, of the Annual Accounts and Section 2 of Chapter 8 of the Annual Report which also describes developments in the area of human resources management in more detail.

PORTFOLIO MANAGEMENT

The ECB holds two types of investment portfolio, namely the foreign reserves investment portfolio, denominated in US dollars and Japanese yen, and an own funds investment portfolio denominated in euro. In addition, the funds relating to the ECB’s pension plans are invested in an externally managed portfolio. The ECB also holds its share of securities for monetary policy purposes, acquired in the context of the Securities Markets Programme and the two covered bond purchase programmes.

PRODUCTION OF THE ECB’S FINANCIAL ACCOUNTS

Pursuant to Article 26.2 of the Statute of the ESCB, the Annual Accounts of the ECB are drawn up by the Executive Board, in accordance with the principles established by the Governing Council.²

The Financial Reporting and Policy Division of the Directorate General Administration is responsible for producing the Annual Accounts in cooperation with other business areas and for ensuring that all related documentation is submitted in a timely manner to the auditors and thereafter to the decision-making bodies.

The Directorate Internal Audit provides independent and objective assurance and consulting services designed to improve the ECB’s operations. In this context, financial reporting processes and the ECB’s Annual Accounts may be subject to internal audits. Internal audit reports, which

¹ Staff on unpaid leave are excluded. This number includes staff with permanent, fixed or short-term contracts and the participants in the ECB’s Graduate Programme. Staff on maternity or long-term sick leave are also included.

² See the notes on accounting policies.

may include audit recommendations addressed to the business areas concerned, are submitted to the Executive Board.

The ECB's Assets and Liabilities Committee, which is composed of representatives from the ECB's market operations, financial reporting, risk management and budget functions, systematically monitors and assesses all factors that may have a bearing on the ECB's Balance Sheet and Profit and Loss Account. It reviews the Annual Accounts and the related documentation before they are submitted to the Executive Board for endorsement.

Furthermore, the Annual Accounts of the ECB are audited by independent external auditors recommended by the Governing Council and approved by the EU Council. The external auditors examine the books and accounts of the ECB and have full access to all information about its transactions. The responsibility of the external auditors is to express an opinion as to whether the Annual Accounts give a true and fair view of the financial position of the ECB and of the results of its operations, in accordance with the principles established by the Governing Council. In this regard, the external auditors evaluate the adequacy of internal controls applied to the preparation and presentation of the Annual Accounts and assess the appropriateness of the accounting policies used and the reasonableness of accounting estimates made by the Executive Board.

After the Executive Board has authorised their issuance, the Annual Accounts, together with the external auditors' opinion and all relevant documentation, are submitted to the Audit Committee for review prior to their submission to the Governing Council for approval.

The Executive Board has decided that from 2013 the ECB's Annual Accounts will be approved at the second Governing Council meeting in February of each year and published immediately thereafter.

4 RISK MANAGEMENT

The ECB is exposed to both financial and operational risks. Risk management is therefore a critical component of its activities and is conducted through a continuous process of risk identification, assessment, mitigation and monitoring.

FINANCIAL RISKS

Financial risks arise from the ECB's core activities and capital allocation and, in particular, from the management of its (i) holdings of foreign reserves and gold, (ii) euro-denominated investment portfolios, and (iii) holdings of securities purchased for monetary policy purposes. They encompass credit, market and liquidity risks. The ECB decides its asset allocation and implements appropriate risk management frameworks, taking into account the objectives and purposes of the various portfolios and the financial exposures, as well as the risk preferences of its decision-making bodies. To ensure such preferences are met at all times, the ECB monitors and measures risks on a regular basis, takes appropriate risk mitigation actions when needed and regularly reviews its asset allocation as well as its risk management frameworks.

Financial risks can be quantified using a variety of risk measures. In order to estimate such risks, the ECB applies risk estimation techniques developed in-house, which rely on a joint market and credit risk simulation framework. The core modelling concepts, techniques and assumptions

underlying the risk measures are inspired by and reflect market standards.³ In order to obtain a comprehensive understanding of potential risk events that could occur at different frequencies with different degrees of severity, the ECB uses two types of statistical measure, Value at Risk (VaR) and Expected Shortfall,⁴ which are calculated for a number of confidence levels. Furthermore, sensitivity and scenario analyses are used to better understand and complement the statistical risk estimates.

Measured as VaR at a 95% confidence level over a one-year horizon (VaR95%), as at 31 December 2013 the financial risks to which the ECB was exposed through its financial assets amounted to a total of €8.6 billion, representing a decrease in risks compared with the risk figures estimated as at 31 December 2012 (€10.5 billion).⁵

CREDIT RISK⁶

The ECB manages its credit risk, which comprises credit default and credit migration risks, mainly through systems of exposure limits and, in certain credit operations, also by means of collateralisation techniques. The risk controls and limits that the ECB uses to determine its credit risk exposure differ across types of operation, reflecting the policy or investment objectives of the different portfolios.

The ECB's foreign reserves holdings are subject to both credit default and credit migration risks. However, these risks are minimal, as the reserves are mainly held for the purposes of potential foreign exchange interventions and are therefore invested in assets with a high credit quality.

The ECB's holdings of gold are not subject to credit risk, as gold is not lent to third parties.

The purpose of the euro-denominated investment portfolio is to provide the ECB with income to help cover its operating expenses, while preserving the invested capital. Return considerations therefore play a relatively greater role in the asset allocation and risk control framework for these holdings than they do for the ECB's foreign reserves. Notwithstanding, the credit risk in respect of these holdings is kept at moderate levels.

The ECB's exposures stemming from securities acquired within the scope of the two covered bond purchase programmes and the Securities Markets Programme are not likely to be affected by credit migration risk, as they are classified as held-to-maturity and are therefore not revalued at market prices. However, these exposures may be subject to credit default risk. In the case of the portfolios for the covered bond purchase programmes, credit default risk is kept at moderate levels through the

³ Default and rating migration probabilities are derived from default and rating transition studies published by the major rating agencies. Volatilities, correlations and, more generally, the co-movement of credit and market risk variables are modelled by means of a multi-factor copula approach, calibrated on the basis of historical data.

⁴ Value at Risk (VaR) is defined as the maximum potential loss threshold for the portfolio of financial assets that, according to a statistical model, will not be exceeded with a given probability (confidence level) over a specified risk horizon. Expected Shortfall is a coherent risk measure that is more conservative than VaR when using the same horizon and the same confidence level, as it measures the probability-weighted average losses that could occur in the worst-case scenarios that exceed the VaR threshold. Losses, in this context, are defined as differences between the net worth of the ECB's portfolios as stated on the Balance Sheet at the beginning of the horizon, compared with simulated values at the end of the horizon.

⁵ Risk estimates provided in this Management Report have been produced using a consistent set of methodologies, assumptions and input parameters for exposures measured as at 31 December 2012 and 31 December 2013. Numerical differences between the risk estimates reported in this report for 31 December 2012 and those reported in the 2012 Annual Report of the ECB are due to methodological refinements.

⁶ Credit default risk is defined as the risk of incurring financial losses owing to a "default event", which stems from the failure of an obligor (counterparty or issuer) to meet its financial obligations in a timely manner. In addition to credit default risk, a broad definition of credit risk encompasses credit migration risk, which is the risk of incurring financial losses owing to a repricing of financial assets following a significant deterioration in their credit quality and ratings.

asset allocations, exposure limits and eligibility frameworks, which result in a diversified portfolio of covered bonds with a high credit quality. In the case of the Securities Markets Programme, the credit risk profile is determined by the allocation of purchases across countries, which is driven by monetary policy considerations. The resulting level of credit risk is within the tolerance levels of the ECB.

MARKET RISK⁷

The main types of market risk to which the ECB is subject in managing its holdings are currency and commodity (gold price) risks.⁸ The ECB is also exposed to interest rate risk.⁹

Currency and commodity risks

The ECB is exposed to currency risks and commodity risks owing to its holdings of foreign reserves and gold. Given the size of its exposure and the volatility of exchange rates and gold prices, currency and commodity risks dominate the ECB's financial risk profile.

In view of the policy role of gold and foreign reserves, described in Section 1.3 of Chapter 2 of the Annual Report, the ECB does not seek to eliminate currency and commodity risks. These risks are largely mitigated by the diversification of the holdings across different currencies and gold, even though the asset allocation is primarily driven by the potential need for policy interventions.

The contributions of currency and commodity (gold price) risks dominate the ECB's total risk profile. The bulk of the risks stems from the volatility of gold prices and of the US dollar exchange rate. In line with the Eurosystem rules, the gold and US dollar revaluation accounts, which amounted to €10.1 billion (2012: €16.4 billion) and €1.7 billion (2012: €3.3 billion) respectively as at 31 December 2013, can be used to absorb the impact of any future unfavourable movements in the prices of the underlying assets, thereby preventing any impact on the ECB's Profit and Loss Account.

The value of the ECB's gold holdings depreciated sharply over the course of 2013, but the impact of this depreciation was entirely absorbed by the respective revaluation account. As a result of the depreciation, the market value of the ECB's gold holdings has been reduced, leading to a decrease in currency and commodity risks.

Interest rate risk

Securities acquired within the scope of the two covered bond purchase programmes and the Securities Markets Programme are classified as held-to-maturity and are therefore not revalued at market prices and are not exposed to interest rate risk.

Conversely, the bulk of the ECB's foreign reserves and euro-denominated investment portfolios is invested in fixed income securities which are revalued at market prices and are therefore exposed to interest rate risk. The interest rate risk arising from these portfolios is managed through asset allocation policies and market risk limits which ensure that the market risk remains contained at levels that reflect the ECB's risk-return preferences for the different portfolios. When expressed in terms of the modified duration¹⁰ of the fixed income portfolios, the different risk-return preferences

7 Market risk is the risk of incurring financial losses owing to movements in market prices and interest rates that are not related to credit events.

8 Currency risk is the risk of incurring financial losses on positions denominated in foreign currency, owing to fluctuations in exchange rates. Commodity risk is the risk of incurring financial losses on holdings of commodities, owing to fluctuations in their market prices.

9 Interest rate risk is defined as the risk of incurring financial losses owing to a mark-to-market decline in the value of financial instruments as a result of adverse changes in applicable interest rates (yields).

10 Modified duration is a measure of the sensitivity of the value of the portfolios to parallel shifts in yield curves.

result in a longer modified duration for the euro-denominated investment portfolio than for the foreign reserves holdings.

The interest rate risk to which the ECB is exposed is limited and remained broadly stable at low levels over the course of 2013.

LIQUIDITY RISK ¹¹

In view of the role of the euro as a major reserve currency, the ECB's role as a central bank and its asset and liability structure, the only significant liquidity risk that the ECB is subject to is the risk of incurring financial losses owing to the inability to liquidate an asset at its prevailing market value within an appropriate time frame. In this regard, given the stability of the ECB's portfolios and their distinct objectives, the ECB's main exposure to liquidity risk stems from its foreign reserves, as, in order to carry out foreign exchange interventions, large amounts of these holdings may have to be liquidated within short periods of time.

The liquidity risk in respect of the ECB's foreign reserves is managed by establishing an asset allocation and limits which ensure that a sufficiently large share of the ECB's holdings are invested in assets that can be liquidated quickly with a negligible impact on the price.

The liquidity risk profile of the ECB's portfolios remained broadly stable in 2013.

OPERATIONAL RISK

In the case of the ECB, operational risk is defined as the risk of a negative financial, business or reputational impact resulting from people,¹² the inadequate implementation or failure of internal governance and business processes, the failure of systems on which processes rely, or external events (e.g. natural disasters or external attacks). The operational risk management (ORM) framework covers all the activities of the ECB and is an integral part of the bank's governance and management processes. The main objectives of ORM at the ECB are to provide reasonable assurance that the ECB will achieve its mission and objectives, as well as to protect its reputation and other assets against loss, misuse and damage.

All risks are initially identified by the individual business areas. Each business area is assisted by the Operational Risk and Business Continuity Management Function team in handling all operational risk-related issues. The ECB has outlined potential root causes of risk, as well as risk events and the impacts which might arise from these causes. The ECB applies a defined risk life cycle which comprises a process of continuously and systematically identifying, analysing, responding to, reporting on and monitoring operational risk. The ECB has also put in place a risk tolerance policy which defines the level of operational risk it is prepared to tolerate.

¹¹ In the case of the ECB, liquidity risk can be described as the possibility of incurring losses owing to the market's inability to absorb large sell orders without a significant decline in the price.

¹² The term "people" is used in a broad sense and covers any negative impact resulting from actions of the workforce, as well as from deficient personnel resourcing and personnel policies.

5 FINANCIAL RESOURCES

CAPITAL

Upon the accession of Croatia as a new EU Member State as at 1 July 2013 the NCBs' capital key shares were adjusted and the subscribed capital of the ECB was increased to €10,825 million.

In addition, Hrvatska narodna banka, in the same way as the other non-euro area NCBs, paid up 3.75% of its subscribed capital as a contribution to the operational costs of the ECB. Overall, as a result of the accession of Croatia as a new Member State, the ECB's paid-up capital increased from €7,650 million on 30 June 2013 to €7,653 million on 1 July 2013.

Details of these changes are provided in note 16, "Capital and reserves", of the Annual Accounts.

PROVISION FOR FOREIGN EXCHANGE RATE, INTEREST RATE, CREDIT AND GOLD PRICE RISKS

Since most of the ECB's assets and liabilities are periodically revalued at current market exchange rates and security prices, the ECB's profitability is strongly affected by exchange rate exposures and, to a lesser extent, interest rate exposures. These exposures stem mainly from its holdings of gold and foreign reserve assets denominated in US dollars and Japanese yen, which are predominantly invested in interest-bearing instruments. The ECB's investment portfolios and its holdings of securities purchased for monetary policy purposes entail a further exposure to credit risk.

In view of its large exposure to these risks and the size of its revaluation accounts, the ECB maintains a provision for foreign exchange rate, interest rate, credit and gold price risks. The size of and continuing requirement for this provision is reviewed annually, taking a range of factors into account, including in particular the level of holdings of risk-bearing assets, the extent of materialised risk exposures in the current financial year, projected results for the coming year and a risk assessment involving calculations of Values at Risk (VaR) on risk-bearing assets, which is applied consistently over time. The risk provision, together with any amounts held in the ECB's general reserve fund, may not exceed the value of the capital paid up by the euro area NCBs.

As at 31 December 2012 the provision for foreign exchange rate, interest rate, credit and gold price risks amounted to €7,529 million. After taking the results of its risk assessment into account, the Governing Council decided to increase the size of the risk provision to €7,530 million as at 31 December 2013. This amount equates to the value of the ECB's capital paid up by the euro area NCBs as at 31 December 2013.

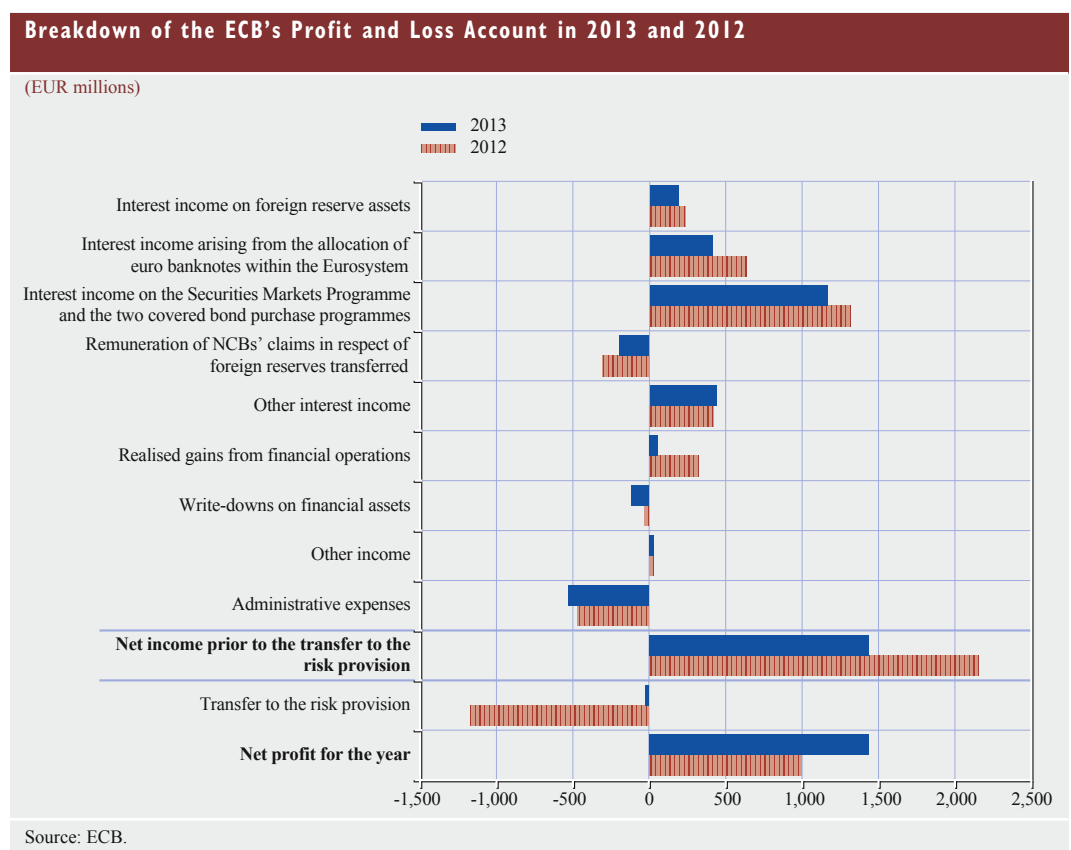
6 FINANCIAL RESULT FOR 2013

In 2013 the ECB's net profit was €1,440 million (2012: €995 million)¹³ after a transfer to the risk provision of €0.4 million (2012: €1,166 million). Following this transfer and the retention of an amount of €9.5 million owing to an adjustment of the profits earned in previous years (see "The ECB's pension plans, other post-employment benefits and other long-term benefits")

¹³ As restated owing to a change in the accounting policies (see "The ECB's pension plans, other post-employment benefits and other long-term benefits" in the notes on accounting policies).

in the notes on accounting policies) the remaining net profit, amounting to €1,430 million, was distributed to the euro area NCBs.

The chart presents the components of the ECB's Profit and Loss Account in 2013 and a comparison with 2012.



In 2013 net interest income amounted to €2,005 million, compared with €2,289 million in 2012. The decrease in net interest income was mainly due to (a) the lower interest income on the ECB's share of the total euro banknotes in circulation; and (b) the decrease in interest income generated on the securities purchased under the Securities Markets Programme and the two covered bond purchase programmes. The effects of these developments were in part offset by the lower interest expense arising from the euro area NCBs' claims in respect of the foreign reserve assets transferred by them to the ECB.

Net realised gains arising from financial operations decreased from €319 million in 2012 to €52 million in 2013, owing mainly to lower realised price gains generated on the US dollar portfolio.

In 2013 the overall decrease in the market value of securities held in the ECB's US dollar portfolio resulted in substantially higher write-downs in that year, amounting to €115 million (2012: €4 million).

As at the end of 2012 unrealised foreign exchange gains, mainly arising on the US dollar portfolio and the Japanese yen portfolio, amounted to €6,053 million and unrealised gold price gains amounted to €16,434 million. In 2013 the appreciation of the euro vis-à-vis the Japanese yen and the US dollar resulted in a decrease in unrealised foreign exchange gains, which fell to €2,540 million, and the fall in the price of gold during 2013 led to a decrease in unrealised gold price gains, which fell to €10,139 million. In line with the Eurosystem's accounting policies, these amounts were recorded in revaluation accounts.

The total administrative expenses of the ECB, including depreciation, amounted to €527 million in 2013, compared with €464 million in 2012. The vast majority of the costs incurred in connection with the construction of the ECB's new premises have been capitalised and are excluded from this item.

BALANCE SHEET AS AT 31 DECEMBER 2013

ASSETS	NOTE NUMBER	2013 €	2012 €
Gold and gold receivables	1	14,063,991,807	20,359,049,520
Claims on non-euro area residents denominated in foreign currency	2		
Receivables from the IMF	2.1	627,152,259	653,250,711
Balances with banks and security investments, external loans and other external assets	2.2	38,764,255,039	40,669,958,425
		39,391,407,298	41,323,209,136
Claims on euro area residents denominated in foreign currency	2.2	1,270,792,764	2,838,176,026
Claims on non-euro area residents denominated in euro	3		
Balances with banks, security investments and loans	3.1	535,000,000	0
Other claims on euro area credit institutions denominated in euro	4	9,487	5,000
Securities of euro area residents denominated in euro	5		
Securities held for monetary policy purposes	5.1	18,159,937,704	22,055,516,689
Intra-Eurosystem claims	6		
Claims related to the allocation of euro banknotes within the Eurosystem	6.1	76,495,146,585	73,007,429,075
Other claims within the Eurosystem (net)	12.2	0	24,673,515,571
		76,495,146,585	97,680,944,646
Other assets	7		
Tangible and intangible fixed assets	7.1	971,175,790	638,474,832
Other financial assets	7.2	20,466,245,900	19,099,638,796
Off-balance-sheet instruments revaluation differences	7.3	104,707,529	207,025,391
Accruals and prepaid expenses	7.4	977,552,068	1,660,056,235
Sundry	7.5	1,739,308,724	1,430,315,885
		24,258,990,011	23,035,511,139
Total assets		174,175,275,656	207,292,412,156

LIABILITIES	NOTE NUMBER	2013 €	2012 €
Banknotes in circulation	8	76,495,146,585	73,007,429,075
Liabilities to other euro area residents denominated in euro	9		
Other liabilities	9.1	1,054,000,000	1,024,000,000
Liabilities to non-euro area residents denominated in euro	10	24,765,513,795	50,887,527,294
Liabilities to non-euro area residents denominated in foreign currency	11		
Deposits, balances and other liabilities	11.1	18,478,777	0
Intra-Eurosystem liabilities	12		
Liabilities equivalent to the transfer of foreign reserves	12.1	40,309,644,425	40,307,572,893
Other liabilities within the Eurosystem (net)	12.2	119,857,494	0
		40,429,501,919	40,307,572,893
Other liabilities	13		
Off-balance-sheet instruments revaluation differences	13.1	185,010,549	585,953,062
Accruals and income collected in advance	13.2	370,542,207	975,648,659
Sundry	13.3	786,331,706	928,422,271
		1,341,884,462	2,490,023,992
Provisions	14	7,619,546,534	7,595,452,415
Revaluation accounts	15	13,358,190,073	23,334,941,183
Capital and reserves	16		
Capital	16.1	7,653,244,411	7,650,458,669
Profit for the year		1,439,769,100	995,006,635
Total liabilities		174,175,275,656	207,292,412,156

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDING 31 DECEMBER 2013

	NOTE NUMBER	2013 €	2012 €
Interest income on foreign reserve assets	24.1	187,279,973	228,883,700
Interest income arising from the allocation of euro banknotes within the Eurosystem	24.2	406,310,130	633,084,427
Other interest income	24.4	6,477,297,658	10,917,006,128
<i>Interest income</i>		<i>7,070,887,761</i>	<i>11,778,974,255</i>
Remuneration of NCBs' claims in respect of foreign reserves transferred	24.3	(192,248,631)	(306,925,375)
Other interest expense	24.4	(4,873,777,652)	(9,182,641,280)
<i>Interest expense</i>		<i>(5,066,026,283)</i>	<i>(9,489,566,655)</i>
Net interest income	24	2,004,861,478	2,289,407,600
Realised gains/losses arising from financial operations	25	52,122,402	318,835,838
Write-downs on financial assets and positions	26	(114,607,365)	(4,180,784)
Transfer to/from provisions for foreign exchange rate, interest rate, credit and gold price risks		(386,953)	(1,166,175,000)
Net result of financial operations, write-downs and risk provisions		(62,871,916)	(851,519,946)
Net expense from fees and commissions	27	(2,126,773)	(2,127,108)
Income from equity shares and participating interests	28	1,168,907	1,188,176
Other income	29	26,107,807	21,938,157
Total net income		1,967,139,503	1,458,886,879
Staff costs	30	(240,523,980)	(222,374,856)
Administrative expenses	31	(260,070,567)	(220,422,011)
Depreciation of tangible and intangible fixed assets		(18,581,856)	(12,918,830)
Banknote production services	32	(8,194,000)	(8,164,547)
Profit for the year		1,439,769,100	995,006,635

Frankfurt am Main, 11 February 2014

EUROPEAN CENTRAL BANK

Mario Draghi
President

ACCOUNTING POLICIES¹

FORM AND PRESENTATION OF THE FINANCIAL STATEMENTS

The financial statements of the ECB have been designed to present fairly the financial position of the ECB and the results of its operations. They have been drawn up in accordance with the following accounting policies,² which the Governing Council of the ECB considers to be appropriate to the nature of central bank activity.

ACCOUNTING PRINCIPLES

The following accounting principles have been applied: economic reality and transparency, prudence, recognition of post-balance-sheet events, materiality, going concern, the accruals principle, consistency and comparability.

RECOGNITION OF ASSETS AND LIABILITIES

An asset or liability is only recognised in the Balance Sheet when it is probable that any associated future economic benefit will flow to or from the ECB, substantially all of the associated risks and rewards have been transferred to the ECB, and the cost or value of the asset or the amount of the obligation can be measured reliably.

BASIS OF ACCOUNTING

The accounts have been prepared on a historical cost basis, modified to include the market valuation of marketable securities (other than those classified as held-to-maturity), gold and all other on-balance-sheet and off-balance-sheet assets and liabilities denominated in foreign currency. Transactions in financial assets and liabilities are reflected in the accounts on the basis of the date on which they were settled.

With the exception of spot transactions in securities, transactions in financial instruments denominated in foreign currency are recorded in off-balance-sheet accounts on the trade date. At the settlement date the off-balance-sheet entries are reversed and transactions are booked on-balance-sheet. Purchases and sales of foreign currency affect the net foreign currency position on the trade date, and realised results arising from sales are also calculated on that date. Accrued interest, premiums and discounts related to financial instruments denominated in foreign currency are calculated and recorded daily, and the foreign currency position is also affected daily by these accruals.

GOLD AND FOREIGN CURRENCY ASSETS AND LIABILITIES

Assets and liabilities denominated in foreign currency are converted into euro at the exchange rate prevailing on the balance sheet date. Income and expenses are converted at the exchange rate prevailing on the recording date. The revaluation of foreign exchange assets and liabilities, including on-balance-sheet and off-balance-sheet instruments, is performed on a currency-by-currency basis.

¹ The detailed accounting policies of the ECB are laid down in Decision ECB/2010/21 of 11 November 2010, OJ L 35, 9.2.2011, p. 1, as amended.

² These policies are consistent with the provisions of Article 26.4 of the Statute of the ESCB, which require a harmonised approach to the rules governing the accounting and financial reporting of Eurosystem operations.

Revaluation to the market price for assets and liabilities denominated in foreign currency is treated separately from the exchange rate revaluation.

Gold is valued at the market price prevailing at the year-end. No distinction is made between the price and currency revaluation differences for gold. Instead, a single gold valuation is accounted for on the basis of the price in euro per fine ounce of gold, which, for the year ending 31 December 2013, was derived from the exchange rate of the euro against the US dollar on 31 December 2013.

The special drawing right (SDR) is defined in terms of a basket of currencies. To revalue the ECB's holdings of SDRs, the value of the SDR was calculated as the weighted sum of the exchange rates of four major currencies (the US dollar, euro, Japanese yen and pound sterling) converted into euro as at 31 December 2013.

SECURITIES

Marketable securities (other than those classified as held-to-maturity) and similar assets are valued either at the mid-market prices or on the basis of the relevant yield curve prevailing on the balance sheet date, on a security-by-security basis. For the year ending 31 December 2013, mid-market prices on 30 December 2013 were used.

Marketable securities classified as held-to-maturity and illiquid equity shares are all valued at cost subject to impairment.

INCOME RECOGNITION

Income and expenses are recognised in the period in which they are earned or incurred.³ Realised gains and losses arising from the sale of foreign currency, gold and securities are taken to the Profit and Loss Account. Such realised gains and losses are calculated by reference to the average cost of the respective asset.

Unrealised gains are not recognised as income but are transferred directly to a revaluation account.

Unrealised losses are taken to the Profit and Loss Account if, at the year-end, they exceed previous revaluation gains registered in the corresponding revaluation account. Such unrealised losses on any one security or currency or on gold are not netted against unrealised gains on other securities or currencies or gold. In the event of such unrealised loss on any item taken to the Profit and Loss Account, the average cost of that item is reduced to the year-end exchange rate or market price. Unrealised losses on interest rate swaps that are taken to the Profit and Loss Account at the year-end are amortised in subsequent years.

Impairment losses are taken to the Profit and Loss Account and are not reversed in subsequent years unless the impairment decreases and the decrease can be related to an observable event that occurred after the impairment was first recorded.

Premiums or discounts arising on purchased securities, including those classified as held-to-maturity, are calculated and presented as part of interest income and are amortised over the remaining life of the securities.

³ A minimum threshold of €100,000 applies for administrative accruals and provisions.

REVERSE TRANSACTIONS

Reverse transactions are operations whereby the ECB buys or sells assets under a repurchase agreement or conducts credit operations against collateral.

Under a repurchase agreement, securities are sold for cash with a simultaneous agreement to repurchase them from the counterparty at an agreed price on a set future date. Repurchase agreements are recorded as collateralised deposits on the liability side of the Balance Sheet. Securities sold under such an agreement remain on the Balance Sheet of the ECB.

Under a reverse repurchase agreement, securities are bought for cash with a simultaneous agreement to sell them back to the counterparty at an agreed price on a set future date. Reverse repurchase agreements are recorded as collateralised loans on the asset side of the Balance Sheet but are not included in the ECB's security holdings.

Reverse transactions (including security lending transactions) conducted under an automated security lending programme are recorded on the Balance Sheet only where collateral is provided in the form of cash placed on an account of the ECB. In 2013 the ECB did not receive any collateral in the form of cash in connection with such transactions.

OFF-BALANCE-SHEET INSTRUMENTS

Currency instruments, namely foreign exchange forward transactions, forward legs of foreign exchange swaps and other currency instruments involving an exchange of one currency for another at a future date, are included in the net foreign currency position for the purpose of calculating foreign exchange gains and losses.

Interest rate instruments are revalued on an item-by-item basis. Daily changes in the variation margin of open interest rate futures contracts are recorded in the Profit and Loss Account. The valuation of forward transactions in securities and of interest rate swaps is based on generally accepted valuation methods using observable market prices and rates, as well as discount factors from the settlement dates to the valuation date.

POST-BALANCE-SHEET EVENTS

The values of assets and liabilities are adjusted for events that occur between the annual balance sheet date and the date on which the Executive Board authorises the submission of the ECB's Annual Accounts to the Governing Council for approval, if such events materially affect the condition of assets and liabilities at the balance sheet date.

Important post-balance-sheet events that do not affect the condition of assets and liabilities at the balance sheet date are disclosed in the notes.

INTRA-ESCB BALANCES/INTRA-EUROSYSTEM BALANCES

Intra-ESCB balances result primarily from cross-border payments in the EU that are settled in central bank money in euro. These transactions are for the most part initiated by private entities (i.e. credit institutions, corporations and individuals). They are settled in TARGET2 – the Trans-European Automated Real-time Gross settlement Express Transfer system – and give rise to bilateral

balances in the TARGET2 accounts of EU central banks. These bilateral balances are netted out and then assigned to the ECB on a daily basis, leaving each NCB with a single net bilateral position vis-à-vis the ECB only. This position in the books of the ECB represents the net claim or liability of each NCB against the rest of the ESCB. Intra-Eurosystem balances of euro area NCBs vis-à-vis the ECB arising from TARGET2, as well as other intra-Eurosystem balances denominated in euro (e.g. interim profit distributions to NCBs), are presented on the Balance Sheet of the ECB as a single net asset or liability position and disclosed under “Other claims within the Eurosystem (net)” or “Other liabilities within the Eurosystem (net)”. Intra-ESCB balances of non-euro area NCBs vis-à-vis the ECB, arising from their participation in TARGET2,⁴ are disclosed under “Liabilities to non-euro area residents denominated in euro”.

Intra-Eurosystem balances arising from the allocation of euro banknotes within the Eurosystem are included as a single net asset under “Claims related to the allocation of euro banknotes within the Eurosystem” (see “Banknotes in circulation” in the notes on accounting policies).

Intra-Eurosystem balances arising from the transfer of foreign reserve assets to the ECB by NCBs joining the Eurosystem are denominated in euro and reported under “Liabilities equivalent to the transfer of foreign reserves”.

TREATMENT OF FIXED ASSETS

Fixed assets, including intangible assets, but with the exception of land and works of art, are valued at cost less depreciation. Depreciation is calculated on a straight-line basis over the expected useful life of the asset, beginning in the quarter after the asset is available for use. The useful lives applied for the main asset classes are as follows:

Computers, related hardware and software, and motor vehicles	4 years
Technical equipment	4 or 10 years
Furniture and plant in building	10 years

The depreciation period for capitalised refurbishment expenditure relating to the ECB’s existing rented premises is adjusted to take account of any events that have an impact on the expected useful life of the affected asset. Land and works of art are valued at cost.

Fixed assets costing less than €10,000 are written off in the year of acquisition.

Fixed assets that comply with the capitalisation criteria but are still under construction or development are recorded under the heading “Assets under construction”. The related costs are transferred to the relevant fixed asset headings once the assets are available for use. For the depreciation of the ECB’s new premises, costs are assigned to the appropriate asset components which will be depreciated in accordance with their estimated useful lives.

THE ECB’S PENSION PLANS, OTHER POST-EMPLOYMENT BENEFITS AND OTHER LONG-TERM BENEFITS

The ECB operates defined benefit plans for its staff and Executive Board members.

⁴ As at 31 December 2013 the non-euro area NCBs participating in TARGET2 were Българска народна банка (Bulgarian National Bank), Danmarks Nationalbank, Latvijas Banka, Lietuvos bankas, Narodowy Bank Polski and Banca Națională a României.

The staff pension plan is funded by assets held in a long-term employee benefit fund. The compulsory contributions made by the ECB and the staff are 18% and 6% of basic salary respectively and are reflected in the defined benefit pillar of the plan. Staff can make additional contributions on a voluntary basis in a defined contribution pillar that can be used to provide additional benefits.⁵ These additional benefits are determined by the amount of voluntary contributions together with the investment returns arising from these contributions.

Unfunded arrangements are in place for the post-employment and other long-term benefits of members of the Executive Board of the ECB. For staff, unfunded arrangements are in place for post-employment benefits other than pensions and for other long-term benefits.

Revised accounting policy

Prior to 2013 the ECB applied the so-called “10% corridor” approach for recognising actuarial gains and losses on post-employment benefits, as provided for under International Accounting Standard (IAS) 19 “Employee benefits”. Under this approach, net cumulative unrecognised actuarial gains and losses on post-employment benefits which exceeded the greater of (a) 10% of the present value of the defined benefit obligation; and (b) 10% of the fair value of plan assets held against the defined benefit obligation, were amortised over the expected average remaining working lives of the participating employees. In addition, returns on plan assets held against the defined benefit obligation, which were recorded in the Profit and Loss Account, were calculated on the basis of the expected rate of return.

Following the revision of IAS 19, the option to apply the “10% corridor” approach is no longer available. Consequently, in 2013 the ECB decided that (a) remeasurements⁶ of the net defined benefit liability in respect of post-employment benefits will be recognised in their entirety and shown in the Balance Sheet under “Revaluation accounts”; and (b) interest on plan assets will be calculated by applying the discount rate. Thus, previously unrecognised actuarial losses, amounting to €146,603,113 as at 31 December 2012, are now included in the Balance Sheet under “Revaluation accounts”. These changes were applied retrospectively and the comparative amounts for 2012 have been restated as follows:

	Published in 2012 €	Adjustment €	Restated amount €
Assets			
Other assets – sundry	1,423,836,885	6,479,000	1,430,315,885
Total adjustment		6,479,000	
Liabilities			
Other liabilities – sundry	781,819,158	146,603,113	928,422,271
Revaluation accounts	23,472,041,296	(137,100,113)	23,334,941,183
Profit for the year	998,030,635	(3,024,000)	995,006,635
Total adjustment		6,479,000	

The Profit and Loss Account was adjusted retrospectively to reflect (a) the use of the discount rate for calculating the interest on plan assets held against the defined benefit obligation; and (b) the recognition under “Revaluation accounts” of those actuarial gains and losses that were previously

⁵ The funds accumulated by a staff member through voluntary contributions can be used at retirement to purchase an additional pension. This pension is included in the defined benefit obligation from that point on.

⁶ An explanation of the new terminology is provided below.

amortised. The downward adjustment of the Profit and Loss Account for financial years prior to 2012, amounting to €6,479,000, is shown under “Other assets”, while the profit for the year ending 31 December 2012 has been adjusted downwards by €3,024,000.⁷

The cumulative adjustment of the Profit and Loss Account of €9,503,000, combined with the recognition of actuarial losses of €146,603,113, led to a net decrease of €137,100,113 in the revaluation accounts.

The Governing Council has decided to offset the cumulative adjustment of €9,503,000 by reducing the amount to be distributed to the NCBs out of the net profit reported in 2013.

The increase in “Other liabilities” and the decrease in “Revaluation accounts” reflect the previously unrecognised actuarial losses and the cumulative remeasurements of the net defined benefit liability as at 31 December 2012 respectively.

The following terminology, stemming from the revised IAS 19, is used under the new rules:

Net defined benefit liability

The liability recognised in the Balance Sheet under “Other liabilities” in respect of the defined benefit plans is the present value of the defined benefit obligation at the balance sheet date, *less* the fair value of plan assets used to fund the obligation.

The defined benefit obligation is calculated annually by independent actuaries using the projected unit credit method. The present value of the defined benefit obligation is calculated by discounting the estimated future cash flows using a rate which is determined by reference to market yields at the balance sheet date on high quality euro-denominated corporate bonds that have similar terms of maturity to the term of the pension obligation.

Actuarial gains and losses can arise from experience adjustments (where actual outcomes are different from the actuarial assumptions previously made) and changes in actuarial assumptions.

Net defined benefit cost

The net defined benefit cost is split into components reported in the Profit and Loss Account and remeasurements in respect of post-employment benefits shown in the Balance Sheet under “Revaluation accounts”.

The net amount charged to the Profit and Loss Account comprises:

- (a) the current service cost of the defined benefits accruing for the year;
- (b) net interest at the discount rate on the net defined benefit liability; and
- (c) remeasurements in respect of other long-term benefits, in their entirety.

⁷ This adjustment is reflected in the Profit and Loss Account under “Staff costs”.

Remeasurements of the net defined benefit liability

These comprise the following items:

- (a) actuarial gains and losses on the defined benefit obligation;
- (b) the actual return on plan assets, excluding amounts included in the net interest on the net defined benefit liability; and
- (c) any change in the effect of the asset ceiling, excluding amounts included in the net interest on the net defined benefit liability.

These amounts are valued annually by independent actuaries to establish the appropriate liability in the financial statements.

BANKNOTES IN CIRCULATION

The ECB and the euro area NCBs, which together comprise the Eurosystem, issue euro banknotes.⁸ The total value of euro banknotes in circulation is allocated to the Eurosystem central banks on the last working day of each month in accordance with the banknote allocation key.⁹

The ECB has been allocated a share of 8% of the total value of euro banknotes in circulation, which is disclosed in the Balance Sheet under the liability item “Banknotes in circulation”. The ECB’s share of the total euro banknote issue is backed by claims on the NCBs. These claims, which bear interest,¹⁰ are disclosed under the sub-item “Intra-Eurosystem claims: claims related to the allocation of euro banknotes within the Eurosystem” (see “Intra-ESCB balances/intra-Eurosystem balances” in the notes on accounting policies). Interest income on these claims is included in the Profit and Loss Account under the item “Interest income arising from the allocation of euro banknotes within the Eurosystem”.

INTERIM PROFIT DISTRIBUTION

The ECB’s income on euro banknotes in circulation and income arising from securities purchased under the Securities Markets Programme is due to the euro area NCBs in the financial year in which it accrues. Unless otherwise decided by the Governing Council, the ECB distributes this income in January of the following year by means of an interim profit distribution.¹¹ It is distributed in full unless the ECB’s net profit for the year is less than its income earned on euro banknotes in circulation and securities purchased under the Securities Markets Programme, and subject to any decisions by the Governing Council to make transfers to the provision for foreign exchange rate, interest rate, credit and gold price risks. The Governing Council may also decide to charge costs incurred by the ECB in connection with the issue and handling of euro banknotes against income earned on euro banknotes in circulation.

⁸ Decision ECB/2010/29 of 13 December 2010 on the issue of euro banknotes (recast), OJ L 35, 9.2.2011, p. 26, as amended.

⁹ “Banknote allocation key” means the percentages that result from taking into account the ECB’s share in the total euro banknote issue and applying the subscribed capital key to the NCBs’ share in that total.

¹⁰ Decision ECB/2010/23 of 25 November 2010 on the allocation of monetary income of the national central banks of Member States whose currency is the euro (recast), OJ L 35, 9.2.2011, p. 17, as amended.

¹¹ Decision ECB/2010/24 of 25 November 2010 on the interim distribution of the income of the European Central Bank on euro banknotes in circulation and arising from securities purchased under the Securities Markets Programme (recast), OJ L 6, 11.1.2011, p. 35, as amended.

OTHER ISSUES

Taking account of the ECB's role as a central bank, the Executive Board considers that the publication of a cash-flow statement would not provide the readers of the financial statements with any additional relevant information.

In accordance with Article 27 of the Statute of the ESCB, and on the basis of a recommendation of the Governing Council, the EU Council has approved the appointment of Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft as the external auditors of the ECB for a five-year period up to the end of the financial year 2017.

NOTES ON THE BALANCE SHEET

I GOLD AND GOLD RECEIVABLES

As at 31 December 2013 the ECB held 16,142,871 ounces¹² of fine gold (2012: 16,142,871 ounces). No transactions in gold took place in 2013. The decrease in the euro equivalent value of the ECB's holdings of fine gold was due to the decline in the price of gold during 2013 (see "Gold and foreign currency assets and liabilities" in the notes on accounting policies and note 15, "Revaluation accounts").

2 CLAIMS ON NON-EURO AREA AND EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY

2.1 RECEIVABLES FROM THE IMF

This asset represents the ECB's holdings of SDRs as at 31 December 2013. It arises as the result of a two-way SDR buying and selling arrangement with the International Monetary Fund (IMF), whereby the IMF is authorised to arrange sales or purchases of SDRs against euro, on behalf of the ECB, within minimum and maximum holding levels. For accounting purposes, SDRs are treated as a foreign currency (see "Gold and foreign currency assets and liabilities" in the notes on accounting policies).

2.2 BALANCES WITH BANKS AND SECURITY INVESTMENTS, EXTERNAL LOANS AND OTHER EXTERNAL ASSETS; AND CLAIMS ON EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY

These two items consist of balances with banks and loans denominated in foreign currency, and investments in securities denominated in US dollars and Japanese yen.

<i>Claims on non-euro area residents</i>	2013	2012	Change
	€	€	€
Current accounts	939,722,501	1,503,909,190	(564,186,689)
Money market deposits	1,001,428,468	345,932,462	655,496,006
Reverse repurchase agreements	87,738,380	56,844,020	30,894,360
Security investments	36,735,365,690	38,763,272,753	(2,027,907,063)
Total	38,764,255,039	40,669,958,425	(1,905,703,386)

<i>Claims on euro area residents</i>	2013	2012	Change
	€	€	€
Current accounts	4,242,115	1,189,425	3,052,690
Money market deposits	1,266,550,649	2,836,986,601	(1,570,435,952)
Total	1,270,792,764	2,838,176,026	(1,567,383,262)

The decrease in these items in 2013 was mainly due to the depreciation of both the Japanese yen and the US dollar against the euro.

¹² This corresponds to 502.1 tonnes.

The ECB's net foreign currency holdings of US dollars and Japanese yen,¹³ as at 31 December 2013, were as follows:

	2013 Currency in millions	2012 Currency in millions
US dollars	45,351	45,235
Japanese yen	1,051,062	1,046,552

3 CLAIMS ON NON-EURO AREA RESIDENTS DENOMINATED IN EURO

3.1 BALANCES WITH BANKS, SECURITY INVESTMENTS AND LOANS

As at 31 December 2013 this item consisted of a claim on a non-euro area central bank in connection with an agreement on repurchase transactions established with the ECB. Under this agreement the non-euro area central bank can borrow euro against eligible collateral in order to support its domestic liquidity-providing operations.

4 OTHER CLAIMS ON EURO AREA CREDIT INSTITUTIONS DENOMINATED IN EURO

As at 31 December 2013 this item consisted of current accounts with euro area residents.

5 SECURITIES OF EURO AREA RESIDENTS DENOMINATED IN EURO

5.1 SECURITIES HELD FOR MONETARY POLICY PURPOSES

As at 31 December 2013 this item consisted of securities acquired by the ECB within the scope of the two covered bond purchase programmes and the Securities Markets Programme.

	2013 €	2012 €	Change €
First covered bond purchase programme	3,710,724,329	4,426,521,354	(715,797,025)
Second covered bond purchase programme	1,459,074,444	1,504,280,207	(45,205,763)
Securities Markets Programme	12,990,138,931	16,124,715,128	(3,134,576,197)
Total	18,159,937,704	22,055,516,689	(3,895,578,985)

Purchases under the first covered bond purchase programme were completed by the end of June 2010, while the second covered bond purchase programme ended on 31 October 2012. The Securities Markets Programme was terminated on 6 September 2012. The decrease in these items in 2013 was due to redemptions.

Securities purchased under the Securities Markets Programme and the covered bond purchase programmes are classified as held-to-maturity securities and are valued on an amortised cost basis

¹³ These holdings comprise assets minus liabilities denominated in the given foreign currency that are subject to foreign currency revaluation. They are included under the headings "Claims on non-euro area residents denominated in foreign currency", "Claims on euro area residents denominated in foreign currency", "Accruals and prepaid expenses", "Liabilities to non-euro area residents denominated in foreign currency", "Off-balance-sheet instruments revaluation differences" (liabilities side) and "Accruals and income collected in advance" and take into account foreign exchange forward and swap transactions included in off-balance-sheet items. Price gains on financial instruments denominated in foreign currency arising as a result of revaluations are not included.

subject to impairment (see “Securities” in the notes on accounting policies). Annual impairment tests are conducted on the basis of the information available and estimated recoverable amounts as at the year-end. The Governing Council considered that the identified impairment indicators had not affected the estimated future cash flows expected to be received by the ECB. Therefore, no losses were recorded for these securities in 2013.

The Governing Council assesses on a regular basis the financial risks associated with the securities held under the Securities Markets Programme and the two covered bond purchase programmes.

6 INTRA-EUROSYSTEM CLAIMS

6.1 CLAIMS RELATED TO THE ALLOCATION OF EURO BANKNOTES WITHIN THE EUROSYSTEM

This item consists of the claims of the ECB vis-à-vis the euro area NCBs relating to the allocation of euro banknotes within the Eurosystem (see “Banknotes in circulation” in the notes on accounting policies). The remuneration of these claims is calculated daily at the latest available marginal interest rate used by the Eurosystem in its tenders for main refinancing operations (see note 24.2, “Interest income arising from the allocation of euro banknotes within the Eurosystem”).

7 OTHER ASSETS

7.1 TANGIBLE AND INTANGIBLE FIXED ASSETS

These assets comprised the following items on 31 December 2013:

	2013 €	2012 €	Change €
Cost			
Land and buildings	170,824,151	170,824,151	0
Computer hardware and software	76,353,659	64,633,290	11,720,369
Equipment, furniture, plant in building and motor vehicles	13,818,952	13,926,711	(107,759)
Assets under construction	847,217,209	529,636,881	317,580,328
Other fixed assets	7,751,953	7,508,349	243,604
Total cost	1,115,965,924	786,529,382	329,436,542
Accumulated depreciation			
Land and buildings	(86,542,592)	(82,957,070)	(3,585,522)
Computer hardware and software	(45,004,046)	(51,687,755)	6,683,709
Equipment, furniture, plant in building and motor vehicles	(12,869,788)	(13,274,149)	404,361
Other fixed assets	(373,708)	(135,576)	(238,132)
Total accumulated depreciation	(144,790,134)	(148,054,550)	3,264,416
Net book value	971,175,790	638,474,832	332,700,958

The increase in the category “Assets under construction” was almost entirely due to activities related to the ECB’s new premises in 2013.

The net increase in the cost of items in the category “Computer hardware and software” reflected acquisitions in 2013. These costs were only partially offset by the derecognition of obsolete items that were no longer in use at the end of December 2013. The derecognition of these items resulted in a net decrease in the accumulated depreciation in respect of this category.

7.2 OTHER FINANCIAL ASSETS

This item consists of the investment of the ECB's own funds¹⁴ held as a direct counterpart to the capital and reserves of the ECB, as well as other financial assets which include 3,211 shares in the Bank for International Settlements (BIS) at the acquisition cost of €41.8 million.

The components of this item are as follows:

	2013 €	2012 €	Change €
Current accounts in euro	4,620,701	5,193,816	(573,115)
Securities denominated in euro	18,068,315,142	16,349,560,714	1,718,754,428
Reverse repurchase agreements in euro	2,351,403,533	2,702,963,941	(351,560,408)
Other financial assets	41,906,524	41,920,325	(13,801)
Total	20,466,245,900	19,099,638,796	1,366,607,104

The net increase in this item was due mainly to the investment in the own funds portfolio of (a) the counterpart of the amount transferred to the ECB's provision for foreign exchange rate, interest rate, credit and gold price risks in 2012; and (b) income generated on this portfolio in 2013.

7.3 OFF-BALANCE-SHEET INSTRUMENTS REVALUATION DIFFERENCES

This item is composed mainly of valuation changes in swap and forward transactions in foreign currency that were outstanding on 31 December 2013 (see note 21, "Foreign exchange swap and forward transactions"). These valuation changes are the result of the conversion of such transactions into their euro equivalents at the exchange rates prevailing on the balance sheet date, compared with the euro values resulting from the conversion of the transactions at the average cost of the respective foreign currency on that date (see "Off-balance-sheet instruments" and "Gold and foreign currency assets and liabilities" in the notes on accounting policies).

Valuation gains on outstanding interest rate swap transactions are also included in this item (see note 20, "Interest rate swaps").

7.4 ACCRUALS AND PREPAID EXPENSES

In 2013 this item included accrued coupon interest on securities, including outstanding interest paid at acquisition, amounting to €708.3 million (2012: €792.7 million) (see note 2.2, "Balances with banks and security investments, external loans and other external assets; and Claims on euro area residents denominated in foreign currency", note 5, "Securities of euro area residents denominated in euro", and note 7.2, "Other financial assets").

It also included accrued interest receivable on the TARGET2 balances due from euro area NCBs for the final month of 2013, amounting to €155.1 million (2012: €650.4 million), and accrued interest receivable on the ECB's claims related to the allocation of euro banknotes within the Eurosystem for the final quarter of the year (see "Banknotes in circulation" in the notes on accounting policies), amounting to €69.2 million (2012: €136.7 million).

¹⁴ Repurchase agreements conducted in the context of the management of the own funds portfolio are reported under "Sundry" on the liabilities side (see note 13.3, "Sundry").

Other accrued income, including accrued interest income on other financial assets, and miscellaneous prepayments are also reported under this item.

7.5 SUNDRY

This item consisted mainly of the accrued amounts of the ECB's interim profit distribution (see "Interim profit distribution" in the notes on accounting policies and note 12.2, "Other claims/liabilities within the Eurosystem (net)").

It also included:

- (a) balances related to swap and forward transactions in foreign currency outstanding on 31 December 2013 that arose from the conversion of such transactions into their euro equivalents at the respective currency's average cost on the balance sheet date, compared with the euro values at which the transactions were initially recorded (see "Off-balance-sheet instruments" in the notes on accounting policies).
- (b) a claim against the German Federal Ministry of Finance in respect of recoverable value added tax and other indirect taxes paid. Such taxes are refundable under the terms of Article 3 of the Protocol on the privileges and immunities of the European Union, which applies to the ECB by virtue of Article 39 of the Statute of the ESCB.
- (c) the cumulative adjustment of the Profit and Loss Account for the financial years prior to 2013, owing to the change in the accounting policy for post-employment benefits (see "The ECB's pension plans, other post-employment benefits and other long-term benefits" in the notes on accounting policies).

8 BANKNOTES IN CIRCULATION

This item consists of the ECB's share (8%) of the total euro banknotes in circulation (see "Banknotes in circulation" in the notes on accounting policies).

9 LIABILITIES TO OTHER EURO AREA RESIDENTS DENOMINATED IN EURO

9.1 OTHER LIABILITIES

This item comprises deposits by members of the Euro Banking Association (EBA) which are used in order to provide the ECB with collateral in respect of the EBA's payments settled through the TARGET2 system.

10 LIABILITIES TO NON-EURO AREA RESIDENTS DENOMINATED IN EURO

As at 31 December 2013 this item included an amount of €24.6 billion (2012: €44.0 billion), consisting of balances held with the ECB by non-euro area NCBs and other central banks that arise from, or are the counterpart of, transactions processed via the TARGET2 system.

The remainder of this item comprised an amount of €0.2 billion (2012: €6.8 billion) arising from the temporary reciprocal currency arrangement with the Federal Reserve.¹⁵ Under this arrangement, US dollars are provided by the Federal Reserve to the ECB by means of swap transactions, with the aim of offering short-term US dollar funding to Eurosystem counterparties. The ECB simultaneously enters into back-to-back swap transactions with euro area NCBs, which use the resulting funds to conduct US dollar liquidity-providing operations with Eurosystem counterparties in the form of reverse transactions. The back-to-back swap transactions result in intra-Eurosystem balances between the ECB and the NCBs. The swap transactions conducted with the Federal Reserve and the euro area NCBs also result in forward claims and liabilities that are recorded in off-balance-sheet accounts (see note 21, “Foreign exchange swap and forward transactions”).

11 LIABILITIES TO NON-EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY

11.1 DEPOSITS, BALANCES AND OTHER LIABILITIES

In 2013 this item consisted of a liability that arose under a repurchase agreement conducted with a non-euro area resident in connection with the management of the foreign currency reserves of the ECB.

12 INTRA-EUROSYSTEM LIABILITIES

12.1 LIABILITIES EQUIVALENT TO THE TRANSFER OF FOREIGN RESERVES

These represent the liabilities to the euro area NCBs that arose from the transfer of foreign reserve assets to the ECB when they joined the Eurosystem.

	Since 1 July 2013 €	As at 31 December 2012 €
Nationale Bank van België/Banque Nationale de Belgique	1,401,024,415	1,397,303,847
Deutsche Bundesbank	10,871,789,515	10,909,120,274
Eesti Pank	103,152,857	103,115,678
Central Bank of Ireland	643,894,039	639,835,662
Bank of Greece	1,129,060,170	1,131,910,591
Banco de España	4,782,873,430	4,783,645,755
Banque de France	8,190,916,316	8,192,338,995
Banca d'Italia	7,218,961,424	7,198,856,881
Central Bank of Cyprus	77,248,740	78,863,331
Banque centrale du Luxembourg	100,776,864	100,638,597
Central Bank of Malta	36,798,912	36,407,323
De Nederlandsche Bank	2,298,512,218	2,297,463,391
Oesterreichische Nationalbank	1,122,511,702	1,118,545,877
Banco de Portugal	1,022,024,594	1,008,344,597
Banka Slovenije	189,499,911	189,410,251
Národná banka Slovenska	398,761,127	399,443,638
Suomen Pankki – Finlands Bank	721,838,191	722,328,205
Total	40,309,644,425	40,307,572,893

¹⁵ In January 2014 the Governing Council decided, in view of the considerable improvement in US dollar funding conditions and the low demand for US dollar liquidity-providing operations, to gradually reduce its offering of such operations (see the press release of 24 January 2014).

The enlargement of the EU through the accession of Croatia, and the concomitant adjustment of the total limit of NCBs' claims and weightings in the ECB's capital key (see note 16, "Capital and reserves"), led to an increase of €2,071,532 in these liabilities.

The remuneration of these liabilities is calculated daily at the latest available marginal interest rate used by the Eurosystem in its tenders for main refinancing operations, adjusted to reflect a zero return on the gold component (see note 24.3, "Remuneration of NCBs' claims in respect of foreign reserves transferred").

12.2 OTHER CLAIMS/LIABILITIES WITHIN THE EUROSISTEM (NET)

In 2013 this item consisted mainly of the TARGET2 balances of the euro area NCBs vis-à-vis the ECB (see "Intra-ESCB balances/intra-Eurosystem balances" in the notes on accounting policies). The ECB had a net claim vis-à-vis the euro area NCBs at the end of 2012. This net claim turned into a net liability at the end of 2013 mainly owing to the settlement in TARGET2 of payments from non-euro area residents to euro area residents (see note 10, "Liabilities to non-euro area residents denominated in euro"). The reduction in the outstanding amounts related to back-to-back swap transactions conducted with NCBs in connection with US dollar liquidity-providing operations also contributed to the elimination of the net claim and the creation of the net liability in 2013. The impact of these two factors was partially offset by redemptions of securities purchased under the Securities Markets Programme that were settled via TARGET2 accounts.

The remuneration of TARGET2 positions, with the exception of balances arising from back-to-back swap transactions in connection with US dollar liquidity-providing operations, is calculated daily at the latest available marginal interest rate used by the Eurosystem in its tenders for main refinancing operations.

This item also included the amount due to euro area NCBs in respect of the ECB's interim profit distribution (see "Interim profit distribution" in the notes on accounting policies).

	2013 €	2012 €
Due from euro area NCBs in respect of TARGET2	(687,997,098,717)	(981,081,428,771)
Due to euro area NCBs in respect of TARGET2	686,747,265,644	955,833,285,908
Due to euro area NCBs in respect of the ECB's interim profit distribution	1,369,690,567	574,627,292
Other (claims)/liabilities within the Eurosystem (net)	119,857,494	(24,673,515,571)

13 OTHER LIABILITIES

13.1 OFF-BALANCE-SHEET INSTRUMENTS REVALUATION DIFFERENCES

This item is composed mainly of valuation changes in swap and forward transactions in foreign currency that were outstanding on 31 December 2013 (see note 21, "Foreign exchange swap and forward transactions"). These valuation changes are the result of the conversion of such transactions into their euro equivalents at the exchange rates prevailing on the balance sheet date, compared with the euro values resulting from the conversion of the transactions at the average cost of the respective foreign currency on that date (see "Off-balance-sheet instruments" and "Gold and foreign currency assets and liabilities" in the notes on accounting policies).

Valuation losses on outstanding interest rate swaps are also included in this item (see note 20, “Interest rate swaps”).

13.2 ACCRUALS AND INCOME COLLECTED IN ADVANCE

As at 31 December 2013 the two main items under this heading were, first, accrued interest payable to the NCBs for the whole of 2013 in respect of their claims relating to foreign reserves transferred to the ECB (see note 12.1, “Liabilities equivalent to the transfer of foreign reserves”), amounting to €192.2 million (2012: €306.9 million), and, second, accrued interest payable on TARGET2 balances due to NCBs for the final month of 2013, amounting to €155.8 million (2012: €641.1 million). These amounts were settled in January 2014. Accruals on financial instruments and other accruals are also reported in this item.

Also included under this heading is a contribution to the ECB from the City of Frankfurt of €15.3 million for the preservation of the Grossmarkthalle, which is a listed building, in connection with the construction of the ECB’s new premises. This amount will be netted against the cost of the building once it is available for use (see note 7.1, “Tangible and intangible fixed assets”).

13.3 SUNDRY

In 2013 this item included outstanding repurchase transactions of €480.4 million (2012: €360.1 million) conducted in connection with the management of the ECB’s own funds (see note 7.2, “Other financial assets”).

It also included balances related to swap and forward transactions in foreign currency outstanding on 31 December 2013 that arose from the conversion of such transactions into their euro equivalents at the respective currency’s average cost on the balance sheet date, compared with the euro values at which the transactions were initially recorded (see “Off-balance-sheet instruments” in the notes on accounting policies).

THE ECB’S PENSION PLANS, OTHER POST-EMPLOYMENT BENEFITS AND OTHER LONG-TERM BENEFITS

In addition, this item included the ECB’s net liability in respect of the post-employment and other long-term benefits of its staff and the members of the Executive Board, amounting to €131.9 million. Amounts for 2012 have been restated owing to the change in the applicable accounting policy (see “The ECB’s pension plans, other post-employment benefits and other long-term benefits” in the notes on accounting policies).

The amounts recognised in the Balance Sheet in respect of post-employment and other long-term employee benefits were as follows:

	2013 Staff € millions	2013 Executive Board € millions	2013 Total € millions	2012 Staff € millions	2012 Executive Board € millions	2012 Total € millions
Present value of obligation	650.6	17.8	668.4	677.8	17.8	695.6
Fair value of plan assets	(536.5)	-	(536.5)	(439.3)	-	(439.3)
Net defined benefit liability recognised in the Balance Sheet	114.1	17.8	131.9	238.5	17.8	256.3

Prior to 2013 the fair value of plan assets included the assets that were accumulated as a result of voluntary contributions made by staff in a defined contribution pillar. In 2013 the value of these assets amounted to €96.5 million (2012: €83.5 million). These assets give rise to a corresponding obligation of an equal value which is included in the present value of the obligation. For presentational reasons, the tables in 2013 only show the amounts relating to the defined benefit pillar and the comparative figures for 2012 have been adjusted accordingly. Consequently, the reported values for the closing obligation and the closing fair value of plan assets in 2012 decreased to €695.6 million and €439.3 million respectively.

In 2013 the present value of the obligation vis-à-vis staff of €650.6 million (2012: €677.8 million) included unfunded benefits amounting to €109.4 million (2012: €109.1 million) relating to post-employment benefits other than pensions and to other long-term benefits. Unfunded arrangements are also in place for the post-employment and other long-term benefits of members of the Executive Board.

The amounts recognised in the Profit and Loss Account in 2013 were as follows:

	2013 Staff	2013 Executive Board	2013 Total	2012 Staff	2012 Executive Board	2012 Total
	€ millions	€ millions	€ millions	€ millions	€ millions	€ millions
Current service cost	45.9	1.4	47.3	29.0	1.3	30.3
Net interest on the net defined benefit liability	8.6	0.6	9.2	6.5	0.9	7.4
Cost on the obligation	24.4	0.6	25.0	24.5	0.9	25.4
Income on plan assets	(15.8)	-	(15.8)	(18.0)	-	(18.0)
Remeasurement (gains)/losses on other long-term benefits	(3.2)	0	(3.2)	0.1	0	0.1
Total included in "Staff costs"	51.3	2.0	53.3	35.6	2.2	37.8 ¹⁾

1) As restated owing to the change in accounting policies (see "The ECB's pension plans, other post-employment benefits and other long-term benefits" in the notes on accounting policies).

The current service cost increased in 2013 to €47.3 million (2012: €30.3 million), primarily owing to the reduction in the discount rate from 5.00% in 2011 to 3.50% in 2012.¹⁶

Changes in the present value of the defined benefit obligation were as follows:

	2013 Staff	2013 Executive Board	2013 Total	2012 Staff	2012 Executive Board	2012 Total
	€ millions	€ millions	€ millions	€ millions	€ millions	€ millions
Opening defined benefit obligation	677.8	17.8	695.6	478.2	17.9	496.1
Current service cost	45.9	1.4	47.3	29.0	1.3	30.3
Interest cost on the obligation	24.4	0.6	25.0	24.5	0.9	25.4
Contributions paid by plan participants	12.3	0.1	12.4	11.5	0.1	11.6
Benefits paid	(5.5)	(1.1)	(6.6)	(5.0)	(4.0)	(9.0)
Remeasurement (gains)/losses	(104.3)	(1.0)	(105.3)	139.6	1.6	141.2
Closing defined benefit obligation	650.6	17.8	668.4	677.8	17.8	695.6

The remeasurement gains of €104.3 million for 2013 on the defined benefit obligation vis-à-vis staff arose primarily owing to the lower conversion factors applied for the calculation of future pension payments, as well as the increase in the discount rate from 3.50% in 2012 to 3.75% in 2013.

¹⁶ The current service cost is estimated using the previous year's discount rate.

The remeasurement losses of €139.6 million for 2012 on the defined benefit obligation vis-à-vis staff arose primarily owing to the decrease in the discount rate from 5.00% in 2011 to 3.50% in 2012. The resulting increase in the closing obligation was only partially offset by the impact of a reduction in the expected future increase in the guaranteed benefits, which is based on unit price developments, as well as the impact of a reduction in the assumed future increase in pensions from 1.65% to 1.40%.

Benefits paid in 2012 included the settlement of pension rights of some members of the Executive Board who left the ECB.

Changes in 2013 in the fair value of plan assets in the defined benefit pillar relating to staff were as follows:¹⁷

	2013 € millions	2012 € millions
Opening fair value of plan assets	439.3	347.5
Interest income on plan assets	15.8	18.0
Remeasurement gains	39.8	33.7
Contributions paid by employer	33.2	31.9
Contributions paid by plan participants	12.3	11.5
Benefits paid	(3.9)	(3.3)
Closing fair value of plan assets	536.5	439.3

Remeasurement gains on plan assets in both 2013 and 2012 reflected the fact that actual returns on the fund units were higher than the estimated interest income on plan assets.

In line with the Conditions of Employment for Staff of the European Central Bank, a long-term valuation of the ECB's staff pension plan was carried out by the ECB's actuaries as at 31 December 2011. Following this valuation, and acting on actuarial advice, the Governing Council approved on 2 August 2012 an annual supplementary contribution of €10.3 million, to be paid for a period of twelve years starting in 2012. This decision will be reviewed in 2014.

In preparing the valuations referred to in this note, the actuaries have used assumptions which the Executive Board has accepted for the purposes of accounting and disclosure. The principal assumptions used for the purposes of calculating the benefits scheme liability are as follows:

	2013 %	2012 %
Discount rate	3.75	3.50
Expected return on plan assets ¹⁾	4.75	4.50
General future salary increases ²⁾	2.00	2.00
Future pension increases ³⁾	1.40	1.40

1) These assumptions were used for calculating the part of the ECB's defined benefit obligation which is funded by assets with an underlying capital guarantee.

2) In addition, allowance is made for prospective individual salary increases of up to 1.8% per annum, depending on the age of the plan participants.

3) According to the ECB's pension plan rules, pensions will be increased annually. If general salary adjustments for ECB employees were below price inflation, any increase in pensions will be in line with the general salary adjustments. If the general salary adjustments exceed price inflation, they will be applied to determine the increase in pensions, provided that the financial position of the ECB's pension plans permits such an increase.

¹⁷ In previous years amounts paid by the ECB for post-employment benefits other than pensions and for other long-term benefits were included under the items "Contributions paid by employer" and "Benefits paid". These amounts are not included in these items in the figures for 2013, as unfunded arrangements are in place for these benefits. The comparative figures for 2012 have been adjusted accordingly.

14 PROVISIONS

This item consists of a provision for foreign exchange rate, interest rate, credit and gold price risks as well as other miscellaneous provisions.

The provision for foreign exchange rate, interest rate, credit and gold price risks will be used to the extent deemed necessary by the Governing Council to offset future realised and unrealised losses, in particular valuation losses not covered by the revaluation accounts. The size of and continuing requirement for this provision is reviewed annually, based on the ECB's assessment of its exposure to these risks. This assessment takes a range of factors into account, including in particular the level of holdings of risk-bearing assets, the extent of materialised risk exposures in the current financial year, projected results for the coming year, and a risk assessment involving calculations of Values at Risk (VaR) on risk-bearing assets, which is applied consistently over time. The provision, together with any amount held in the general reserve fund, may not exceed the value of the ECB's capital paid up by the euro area NCBs.

As at 31 December 2012 the provision for foreign exchange rate, interest rate, credit and gold price risks amounted to €7,529,282,289. Taking the results of its assessment into account, the Governing Council decided to transfer, as at 31 December 2013, an amount of €386,953 to the provision. This transfer reduced the ECB's net profit for 2013 to €1,439,769,100 and increased the size of the provision to €7,529,669,242. Following the increase in the ECB's paid-up capital in 2013 (see note 16, "Capital and reserves"), this amount corresponds to the value of the ECB's capital paid up by the euro area NCBs as at 31 December 2013.

15 REVALUATION ACCOUNTS

This item consists mainly of revaluation balances arising from unrealised gains on assets, liabilities and off-balance-sheet instruments (see "Income recognition", "Gold and foreign currency assets and liabilities", "Securities" and "Off-balance-sheet instruments" in the notes on accounting policies). It also includes the remeasurements of the ECB's net defined benefit liability in respect of post-employment benefits (see "The ECB's pension plans, other post-employment benefits and other long-term benefits" in the notes on accounting policies and note 13.3 "Sundry").

	2013 €	2012 €	Change €
Gold	10,138,805,097	16,433,862,811	(6,295,057,714)
Foreign currency	2,540,202,558	6,053,396,675	(3,513,194,117)
Securities and other instruments	674,356,531	984,781,810	(310,425,279)
Net defined benefit liability in respect of post-employment benefits	4,825,887	(137,100,113)	141,926,000
Total	13,358,190,073	23,334,941,183	(9,976,751,110)

The foreign exchange rates used for the year-end revaluation were as follows:

Exchange rates	2013	2012
US dollars per euro	1.3791	1.3194
Japanese yen per euro	144.72	113.61
Euro per SDR	1.1183	1.1657
Euro per fine ounce of gold	871.220	1,261.179

16 CAPITAL AND RESERVES

16.1 CAPITAL

(A) CHANGE TO THE ECB'S CAPITAL KEY

Pursuant to Article 29 of the Statute of the ESCB, the shares of the NCBs in the ECB's capital key are weighted according to the shares of the respective Member States in the EU's total population and GDP in equal measure, as notified to the ECB by the European Commission. These weights are adjusted every five years and whenever new Member States join the EU.

Based on Council Decision 2003/517/EC of 15 July 2003 on the statistical data to be used for the adjustment of the key for subscription to the capital of the European Central Bank,¹⁸ the NCBs' capital key shares were adjusted on 1 July 2013, upon the accession of Croatia as a new Member State, as follows:

	Capital key since 1 July 2013 %	Capital key as at 31 December 2012 %
Nationale Bank van België/Banque Nationale de Belgique	2.4176	2.4256
Deutsche Bundesbank	18.7603	18.9373
Eesti Pank	0.1780	0.1790
Central Bank of Ireland	1.1111	1.1107
Bank of Greece	1.9483	1.9649
Banco de España	8.2533	8.3040
Banque de France	14.1342	14.2212
Banca d'Italia	12.4570	12.4966
Central Bank of Cyprus	0.1333	0.1369
Banque centrale du Luxembourg	0.1739	0.1747
Central Bank of Malta	0.0635	0.0632
De Nederlandsche Bank	3.9663	3.9882
Oesterreichische Nationalbank	1.9370	1.9417
Banco de Portugal	1.7636	1.7504
Banka Slovenije	0.3270	0.3288
Národná banka Slovenska	0.6881	0.6934
Suomen Pankki – Finlands Bank	1.2456	1.2539
Subtotal for euro area NCBs	69.5581	69.9705
Българска народна банка (Bulgarian National Bank)	0.8644	0.8686
Česká národní banka	1.4539	1.4472
Danmarks Nationalbank	1.4754	1.4835
Hrvatska narodna banka	0.5945	-
Latvijas Banka	0.2742	0.2837
Lietuvos bankas	0.4093	0.4256
Magyar Nemzeti Bank	1.3740	1.3856
Narodowy Bank Polski	4.8581	4.8954
Banca Națională a României	2.4449	2.4645
Sveriges Riksbank	2.2612	2.2582
Bank of England	14.4320	14.5172
Subtotal for non-euro area NCBs	30.4419	30.0295
Total	100.0000	100.0000

18 OJ L 181, 19.7.2003, p. 43.

(B) CAPITAL OF THE ECB

In accordance with Article 48.3 of the Statute of the ESCB, the ECB's subscribed capital is automatically increased when a new Member State joins the EU and its NCB joins the ESCB. The increase is determined by multiplying the prevailing amount of the subscribed capital (i.e. €10,761 million as at 30 June 2013) by the ratio, within the expanded capital key, between the weighting of the entering NCB(s) and the weighting of those NCBs that are already members of the ESCB. Therefore, on 1 July 2013 the subscribed capital of the ECB was increased to €10,825 million.

The non-euro area NCBs are required to pay up 3.75% of their share in the ECB's subscribed capital as a contribution to the operational costs of the ECB. Therefore, as at 1 July 2013 Hrvatska narodna banka paid an amount of €2,413,300. Including this amount, the total contribution of non-euro area NCBs amounted to €123,575,169 as at that date. The non-euro area NCBs are not entitled to receive any share of the distributable profits of the ECB, nor are they liable to fund any loss of the ECB.

Overall, the accession of Croatia as a new Member State led to an increase of €2,785,742 in the ECB's paid-up capital, which rose to €7,653,244,411.¹⁹

	Subscribed capital since 1 July 2013 €	Paid-up capital since 1 July 2013 €	Subscribed capital as at 31 December 2012 €	Paid-up capital as at 31 December 2012 €
Nationale Bank van België/ Banque Nationale de Belgique	261,705,371	261,705,371	261,010,385	261,010,385
Deutsche Bundesbank	2,030,803,801	2,030,803,801	2,037,777,027	2,037,777,027
Eesti Pank	19,268,513	19,268,513	19,261,568	19,261,568
Central Bank of Ireland	120,276,654	120,276,654	119,518,566	119,518,566
Bank of Greece	210,903,613	210,903,613	211,436,059	211,436,059
Banco de España	893,420,308	893,420,308	893,564,576	893,564,576
Banque de France	1,530,028,149	1,530,028,149	1,530,293,899	1,530,293,899
Banca d'Italia	1,348,471,131	1,348,471,131	1,344,715,688	1,344,715,688
Central Bank of Cyprus	14,429,734	14,429,734	14,731,333	14,731,333
Banque centrale du Luxembourg	18,824,687	18,824,687	18,798,860	18,798,860
Central Bank of Malta	6,873,879	6,873,879	6,800,732	6,800,732
De Nederlandsche Bank	429,352,255	429,352,255	429,156,339	429,156,339
Oesterreichische Nationalbank	209,680,387	209,680,387	208,939,588	208,939,588
Banco de Portugal	190,909,825	190,909,825	188,354,460	188,354,460
Banka Slovenije	35,397,773	35,397,773	35,381,025	35,381,025
Národná banka Slovenska	74,486,874	74,486,874	74,614,364	74,614,364
Suomen Pankki – Finlands Bank	134,836,288	134,836,288	134,927,820	134,927,820
Subtotal for euro area NCBs	7,529,669,242	7,529,669,242	7,529,282,289	7,529,282,289
Българска народна банка (Bulgarian National Bank)	93,571,361	3,508,926	93,467,027	3,505,014
Česká národní banka	157,384,778	5,901,929	155,728,162	5,839,806
Danmarks Nationalbank	159,712,154	5,989,206	159,634,278	5,986,285
Hrvatska narodna banka	64,354,667	2,413,300	-	-
Latvijas Banka	29,682,169	1,113,081	30,527,971	1,144,799
Lietuvos bankas	44,306,754	1,661,503	45,797,337	1,717,400
Magyar Nemzeti Bank	148,735,597	5,577,585	149,099,600	5,591,235
Narodowy Bank Polski	525,889,668	19,720,863	526,776,978	19,754,137
Banca Națională a României	264,660,598	9,924,772	265,196,278	9,944,860
Sveriges Riksbank	244,775,060	9,179,065	242,997,053	9,112,389
Bank of England	1,562,265,020	58,584,938	1,562,145,431	58,580,454
Subtotal for non-euro area NCBs	3,295,337,827	123,575,169	3,231,370,113	121,176,379
Total	10,825,007,070	7,653,244,411	10,760,652,403	7,650,458,669

19 Individual amounts are shown rounded to the nearest euro. Consequently, totals and subtotals in the table may not add up due to rounding.

17 POST-BALANCE-SHEET EVENTS

CHANGES TO THE ECB'S CAPITAL KEY

Pursuant to Article 29 of the Statute of the ESCB, the weightings assigned to NCBs in the key for subscription to the ECB's capital are adjusted every five years.²⁰ The third such adjustment following the establishment of the ECB was made on 1 January 2014, as follows:

	Capital key since 1 January 2014 %	Capital key as at 31 December 2013 %
Nationale Bank van België/Banque Nationale de Belgique	2.4778	2.4176
Deutsche Bundesbank	17.9973	18.7603
Eesti Pank	0.1928	0.1780
Central Bank of Ireland	1.1607	1.1111
Bank of Greece	2.0332	1.9483
Banco de España	8.8409	8.2533
Banque de France	14.1792	14.1342
Banca d'Italia	12.3108	12.4570
Central Bank of Cyprus	0.1513	0.1333
Latvijas Banka	0.2821	-
Banque centrale du Luxembourg	0.2030	0.1739
Central Bank of Malta	0.0648	0.0635
De Nederlandsche Bank	4.0035	3.9663
Oesterreichische Nationalbank	1.9631	1.9370
Banco de Portugal	1.7434	1.7636
Banka Slovenije	0.3455	0.3270
Národná banka Slovenska	0.7725	0.6881
Suomen Pankki – Finlands Bank	1.2564	1.2456
Subtotal for euro area NCBs	69.9783	69.5581
Българска народна банка (Bulgarian National Bank)	0.8590	0.8644
Česká národní banka	1.6075	1.4539
Danmarks Nationalbank	1.4873	1.4754
Hrvatska narodna banka	0.6023	0.5945
Latvijas Banka	-	0.2742
Lietuvos bankas	0.4132	0.4093
Magyar Nemzeti Bank	1.3798	1.3740
Narodowy Bank Polski	5.1230	4.8581
Banca Națională a României	2.6024	2.4449
Sveriges Riksbank	2.2729	2.2612
Bank of England	13.6743	14.4320
Subtotal for non-euro area NCBs	30.0217	30.4419
Total	100.0000	100.0000

ENTRY OF LATVIA INTO THE EURO AREA

Pursuant to Council Decision 2013/387/EU of 9 July 2013, taken in accordance with Article 140(2) of the Treaty on the Functioning of the European Union, Latvia adopted the single currency on 1 January 2014. In accordance with Article 48.1 of the Statute of the ESCB and the legal acts

²⁰ These weights are also adjusted whenever new Member States join the EU.

adopted by the Governing Council on 31 December 2013,²¹ Latvijas Banka paid up an amount of €29,424,264 as at 1 January 2014, representing the remainder of its capital subscription to the ECB. In accordance with Article 48.1, in conjunction with Article 30.1, of the Statute of the ESCB, Latvijas Banka transferred foreign reserve assets with a total value equivalent to €205,272,581 to the ECB with effect from 1 January 2014. These foreign reserve assets comprised amounts of Japanese yen in the form of cash, and gold, in proportions of 85 to 15 respectively.

Latvijas Banka was credited with claims in respect of the paid-up capital and foreign reserve assets equivalent to the amounts transferred. The latter is to be treated in an identical manner to the existing claims of the other euro area NCBs (see note 12.1, “Liabilities equivalent to the transfer of foreign reserves”).

EFFECT ON THE ECB'S CAPITAL

The adjustment of the NCB's capital key shares in conjunction with Latvia joining the euro area resulted in an increase of €43,780,929 in the ECB's paid-up capital.

EFFECT ON THE NCB'S CLAIMS EQUIVALENT TO FOREIGN RESERVE ASSETS TRANSFERRED TO THE ECB

The net effect of the change in NCBs' weightings in the ECB's capital key and of the transfer by Latvijas Banka of foreign reserve assets on the NCBs' claims equivalent to the foreign reserve assets transferred to the ECB was an increase of €243,510,283.

OFF-BALANCE-SHEET INSTRUMENTS

18 AUTOMATED SECURITY LENDING PROGRAMME

As part of the management of the ECB's own funds, the ECB has an automated security lending programme agreement in place, whereby an appointed agent enters into security lending transactions on behalf of the ECB with a number of counterparties, designated by the ECB as eligible counterparties. Under this agreement, reverse transactions with a value of €3.8 billion (2012: €1.3 billion) were outstanding as at 31 December 2013.

19 INTEREST RATE FUTURES

As at 31 December 2013 the following foreign currency transactions, presented at year-end market rates, were outstanding:

<i>Foreign currency interest rate futures</i>	2013 Contract value €	2012 Contract value €	Change €
Purchases	495,975,636	2,460,891,314	(1,964,915,678)
Sales	1,727,870,268	6,245,269,283	(4,517,399,015)

These transactions were conducted in the context of the management of the ECB's foreign reserves.

²¹ Decision ECB/2013/53 of 31 December 2013 on the paying-up of capital, transfer of foreign reserve assets and contributions by Latvijas Banka to the European Central Bank's reserves and provisions, OJ L 16, 21.1.2014, p. 65; Agreement of 31 December 2013 between Latvijas Banka and the European Central Bank regarding the claim credited to Latvijas Banka by the European Central Bank under Article 30.3 of the Statute of the European System of Central Banks and of the European Central Bank, OJ C 17, 21.1.2014, p. 5.

20 INTEREST RATE SWAPS

Interest rate swap transactions with a contract value of €252.0 million (2012: €355.1 million), presented at year-end market rates, were outstanding as at 31 December 2013. These transactions were conducted in the context of the management of the ECB's foreign reserves.

21 FOREIGN EXCHANGE SWAP AND FORWARD TRANSACTIONS

MANAGEMENT OF THE FOREIGN RESERVES

Foreign exchange swap and forward transactions were conducted in 2013 in the context of the management of the ECB's foreign reserves. The following forward claims and liabilities resulting from these transactions, presented at year-end market rates, remained outstanding as at 31 December 2013:

<i>Foreign exchange swap and forward transactions</i>	2013 €	2012 €	Change €
Claims	1,845,947,763	2,110,145,191	(264,197,428)
Liabilities	1,730,929,184	1,947,015,270	(216,086,086)

LIQUIDITY-PROVIDING OPERATIONS

US dollar-denominated claims and liabilities with a settlement date in 2014, which arose in connection with the provision of US dollar liquidity to Eurosystem counterparties (see note 10, "Liabilities to non-euro area residents denominated in euro"), were outstanding on 31 December 2013.

22 ADMINISTRATION OF BORROWING AND LENDING OPERATIONS

The ECB is responsible for the administration of the borrowing and lending operations of the EU under the medium-term financial assistance mechanism. In 2013 the ECB processed payments related to loans granted by the EU to Latvia, Hungary and Romania under this scheme.

In the context of the loan facility agreement between the Member States whose currency is the euro²² and Kreditanstalt für Wiederaufbau,²³ as lenders, the Hellenic Republic, as the borrower, and the Bank of Greece, as the agent of the borrower, the ECB is responsible for processing all related payments on behalf of the lenders and the borrower.

Furthermore, the ECB has an operational role in the administration of loans under the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF). In 2013 the ECB processed payments in relation to loans granted to Ireland and Portugal under the EFSM scheme and loans granted to Ireland, Greece and Portugal under the EFSF scheme.

Moreover, the ECB administers payments in relation to the authorised capital stock and stability support operations of the newly established European Stability Mechanism (ESM).²⁴ In 2013 the ECB processed payments from the Member States whose currency is the euro, in respect of the

22 Other than the Hellenic Republic and the Federal Republic of Germany.

23 Acting in the public interest, subject to the instructions of and with the benefit of the guarantee of the Federal Republic of Germany.

24 The Treaty establishing the European Stability Mechanism entered into force on 27 September 2012.

ESM's authorised capital stock, as well as payments from the ESM related to a loan granted to the Republic of Cyprus.

23 PENDING LAWSUITS

An action for damages was brought against the ECB before the Court of First Instance of the European Communities (CFI)²⁵ by Document Security Systems Inc. (DSSI), alleging that the ECB had infringed a DSSI patent²⁶ in the production of euro banknotes.

The CFI dismissed DSSI's action for damages against the ECB.²⁷ Moreover, the ECB succeeded in revoking the patent in all relevant national jurisdictions and consequently there is no likelihood of payments to DSSI.

²⁵ Following the entry into force of the Treaty of Lisbon on 1 December 2009, the name of the Court of First Instance was changed to the General Court.

²⁶ DSSI's European Patent No 0455 750 B1.

²⁷ Order of the Court of First Instance of 5 September 2007, Case T-295/05. Available at www.curia.europa.eu

NOTES ON THE PROFIT AND LOSS ACCOUNT

24 NET INTEREST INCOME

24.1 INTEREST INCOME ON FOREIGN RESERVE ASSETS

This item includes interest income, net of interest expense, in respect of the ECB's net foreign reserve assets, as follows:

	2013 €	2012 €	Change €
Interest income on current accounts	601,611	726,972	(125,361)
Interest income on money market deposits	6,868,776	16,294,022	(9,425,246)
Interest income on reverse repurchase agreements	742,788	1,881,260	(1,138,472)
Net interest income on securities	172,250,735	197,474,767	(25,224,032)
Net interest income on interest rate swaps	1,833,740	2,096,989	(263,249)
Net interest income on foreign exchange swap and forward transactions	5,237,310	10,581,922	(5,344,612)
Total interest income on foreign reserve assets	187,534,960	229,055,932	(41,520,972)
Interest expense on current accounts	(42,758)	(24,240)	(18,518)
Net interest expense on repurchase agreements	(212,229)	(147,992)	(64,237)
Interest income on foreign reserve assets (net)	187,279,973	228,883,700	(41,603,727)

The overall decrease in net interest income in 2013 was due mainly to lower interest income generated on the US dollar portfolio.

24.2 INTEREST INCOME ARISING FROM THE ALLOCATION OF EURO BANKNOTES WITHIN THE EUROSISTEM

This item consists of the interest income relating to the ECB's share of the total euro banknote issue (see "Banknotes in circulation" in the notes on accounting policies and note 6.1, "Claims related to the allocation of euro banknotes within the Eurosystem"). The decrease in income in 2013 mainly reflected the fact that the average main refinancing rate was lower than in 2012.

24.3 REMUNERATION OF NCBs' CLAIMS IN RESPECT OF FOREIGN RESERVES TRANSFERRED

Remuneration paid to euro area NCBs on their claims on the ECB in respect of the foreign reserve assets transferred under Article 30.1 of the Statute of the ESCB (see note 12.1, "Liabilities equivalent to the transfer of foreign reserves") is disclosed under this heading. The decrease in this remuneration in 2013 predominantly reflected the fact that the average main refinancing rate was lower than in 2012.

24.4 OTHER INTEREST INCOME; AND OTHER INTEREST EXPENSE

In 2013 these items included interest income of €4.7 billion (2012: €8.8 billion) and expenses of €4.7 billion (2012: €8.9 billion) arising from TARGET2 balances (see note 12.2, "Other claims/liabilities within the Eurosystem (net)", and note 10, "Liabilities to non-euro area residents denominated in euro").

They also included net interest income of €961.9 million (2012: €1,107.7 million) on the securities purchased by the ECB under the Securities Markets Programme and €204.2 million (2012: €209.4 million) on those purchased under the covered bond purchase programmes. Interest income and interest expense in respect of other assets and liabilities denominated in euro, as well as interest income and interest expense arising from US dollar liquidity-providing operations, are also shown under these headings.

25 REALISED GAINS/LOSSES ARISING FROM FINANCIAL OPERATIONS

Net realised gains arising from financial operations in 2013 were as follows:

	2013 €	2012 €	Change €
Net realised price gains	41,335,392	317,311,647	(275,976,255)
Net realised exchange rate and gold price gains	10,787,010	1,524,191	9,262,819
Net realised gains arising from financial operations	52,122,402	318,835,838	(266,713,436)

Net realised price gains included realised gains on securities, interest rate futures and interest rate swaps. The overall decrease in net realised price gains in 2013 was due mainly to lower realised price gains generated on the US dollar portfolio.

26 WRITE-DOWNS ON FINANCIAL ASSETS AND POSITIONS

Write-downs on financial assets and positions in 2013 were as follows:

	2013 €	2012 €	Change €
Unrealised price losses on securities	(114,606,755)	(1,737,805)	(112,868,950)
Unrealised price losses on interest rate swaps	(610)	(2,442,218)	2,441,608
Unrealised exchange rate losses	0	(761)	761
Total write-downs	(114,607,365)	(4,180,784)	(110,426,581)

In 2013 the overall decrease in the market value of the securities held in the ECB's US dollar portfolio resulted in substantially higher write-downs compared with 2012.

27 NET EXPENSE FROM FEES AND COMMISSIONS

	2013 €	2012 €	Change €
Income from fees and commissions	25,917	90,314	(64,397)
Expenses relating to fees and commissions	(2,152,690)	(2,217,422)	64,732
Net expense from fees and commissions	(2,126,773)	(2,127,108)	335

In 2013 income under this heading consisted of penalties imposed on credit institutions for non-compliance with the minimum reserve requirements. Expenses consisted of fees relating to current accounts and to interest rate futures transactions (see note 19, "Interest rate futures").

28 INCOME FROM EQUITY SHARES AND PARTICIPATING INTERESTS

Dividends received on shares which the ECB holds in the BIS (see note 7.2, "Other financial assets") are shown under this heading.

29 OTHER INCOME

Other miscellaneous income during 2013 arose mainly from the accrued contributions of the euro area NCBs to the costs incurred by the ECB in connection with a major market infrastructure project.

30 STAFF COSTS

Salaries, allowances, staff insurance and other miscellaneous costs of €187.3 million (2012: €184.6 million) are included under this heading. Also included in this item is an amount of €53.3 million (2012: €37.8 million) recognised in connection with the ECB's pension plans, other post-employment benefits and other long-term benefits (see note 13.3, "Sundry"). Staff costs of €1.3 million (2012: €1.3 million) incurred in connection with the construction of the ECB's new premises have been capitalised and are excluded from this item.

Salaries and allowances, including the emoluments of holders of senior management positions, are modelled in essence on, and are comparable with, the remuneration scheme of the European Union.

Members of the Executive Board receive a basic salary and additional allowances for residence and representation. In the case of the President, an official residence owned by the ECB is provided in lieu of a residence allowance. Subject to the Conditions of Employment for Staff of the European Central Bank, members of the Executive Board are entitled to household, child and education allowances, depending on their individual circumstances. Basic salaries are subject to a tax for the benefit of the European Union as well as to deductions in respect of contributions to the pension, medical and accident insurance schemes. Allowances are non-taxable and non-pensionable.

Basic salaries paid to members of the Executive Board in 2013 were as follows:¹

	2013	2012
	€	€
Mario Draghi (President)	378,240	374,124
Vitor Constâncio (Vice-President)	324,216	320,688
José Manuel González-Páramo (Board Member until May 2012)	-	111,345
Peter Praet (Board Member)	270,168	267,228
Jörg Asmussen (Board Member since January 2012)	270,168	267,228
Benoît Cœuré (Board Member since January 2012)	270,168	267,228
Yves Mersch (Board Member since December 2012)	281,833	-
Total	1,794,793	1,607,841

The total allowances paid to the members of the Executive Board and the ECB's contributions to the medical and accident insurance schemes on their behalf amounted to €526,615 (2012: €509,842).

In addition, the benefits on appointment or termination of service paid to Executive Board members joining or leaving the ECB amounted to €44,538 (2012: €133,437). They are reported under "Administrative expenses" in the Profit and Loss Account.

Transitional payments are made to former members of the Executive Board for a limited period after the end of their terms of office. In 2013 these payments, related family allowances and the

¹ Mr Yves Mersch took office on 15 December 2012. The remuneration that accrued to him up to the end of 2012 was paid in January 2013 and was recorded in the staff costs for the financial year 2013.

ECB's contributions to the medical and accident insurance schemes of former members amounted to €618,189 (2012: €1,183,285). Pension payments, including related allowances, to former members of the Executive Board or their dependents and contributions to the medical and accident insurance schemes amounted to €472,891 (2012: €324,830).

At the end of 2013 the actual full-time equivalent number of staff holding contracts with the ECB was 1,790,² including 169 with managerial positions. The change in the number of staff during 2013 was as follows:

	2013	2012
Total staff as at 1 January	1,638	1,609
Newcomers/change of contractual status	496	370
Resignations/end of contract	(347)	(341)
Net increase/(decrease) due to changes in part-time working patterns	3	0
Total staff as at 31 December	1,790	1,638
Average number of staff employed	1,683	1,615

31 ADMINISTRATIVE EXPENSES

These cover all other current expenses relating to the renting and maintenance of premises, goods and equipment of a non-capital nature, professional fees, and other services and supplies, together with staff-related expenses including recruitment, relocation, installation, training and resettlement expenses.

32 BANKNOTE PRODUCTION SERVICES

This expense arises predominantly owing to the cross-border transportation of euro banknotes between banknote printing works and NCBs, for the delivery of new banknotes, and between NCBs, for the compensation of shortages with surplus stocks. These costs are borne centrally by the ECB.

² Staff on unpaid leave are excluded. This number includes staff with permanent, fixed or short-term contracts and the participants in the ECB's Graduate Programme. Staff on maternity or long-term sick leave are also included.

President and Governing Council
of the European Central Bank
Frankfurt am Main

11 February 2014

Independent auditor's report

We have audited the accompanying annual accounts of the European Central Bank, which comprise the balance sheet as at 31 December 2013, the profit and loss account for the year then ended, and a summary of significant accounting policies and other explanatory notes (the "Annual Accounts").

The responsibility of the European Central Bank's Executive Board for the Annual Accounts

The Executive Board is responsible for the preparation and fair presentation of these Annual Accounts in accordance with the principles established by the Governing Council, which are set out in Decision ECB/2010/21 on the annual accounts of the European Central Bank, as amended, and for such internal control as the Executive Board determines is necessary to enable the preparation of the Annual Accounts that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on these Annual Accounts based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the Annual Accounts are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the Annual Accounts. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the Annual Accounts, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the Annual Accounts in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Executive Board, as well as evaluating the overall presentation of the Annual Accounts.

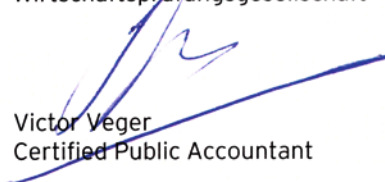
We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the Annual Accounts give a true and fair view of the financial position of the European Central Bank as at 31 December 2013, and of the results of its operations for the year then ended in accordance with the principles established by the Governing Council, which are set out in Decision ECB/2010/21 on the annual accounts of the European Central Bank, as amended.

Yours sincerely,

Ernst & Young GmbH
Wirtschaftsprüfungsgesellschaft



Victor Veger
Certified Public Accountant



Claus-Peter Wagner
Wirtschaftsprüfer

Independent Member of Ernst & Young Global Limited

Chairman Supervisory Board: StB Prof. Dr. Dr. h.c. mult. Otto H. Jacobs - Board of Management: WP/StB Georg Graf Waldersee, Chairman
WP/StB Ute Benzel - WP/StB Rudolf Krämmer - WP/StB Alexander Kron - WP/StB Prof. Dr. Norbert Pfitzer - WP/StB Gunther Ruppel
dipl. WP Markus T. Schweizer - StB/CPA Mark Smith - WP/StB Claus-Peter Wagner - WP/StB Prof. Dr. Peter Wollmert
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NOTE ON PROFIT DISTRIBUTION/ ALLOCATION OF LOSSES

This note is not part of the financial statements of the ECB for the year 2013.

Pursuant to Article 33 of the Statute of the ESCB, the net profit of the ECB shall be transferred in the following order:

- (a) an amount to be determined by the Governing Council, which may not exceed 20% of the net profit, shall be transferred to the general reserve fund, subject to a limit equal to 100% of the capital; and
- (b) the remaining net profit shall be distributed to the shareholders of the ECB in proportion to their paid-up shares.

In the event of a loss incurred by the ECB, the shortfall may be offset against the general reserve fund of the ECB and, if necessary, following a decision by the Governing Council, against the monetary income of the relevant financial year in proportion and up to the amounts allocated to the NCBs in accordance with Article 32.5 of the Statute of the ESCB.¹

After the transfer to the risk provision, the ECB's net profit for 2013 was €1,439.8 million. Following a decision by the Governing Council, there was no transfer to the general reserve fund and an interim profit distribution, amounting to €1,369.7 million, was paid out to the euro area NCBs on 31 January 2014. Furthermore, the Governing Council decided to retain an amount of €9.5 million, owing to adjustments to profits earned in previous years (see "The ECB's pension plans, other post-employment benefits and other long-term benefits" in the notes on accounting policies), and to distribute the remaining profit of €60.6 million to the euro area NCBs.

Profits are distributed to the NCBs in proportion to their paid-up shares in the subscribed capital of the ECB. Non-euro area NCBs are not entitled to receive any share of the ECB's distributable profits, nor are they liable to fund any loss of the ECB.

	2013 €	2012 ¹⁾ €
Profit for the year	1,439,769,100	995,006,635
Interim profit distribution	(1,369,690,567)	(574,627,292)
Retention owing to adjustments to profits earned in previous years	(9,503,000)	0
Profit for the year after the interim profit distribution and retention	60,575,533	420,379,343
Distribution of the remaining profit	(60,575,533)	(423,403,343)
Total	0	(3,024,000)

1) As restated owing to a change in the accounting policies (see "The ECB's pension plans, other post-employment benefits and other long-term benefits" in the notes on accounting policies).

1 Under Article 32.5 of the Statute of the ESCB, the sum of the NCBs' monetary income shall be allocated to the NCBs in proportion to their paid-up shares in the capital of the ECB.

CONSOLIDATED BALANCE SHEET OF THE EUROSYSTEM AS AT 31 DECEMBER 2013

(EUR MILLIONS)¹

ASSETS	31 DECEMBER 2013	31 DECEMBER 2012
1 Gold and gold receivables	302,940	438,686
2 Claims on non-euro area residents denominated in foreign currency	239,288	250,771
2.1 Receivables from the IMF	81,538	86,980
2.2 Balances with banks and security investments, external loans and other external assets	157,750	163,791
3 Claims on euro area residents denominated in foreign currency	22,464	32,727
4 Claims on non-euro area residents denominated in euro	20,101	19,069
4.1 Balances with banks, security investments and loans	20,101	19,069
4.2 Claims arising from the credit facility under ERM II	0	0
5 Lending to euro area credit institutions related to monetary policy operations denominated in euro	752,288	1,126,019
5.1 Main refinancing operations	168,662	89,661
5.2 Longer-term refinancing operations	583,325	1,035,771
5.3 Fine-tuning reverse operations	0	0
5.4 Structural reverse operations	0	0
5.5 Marginal lending facility	301	587
5.6 Credits related to margin calls	0	0
6 Other claims on euro area credit institutions denominated in euro	74,849	202,764
7 Securities of euro area residents denominated in euro	589,763	586,133
7.1 Securities held for monetary policy purposes	235,930	277,153
7.2 Other securities	353,834	308,979
8 General government debt denominated in euro	28,287	29,961
9 Other assets	243,286	276,483
Total assets	2,273,267	2,962,613

¹ Totals/subtotals may not add up due to rounding.

LIABILITIES	31 DECEMBER 2013	31 DECEMBER 2012
1 Banknotes in circulation	956,185	912,592
2 Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	473,155	925,386
2.1 Current accounts (covering the minimum reserve system)	282,578	447,112
2.2 Deposit facility	85,658	280,219
2.3 Fixed-term deposits	104,842	197,559
2.4 Fine-tuning reverse operations	0	0
2.5 Deposits related to margin calls	77	496
3 Other liabilities to euro area credit institutions denominated in euro	3,014	6,688
4 Debt certificates issued	0	0
5 Liabilities to other euro area residents denominated in euro	91,108	135,653
5.1 General government	65,871	95,341
5.2 Other liabilities	25,237	40,312
6 Liabilities to non-euro area residents denominated in euro	115,416	184,404
7 Liabilities to euro area residents denominated in foreign currency	4,589	3,629
8 Liabilities to non-euro area residents denominated in foreign currency	2,998	6,226
8.1 Deposits, balances and other liabilities	2,998	6,226
8.2 Liabilities arising from the credit facility under ERM II	0	0
9 Counterpart of special drawing rights allocated by the IMF	52,717	54,952
10 Other liabilities	219,587	237,731
11 Revaluation accounts	262,633	407,236
12 Capital and reserves	91,864	88,117
Total liabilities	2,273,267	2,962,613



The offices in the high-rise will be air-conditioned, but there will also be the possibility of natural ventilation through the use of a new opening mechanism which is “hidden” behind the outer facade and supplies the offices with fresh air through the ventilation slots that it creates.

Extensive repair work has been carried out on the brick facades of both wing buildings of the Grossmarkthalle. Any bricks that were damaged have been replaced with those collected during the removal of the annexe buildings. All the joints of the brickwork have been raked out and, in keeping with architect Martin Elsaesser’s original design, filled with a pale mortar for the horizontal joints and a dark mortar for the vertical joints.

The concrete grid facades on the northern and southern sides of the Grossmarkthalle have been carefully repaired and cleaned. All the windows, with a few exceptions, have been replaced by new ones consisting of steel frames that are as narrow as the old ones, but strong enough to support double glazing.

ANNEXES

I LEGAL INSTRUMENTS ADOPTED BY THE ECB

The following tables list the legal instruments that were adopted by the ECB in 2013 and early 2014 and published in the “Legal framework” section of the ECB’s website.

(a) ECB legal instruments other than opinions	
Number	Title
ECB/2013/1	Decision of the European Central Bank of 11 January 2013 laying down the framework for a public key infrastructure for the European System of Central Banks (OJ L 74, 16.3.2013, p. 30)
ECB/2013/2	Guideline of the European Central Bank of 23 January 2013 amending Guideline ECB/2012/18 on additional temporary measures relating to Eurosystem refinancing operations and eligibility of collateral (OJ L 34, 5.2.2013, p. 18)
ECB/2013/3	Recommendation of the European Central Bank of 4 February 2013 to the Council of the European Union on the external auditors of the Central Bank of Cyprus (OJ C 37, 9.2.2013, p. 1)
ECB/2013/4	Guideline of the European Central Bank of 20 March 2013 on additional temporary measures relating to Eurosystem refinancing operations and eligibility of collateral and amending Guideline ECB/2007/9 (recast) (OJ L 95, 5.4.2013, p. 23)
ECB/2013/5	Decision of the European Central Bank of 20 March 2013 repealing Decisions ECB/2011/4 on temporary measures relating to the eligibility of marketable debt instruments issued or guaranteed by the Irish Government, ECB/2011/10 on temporary measures relating to the eligibility of marketable debt instruments issued or guaranteed by the Portuguese Government, ECB/2012/32 on temporary measures relating to the eligibility of marketable debt instruments issued or fully guaranteed by the Hellenic Republic and ECB/2012/34 on temporary changes to the rules relating to the eligibility of foreign currency denominated collateral (OJ L 95, 5.4.2013, p. 21)
ECB/2013/6	Decision of the European Central Bank of 20 March 2013 on the rules concerning the use as collateral for Eurosystem monetary policy operations of own-use uncovered government-guaranteed bank bonds (OJ L 95, 5.4.2013, p. 22)
ECB/2013/7	Guideline of the European Central Bank of 22 March 2013 concerning statistics on holdings of securities (OJ L 125, 7.5.2013, p. 17)
ECB/2013/8	Recommendation of the European Central Bank of 17 April 2013 to the Council of the European Union on the external auditors of the Oesterreichische Nationalbank (OJ C 115, 23.4.2013, p. 1)
ECB/2013/9	Recommendation of the European Central Bank of 19 April 2013 to the Council of the European Union on the external auditors of the European Central Bank (OJ C 122, 27.4.2013, p. 1)

Number	Title
ECB/2013/10	Decision of the European Central Bank of 19 April 2013 on the denominations, specifications, reproduction, exchange and withdrawal of euro banknotes (recast) (OJ L 118, 30.4.2013, p. 37)
ECB/2013/11	Guideline of the European Central Bank of 19 April 2013 amending Guideline ECB/2003/5 on the enforcement of measures to counter non-compliant reproductions of euro banknotes and on the exchange and withdrawal of euro banknotes (OJ L 118, 30.4.2013, p. 43)
ECB/2013/12	Recommendation of the European Central Bank of 26 April 2013 to the Council of the European Union on the external auditors of Suomen Pankki (OJ C 126, 3.5.2013, p. 1)
ECB/2013/13	Decision of the European Central Bank of 2 May 2013 on temporary measures relating to the eligibility of marketable debt instruments issued or fully guaranteed by the Republic of Cyprus (OJ L 133, 17.5.2013, p. 26)
ECB/2013/14	Guideline of the European Central Bank of 15 May 2013 amending Guideline ECB/2006/4 on the Eurosystem's provision of reserve management services in euro to central banks and countries located outside the euro area and to international organisations (OJ L 138, 24.5.2013, p. 19)
ECB/2013/15	Decision of the European Central Bank of 21 June 2013 laying down the measures necessary for the contribution to the European Central Bank's accumulated equity value and for adjusting the national central banks' claims equivalent to the transferred foreign reserve assets (OJ L 187, 6.7.2013, p. 9)
ECB/2013/16	Decision of the European Central Bank of 21 June 2013 amending Decision ECB/2010/29 on the issue of euro banknotes (OJ L 187, 6.7.2013, p. 13)
ECB/2013/17	Decision of the European Central Bank of 21 June 2013 on the national central banks' percentage shares in the key for subscription to the European Central Bank's capital (OJ L 187, 6.7.2013, p. 15)
ECB/2013/18	Decision of the European Central Bank of 21 June 2013 laying down the terms and conditions for transfers of the European Central Bank's capital shares between the national central banks and for the adjustment of the paid-up capital (OJ L 187, 6.7.2013, p. 17)
ECB/2013/19	Decision of the European Central Bank of 21 June 2013 on the paying-up of the European Central Bank's capital by the national central banks of Member States whose currency is the euro (OJ L 187, 6.7.2013, p. 23)
ECB/2013/20	Decision of the European Central Bank of 21 June 2013 on the paying-up of the ECB's capital by the non-euro area national central banks (OJ L 187, 6.7.2013, p. 25)

Number	Title
ECB/2013/21	Decision of the European Central Bank of 28 June 2013 repealing Decision ECB/2013/13 on temporary measures relating to the eligibility of marketable debt instruments issued or fully guaranteed by the Republic of Cyprus (OJ L 192, 13.7.2013, p. 75)
ECB/2013/22	Decision of the European Central Bank of 5 July 2013 on temporary measures relating to the eligibility of marketable debt instruments issued or fully guaranteed by the Republic of Cyprus (OJ L 195, 18.7.2013, p. 27)
ECB/2013/23	Guideline of the European Central Bank of 25 July 2013 on government finance statistics (recast) (OJ L 2, 7.1.2014, p. 12)
ECB/2013/24	Guideline of the European Central Bank of 25 July 2013 on the statistical reporting requirements of the European Central Bank in the field of quarterly financial accounts (recast) (OJ L 2, 7.1.2014, p. 34)
ECB/2013/25	Guideline of the European Central Bank of 30 July 2013 amending Guideline ECB/2011/23 on the statistical reporting requirements of the ECB in the field of external statistics (OJ L 247, 18.9.2013, p. 38)
ECB/2013/26	Decision of the European Central Bank of 29 August 2013 laying down the measures necessary for the contribution to the ECB's accumulated equity value and for adjusting the national central banks' claims equivalent to the transferred foreign reserve assets (OJ L 16, 21.1.2014, p. 47)
ECB/2013/27	Decision of the European Central Bank of 29 August 2013 amending Decision ECB/2010/29 on the issue of euro banknotes (OJ L 16, 21.1.2014, p. 51)
ECB/2013/28	Decision of the European Central Bank of 29 August 2013 on the national central banks' percentage shares in the key for subscription to the European Central Bank's capital (OJ L 16, 21.1.2014, p. 53)
ECB/2013/29	Decision of the European Central Bank of 29 August 2013 laying down the terms and conditions for transfers of the European Central Bank's capital shares between the national central banks and for the adjustment of the paid-up capital (OJ L 16, 21.1.2014, p. 55)
ECB/2013/30	Decision of the European Central Bank of 29 August 2013 on the paying-up of the European Central Bank's capital by the national central banks of Member States whose currency is the euro (OJ L 16, 21.1.2014, p. 61)
ECB/2013/31	Decision of the European Central Bank of 30 August 2013 on the paying-up of the European Central Bank's capital by the non-euro area national central banks (OJ L 16, 21.1.2014, p. 63)
ECB/2013/32	Recommendation of the European Central Bank of 2 September 2013 to the Council of the European Union on the external auditors of the Banco de España (OJ C 264, 13.9.2013, p. 1)

Number	Title
ECB/2013/33	Regulation of the European Central Bank of 24 September 2013 concerning the balance sheet of the monetary financial institutions sector (recast) (OJ L 297, 7.11.2013, p. 1)
ECB/2013/34	Regulation of the European Central Bank of 24 September 2013 concerning statistics on interest rates applied by monetary financial institutions (recast) (OJ L 297, 7.11.2013, p. 51)
ECB/2013/35	Decision of the European Central Bank of 26 September 2013 on additional measures relating to Eurosystem refinancing operations and eligibility of collateral (OJ L 301, 12.11.2013, p. 6)
ECB/2013/36	Decision of the European Central Bank of 26 September 2013 on additional temporary measures relating to Eurosystem refinancing operations and eligibility of collateral (OJ L 301, 12.11.2013, p. 13)
ECB/2013/37	Guideline of the European Central Bank of 26 September 2013 amending Guideline ECB/2012/27 on a Trans-European Automated Real-time Gross settlement Express Transfer system (TARGET2) (OJ L 333, 12.12.2013, p. 82)
ECB/2013/38	Regulation of the European Central Bank of 18 October 2013 concerning statistics on the assets and liabilities of investment funds (recast) (OJ L 297, 7.11.2013, p. 73)
ECB/2013/39	Regulation of the European Central Bank of 18 October 2013 on statistical reporting requirements for post office giro institutions that receive deposits from non-monetary financial institution euro area residents (recast) (OJ L 297, 7.11.2013, p. 94)
ECB/2013/40	Regulation of the European Central Bank of 18 October 2013 concerning statistics on the assets and liabilities of financial vehicle corporations engaged in securitisation transactions (recast) (OJ L 297, 7.11.2013, p. 107)
ECB/2013/41	Decision of the European Central Bank of 22 October 2013 on transitional provisions for the application of minimum reserves by the European Central Bank following the introduction of the euro in Latvia (OJ L 3, 8.1.2014, p. 9)
ECB/2013/42	Recommendation of the European Central Bank of 15 November 2013 to the Council of the European Union on the external auditors of Latvijas Banka (OJ C 342, 22.11.2013, p. 1)
ECB/2013/43	Regulation of the European Central Bank of 28 November 2013 on payment statistics (OJ L 352, 24.12.2013, p. 18)
ECB/2013/44	Recommendation of the European Central Bank of 28 November 2013 on payment statistics (OJ C 5, 9.1.2014, p. 1)

Number	Title
ECB/2013/45	Guideline of the European Central Bank of 28 November 2013 on amending Guideline ECB/2008/5 on the management of the foreign reserve assets of the European Central Bank by the national central banks and the legal documentation for operations involving such assets (not yet published in the Official Journal)
ECB/2013/46	Decision of the European Central Bank of 6 December 2013 on the approval of the volume of coin issuance in 2014 (OJ L 349, 21.12.2013, p. 109)
ECB/2013/49	Guideline of the European Central Bank of 18 December 2013 amending Guideline ECB/2004/18 on the procurement of euro banknotes (OJ L 32, 1.2.2014, p. 36)
ECB/2013/51	Recommendation of the European Central Bank of 17 December 2013 to the Council of the European Union on the external auditors of the Banque centrale du Luxembourg (OJ C 378, 24.12.2013, p. 15)
ECB/2013/52	Decision of the European Central Bank of 27 December 2013 on amending Decision ECB/2010/21 on the annual accounts of the European Central Bank (OJ L 33, 4.2.2014, p. 7)
ECB/2013/53	Decision of the European Central Bank of 31 December 2013 on the paying-up of capital, transfer of foreign reserve assets and contributions by Latvijas Banka to the European Central Bank's reserves and provisions (OJ L 16, 21.1.2014, p. 65)
ECB/2013/54	Decision of the European Central Bank of 20 December 2013 on the accreditation procedures for manufacturers of euro secure items and euro items and amending Decision ECB/2008/3 (not yet published in the Official Journal)

(b) ECB opinions following a consultation by a European institution

Number	Originator and subject
CON/2013/2	Council – A proposal for a Council regulation establishing a facility for providing financial assistance for Member States whose currency is not the euro (OJ C 96, 4.4.2013, p. 11)
CON/2013/4	European Parliament – A proposal for a directive of the European Parliament and of the Council amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions (OJ C 96, 4.4.2013, p. 18)
CON/2013/32	Council – A proposal for a directive on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing and on a proposal for a regulation on information accompanying transfers of funds (OJ C 166, 12.6.2013, p. 2)
CON/2013/35	Council – A proposal for a Council regulation on denominations and technical specifications of euro coins intended for circulation (OJ C 176, 21.6.2013, p. 11)
CON/2013/37	European Parliament – A proposal for a directive of the European Parliament and of the Council on the protection of the euro and other currencies against counterfeiting by criminal law, and replacing Council Framework Decision 2000/383/JHA (OJ C 179, 25.6.2013, p. 9)
CON/2013/48	Council – A proposal for a Council regulation amending Regulation (EC) No 974/98 as regards the introduction of the euro in Latvia and on a proposal for a Council regulation amending Regulation (EC) No 2866/98 as regards the conversion rate to the euro for Latvia (OJ C 204, 18.7.2013, p. 1)
CON/2013/72	European Parliament – A proposal for a regulation of the European Parliament and of the Council on the provision and quality of statistics for the macroeconomic imbalances procedure (OJ C 14, 18.1.2014, p. 5)
CON/2013/76	European Parliament – A proposal for a regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council (not yet published in the Official Journal)
CON/2013/77	European Parliament – A proposal for a directive of the European Parliament and of the Council on the comparability of fees related to payment accounts, payment account switching and access to payment accounts with basic features (not yet published in the Official Journal)

Number	Originator and subject
CON/2014/2	European Parliament – A proposal for a regulation on indices used as benchmarks in financial instruments and financial contracts (not yet published in the Official Journal)
CON/2014/9	European Parliament – A proposal for a directive of the European Parliament and of the Council on payment services in the internal market and amending Directives 2002/65/EC, 2013/36/EU and 2009/110/EC and repealing Directive 2007/64/EC (not yet published in the Official Journal)
CON/2014/10	European Parliament – A proposal for a regulation of the European Parliament and of the Council on interchange fees for card-based payment transactions (not yet published in the Official Journal)

(c) ECB opinions following a consultation by a Member State

Number	Consulting Member State and subject
CON/2013/1	Poland – The financial market supervision framework
CON/2013/3	Spain – Early intervention, restructuring and resolution of credit institutions
CON/2013/5	Poland – Credit unions
CON/2013/6	Romania – New competences granted to Banca Națională a României concerning sovereign debt and sovereign credit default swaps
CON/2013/7	Italy – Credit transfer and direct debit transactions
CON/2013/8	France – State guarantee covering certain commitments of subsidiaries of Dexia SA
CON/2013/9	Denmark – Limitations on cash payments
CON/2013/10	Cyprus – Resolution framework for credit and other institutions
CON/2013/11	Finland – Limitations on cash payments in the context of payment of wages
CON/2013/12	Hungary – Deposit-taking and securities account management by the Treasury
CON/2013/13	Belgium – The amended calculation of the annual financial stability contribution
CON/2013/14	Poland – The financial market supervision framework
CON/2013/15	Greece – The profit distribution of the Bank of Greece
CON/2013/16	Austria – The Oesterreichische Nationalbank's contributions to the International Monetary Fund's Poverty Reduction and Growth Trust and a bilateral loan agreement between the International Monetary Fund and the Oesterreichische Nationalbank
CON/2013/17	Greece – The recapitalisation of credit institutions
CON/2013/18	Belgium – The limitation of cash payments
CON/2013/19	Portugal – The recapitalisation of credit institutions
CON/2013/20	Greece – Dormant deposit accounts with credit institutions
CON/2013/21	Slovenia – The measures for strengthening bank stability
CON/2013/22	Austria – Balance of payments reporting
CON/2013/23	Slovakia – Special mortgage transactions
CON/2013/24	Malta – Financial collateral arrangements
CON/2013/25	Spain – The Deposit Guarantee Fund
CON/2013/26	Austria – Crisis planning and early intervention for credit institutions
CON/2013/27	Belgium – The framework for state guarantees and on state guarantees for Dexia SA and Dexia Crédit Local SA

Number	Consulting Member State and subject
CON/2013/28	Germany – Protection from risks and separation of banking businesses
CON/2013/29	France – Consumer credit register
CON/2013/30	Malta – Macro-prudential policy
CON/2013/31	Romania – Strengthening Banca Națională a României’s institutional role and independence
CON/2013/33	Spain – Mortgagor protection
CON/2013/34	Greece – Debt arrangements for over-indebted individuals
CON/2013/36	France – The status of credit institutions and the creation of financing companies
CON/2013/38	Greece – The Hellenic Financial Stability Fund
CON/2013/39	Romania – The macro-prudential oversight of the national financial system
CON/2013/40	Hungary – The new supervisory tasks of the Magyar Nemzeti Bank
CON/2013/41	Cyprus – Changes to the governance of the Central Bank of Cyprus
CON/2013/42	Belgium – Recovery and resolution plans
CON/2013/43	Belgium – The treatment of euro banknotes neutralised by anti-theft devices
CON/2013/44	Cyprus – Special tax on credit institutions
CON/2013/45	Lithuania – Lietuvos bankas’ macro-prudential mandate
CON/2013/46	Ireland – Pay and pension reforms
CON/2013/47	Latvia – Reserve requirements in connection with the introduction of the euro
CON/2013/49	Ireland – Branches of non-EEA credit institutions
CON/2013/50	Romania – Stabilisation measures
CON/2013/51	Cyprus – The supervision of cooperative credit institutions
CON/2013/52	Spain – Savings banks and banking foundations
CON/2013/53	Sweden – The financial independence of Sveriges Riksbank
CON/2013/54	Cyprus – The macro-prudential oversight of the national financial system
CON/2013/55	Belgium – Measures to encourage long-term lending
CON/2013/56	Hungary – The new integrated Hungarian supervisory framework
CON/2013/57	Greece – The special liquidation of credit institutions
CON/2013/58	Slovakia – The financial statements register
CON/2013/59	Belgium – OTC derivatives, central counterparties and trade repositories

Number	Consulting Member State and subject
CON/2013/60	Denmark – The provision of collateral to Danmarks Nationalbank through automatic collateralisation
CON/2013/61	Spain – The autonomy of the Banco de España in staff matters and on the termination of the office of the Governor
CON/2013/62	Slovenia – The provision of payment services by Banka Slovenije for budget users
CON/2013/63	Lithuania – Credit unions
CON/2013/64	Poland – The principles and procedure for exchanging banknotes and coins
CON/2013/65	Latvia – The handling and recirculation of euro banknotes and coins
CON/2013/66	Portugal – The macro-prudential mandate of the Banco de Portugal
CON/2013/67	Slovenia – Measures to strengthen bank stability
CON/2013/68	Belgium – New statistical task of the Nationale Bank van België/Banque Nationale de Belgique
CON/2013/69	Malta – Amendments to the Central Bank of Malta Act
CON/2013/70	Slovenia – The establishment of a Financial Stability Board and the macro-prudential mandate of national authorities
CON/2013/71	Hungary – The integrated Hungarian supervisory framework
CON/2013/73	Slovenia – Measures for bank reorganisation
CON/2013/74	Romania – The transfer of the management of state properties to Banca Națională
CON/2013/75	Slovenia – Financial restructuring of companies
CON/2013/78	Cyprus – Changes to decision-making powers at the Central Bank of Cyprus
CON/2013/79	Lithuania – The reserve requirements for credit institutions
CON/2013/80	Romania – Stabilisation measures and the deposit guarantee fund
CON/2013/81	Cyprus – The licensing, regulation and supervision of cooperative credit
CON/2013/82	Finland – The prudential supervision of credit institutions and macro-prudential
CON/2013/83	Denmark – The Financial Supervisory Authority's governance
CON/2013/84	France – Means of payment and payment systems
CON/2013/85	Lithuania – The legal status of Lietuvos bankas' assets and the scope of its public audit
CON/2013/86	Slovenia – Measures to strengthen bank stability

Number	Consulting Member State and subject
CON/2013/87	Portugal – The recapitalisation of credit institutions
CON/2013/88	Hungary – The data reporting obligations supporting supervisory tasks of the Magyar Nemzeti Bank
CON/2013/89	Hungary – The processing and distribution of banknotes, and their protection against counterfeiting in Hungary
CON/2013/90	Luxembourg – Public finances
CON/2013/91	Estonia – Public finances
CON/2013/92	Italy – The containment of public expenditure as regards the Banca d'Italia
CON/2013/93	Latvia – The credit register
CON/2013/94	Romania – Covered bonds
CON/2013/95	Denmark – Variable remuneration for employees of securities traders
CON/2013/96	Italy – Capital increase of the Banca d'Italia

2 CHRONOLOGY OF MONETARY POLICY MEASURES OF THE EUROSISTEM

10 JANUARY, 7 FEBRUARY, 7 MARCH AND 4 APRIL 2013

The Governing Council of the ECB decides that the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 0.75%, 1.50% and 0.00% respectively.

2 MAY 2013

The Governing Council of the ECB decides to decrease the interest rate on the main refinancing operations by 25 basis points to 0.50%, starting from the operation to be settled on 8 May 2013. In addition, it decides to decrease the interest rate on the marginal lending facility by 50 basis points to 1.00%, with effect from 8 May 2013, and to keep the interest rate on the deposit facility unchanged at 0.00%. It also decides on the details as regards the tender procedures and modalities to be applied in its refinancing operations up to 8 July 2014, notably to continue its fixed rate tender procedures with full allotment.

6 JUNE, 4 JULY, 1 AUGUST, 5 SEPTEMBER AND 2 OCTOBER 2013

The Governing Council of the ECB decides that the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 0.50%, 1.00% and 0.00% respectively.

7 NOVEMBER 2013

The Governing Council of the ECB decides to decrease the interest rate on the main refinancing operations by 25 basis points to 0.25%, starting from the operation to be settled on 13 November 2013. In addition, it decides to decrease the interest rate on the marginal lending facility by 25 basis points to 0.75%, with effect from 13 November 2013, and to keep the interest rate on the deposit facility unchanged at 0.00%. It also decides on the details as regards the tender procedures and modalities to be applied in its refinancing operations up to 7 July 2015, notably to continue its fixed rate tender procedures with full allotment.

5 DECEMBER 2013, AND 9 JANUARY, 6 FEBRUARY AND 6 MARCH 2014

The Governing Council of the ECB decides that the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 0.25%, 0.75% and 0.00% respectively.

3 OVERVIEW OF THE ECB'S COMMUNICATION RELATED TO THE PROVISION OF LIQUIDITY¹

For more details on the liquidity-providing operations conducted by the Eurosystem in 2013, see the "Open market operations" section of the ECB's website.

PROVISION OF LIQUIDITY IN EURO

21 FEBRUARY 2013

The ECB publishes details of the Eurosystem's holdings of securities acquired under the Securities Markets Programme as at 31 December 2012.

21 MARCH 2013

The ECB announces that emergency liquidity assistance (ELA) requested by the Central Bank of Cyprus will be provided until 25 March 2013, while for the period thereafter, ELA could only be provided if an EU-IMF programme were in place.

22 MARCH 2013

The ECB announces that, as of 1 March 2013, it will no longer accept as collateral uncovered government-guaranteed bank bonds which have been issued by a counterparty using them as collateral or by entities closely linked to that counterparty.

25 MARCH 2013

The ECB announces that the ECB's Governing Council has decided not to object to the request for provision of emergency liquidity assistance by the Central Bank of Cyprus in accordance with the prevailing rules, following the Eurogroup agreement on the Cypriot macroeconomic adjustment programme, and that it will continue to monitor the situation closely.

2 MAY 2013

The ECB announces that, as of 9 May 2013, marketable debt instruments issued or fully guaranteed by the Republic of Cyprus and fulfilling all other eligibility criteria will again constitute eligible collateral for the purposes of Eurosystem credit operations, subject to special haircuts. The application of the minimum credit rating threshold for collateral eligibility is suspended.

2 MAY 2013

The ECB announces details of refinancing operations with settlement in the period from 10 July 2013 to 8 July 2014. The ECB announces that it will continue conducting its main refinancing operations (MROs) as well as the special-term refinancing operations with a maturity of one maintenance period as fixed rate tender procedures with full allotment, for as long as necessary, and at least until the end of the sixth maintenance period of 2014 on 8 July 2014. Furthermore, the ECB announces that it will conduct the three-month longer-term refinancing operations (LTROs) to be allotted on 31 July, 28 August, 25 September, 30 October, 27 November and 18 December 2013 and 29 January, 26 February, 26 March, 30 April, 28 May and 25 June 2014 as fixed rate tender procedures with full allotment. The rates in these three-month operations will be fixed at the average rate of the MROs over the life of the respective LTRO.

¹ Dates refer to the date of publication of the announcement.

28 JUNE 2013

The ECB announces the suspension of the eligibility of marketable debt instruments issued or fully guaranteed by the Republic of Cyprus for use as collateral in Eurosystem monetary policy operations.

5 JULY 2013

The ECB announces that, with immediate effect, marketable debt instruments issued or fully guaranteed by the Republic of Cyprus and fulfilling all other eligibility criteria will again constitute eligible collateral for the purposes of Eurosystem credit operations, subject to special haircuts. The application of the minimum credit rating threshold for collateral eligibility is suspended.

18 JULY 2013

The ECB announces changes to its collateral risk control framework, including a new treatment of asset-backed securities, an expansion of the list of collateral accepted under the permanent Eurosystem collateral framework, and an adjustment of the eligibility criteria and haircuts applied by NCBs to pools of credit claims and certain types of the additional credit claims eligible under the temporary Eurosystem collateral framework.

9 SEPTEMBER 2013

The ECB announces modifications to the loan-level data reporting requirements for asset-backed securities.

19 SEPTEMBER 2013

The ECB announces the implementation of loan-level reporting requirements for asset-backed securities backed by credit card receivables.

27 SEPTEMBER 2013

The ECB announces the adoption of decisions to follow up on the review of its collateral risk control framework.

17 OCTOBER 2013

The ECB publishes the procedures related to the provision of emergency liquidity assistance by Eurosystem NCBs to individual credit institutions.

23 OCTOBER 2013

The ECB announces details on the application of minimum reserve requirements for credit institutions and branches of credit institutions in Latvia, following the introduction of the euro in Latvia on 1 January 2014.

8 NOVEMBER 2013

The ECB announces that it will continue conducting its main refinancing operations (MROs) as fixed rate tender procedures with full allotment for as long as necessary, and at least until the end of the sixth maintenance period of 2015 on 7 July 2015, and that this procedure will also remain in use for the Eurosystem's special-term refinancing operations with a maturity of one maintenance period, which will continue to be conducted for as long as needed, and at least until the end of the second quarter of 2015. The fixed rate in these special-term refinancing operations will be the same as the MRO rate prevailing at the time. Furthermore, the ECB announces that it will conduct the three-month longer-term refinancing operations (LTROs) to be allotted on 30 July, 27 August, 24 September, 29 October, 26 November and 17 December 2014 and 28 January, 25 February,

25 March, 29 April, 27 May and 24 June 2015 as fixed rate tender procedures with full allotment. The rates in these three-month operations will be fixed at the average rate of the MROs over the life of the respective LTRO.

22 NOVEMBER 2013

The ECB announces the suspension of repayments of the three-year longer-term refinancing operations during the year-end period, in view of the expected low interest and the concentration of other operations owing to public holidays. Consequently, the last repayment of the year will be settled on 23 December 2013 and the amount of the repayment will be announced on 20 December. Repayment operations will resume in 2014 with a settlement on 15 January. The amount of this repayment will be announced on 10 January. The repayments that were tentatively scheduled for settlement on 30 December 2013 and 8 January 2014 will not take place.

PROVISION OF LIQUIDITY IN OTHER CURRENCIES AND AGREEMENTS WITH OTHER CENTRAL BANKS

16 SEPTEMBER 2013

The ECB announces the prolongation of its swap facility agreement with the Bank of England until 30 September 2014.

10 OCTOBER 2013

The ECB announces the establishment of a bilateral currency swap agreement with the People's Bank of China as a backstop liquidity facility, with a maximum size of 350 billion Chinese renminbi and €45 billion and a validity of three years.

31 OCTOBER 2013

The ECB announces jointly with the Bank of Canada, the Bank of England, the Bank of Japan, the Federal Reserve and the Swiss National Bank that their existing temporary bilateral liquidity swap arrangements are being converted into standing arrangements which are to remain in place until further notice.

4 PUBLICATIONS PRODUCED BY THE ECB

The ECB produces a number of publications which provide information about its core activities: monetary policy, statistics, payment and securities settlement systems, financial stability and supervision, international and European cooperation, and legal matters. These include the following:

STATUTORY PUBLICATIONS

- Annual Report
- Convergence Report
- Monthly Bulletin

RESEARCH PAPERS

- Legal Working Paper Series
- Occasional Paper Series
- Research Bulletin
- Statistics Paper Series
- Working Paper Series

OTHER/TASK-RELATED PUBLICATIONS

- Enhancing monetary analysis
- Financial integration in Europe
- Financial Stability Review
- Statistics Pocket Book
- The European Central Bank: history, role and functions
- The international role of the euro
- The monetary policy of the ECB
- The payment system: payments, securities and derivatives, and the role of the Eurosystem
- Statistics for Economic and Monetary Union: enhancements and new directions 2003-13

The ECB also publishes brochures and information materials on a variety of topics, such as the euro banknotes and coins, as well as seminar and conference proceedings.

For a complete list of documents (in PDF format) published by the ECB and the European Monetary Institute, the ECB's forerunner from 1994 to 1998, please visit the ECB's website at <http://www.ecb.europa.eu/pub/>. Language codes indicate the languages in which each publication is available.

5 GLOSSARY

This glossary contains selected terms that are used in the Annual Report. A more comprehensive and detailed glossary can be found on the ECB's website.

Balance of payments (b.o.p.): a statistical statement that summarises, for a specific period of time, the economic transactions of an economy with the rest of the world. The transactions considered are: those involving goods, services and income; those involving financial claims on, and liabilities to, the rest of the world; and those (such as debt forgiveness) that are classified as transfers.

Banking union: one of the building blocks for completing **Economic and Monetary Union**, which consists of an integrated financial framework with a single rulebook, a **Single Supervisory Mechanism**, common deposit protection and a single bank resolution mechanism.

Central counterparty (CCP): an entity that interposes itself, in one or more markets, between the **counterparties** to the contracts traded, becoming the buyer to every seller and the seller to every buyer and thereby guaranteeing the performance of open contracts.

Central government: the government as defined in the **European System of Accounts 1995**, but excluding regional and local governments (see also **general government**).

Central securities depository (CSD): an entity that: (i) enables securities transactions to be processed and settled by book entry, (ii) provides custodial services (e.g. the administration of corporate actions and redemptions), and (iii) plays an active role in ensuring the integrity of securities issues. Securities can be held in a physical (but immobilised) form or in a dematerialised form (whereby they exist only as electronic records).

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

Comprehensive assessment: an assessment of the banking system in the Member States participating in the **Single Supervisory Mechanism**. The assessment, carried out by the ECB in cooperation with the national competent authorities of the participating Member States, is to be concluded before the ECB assumes its supervisory responsibilities. It comprises a supervisory risk assessment, an asset quality review and a stress test. The objective is to foster transparency, repair balance sheets where needed and enhance confidence in the banking sector.

Correspondent central banking model (CCBM): a mechanism established by the **European System of Central Banks** with the aim of enabling **counterparties** to use eligible **collateral** in a cross-border context. In the CCBM, NCBs act as custodians for one another. This means that each NCB has a securities account in its securities administration for each of the other NCBs and the ECB.

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

Covered bond purchase programme (CBPP): an ECB programme, based on the decision of the **Governing Council** of 7 May 2009 to purchase euro-denominated covered bonds issued in the **euro area**, in support of a specific financial market segment that is important for the funding of banks and was particularly affected by the financial crisis. The purchases under the programme

were for a nominal value of €60 billion, and they were fully implemented by 30 June 2010. On 6 October 2011 the Governing Council decided to launch a second covered bond purchase programme, the CBPP2. This programme allowed the **Eurosystem** to purchase euro-denominated covered bonds issued in the euro area for an intended nominal value of €40 billion. The purchases were conducted in both the primary and secondary markets from November 2011 until the end of October 2012, with the purchases totalling a nominal amount of €16.418 billion.

Credit institution: an undertaking the business of which is to receive deposits or other repayable funds from the public and to grant credit for its own account.

Credit risk: the risk that a **counterparty** will not settle the full value of an obligation – neither when it becomes due, nor at any time thereafter. Credit risk includes replacement cost risk and principal risk. It also includes the risk of the settlement bank failing.

Debt (general government): the total gross debt (currency, deposits, loans and **debt securities**) at nominal value outstanding at the end of the year and consolidated between and within the sectors of **general government**.

Debt security: a promise on the part of the issuer (i.e. the borrower) to make one or more payment(s) to the holder (the lender) on a specified future date or dates. Such securities usually carry a specific rate of interest (the coupon) and/or are sold at a discount to the amount that will be repaid at maturity.

Debt-to-GDP ratio (general government): the ratio of **debt** to **gross domestic product** at current market prices. It is the subject of one of the fiscal criteria laid down in Article 126(2) of the **Treaty** to define the existence of an excessive deficit (see also **excessive deficit procedure**).

Deficit (general government): the **general government's** net borrowing, i.e. the difference between total government revenue and total government expenditure.

Deficit-debt adjustment (general government): the difference between the **general government** budget balance (**deficit** or surplus) and the change in **debt**.

Deficit ratio (general government): the ratio of the **deficit** to **gross domestic product** at current market prices. It is the subject of one of the fiscal criteria laid down in Article 126(2) of the **Treaty** to define the existence of an excessive deficit (see also **excessive deficit procedure**). It is also referred to as the budget deficit ratio or the fiscal deficit ratio.

Deposit facility: a **standing facility** of the **Eurosystem** which **counterparties** may use to make overnight deposits at an NCB. Such deposits are remunerated at a pre-specified interest rate (see also **key ECB interest rates**).

Direct investment: cross-border investment for the purpose of obtaining a lasting interest in an enterprise resident in another economy (assumed, in practice, for ownership of at least 10% of the ordinary shares or voting power). Included are equity capital, reinvested earnings and other capital associated with inter-company operations.

ECOFIN Council: the term often used to refer to the **EU Council** meeting in the composition of the ministers of economics and finance.

Economic analysis: one pillar of the ECB's framework for conducting a comprehensive analysis of the risks to **price stability**, which forms the basis for the **Governing Council's** monetary policy decisions. The economic analysis focuses mainly on the assessment of current economic and financial developments and the implied short to medium-term risks to price stability from the perspective of the interplay between supply and demand in goods, services and factor markets at those horizons. Due attention is paid to the need to identify the nature of shocks affecting the economy, their effects on cost and pricing behaviour, and the short to medium-term prospects for their propagation in the economy (see also **monetary analysis**).

Economic and Financial Committee (EFC): a committee which contributes to the preparation of the work of the **ECOFIN Council** and the European Commission. Its tasks include reviewing the economic and financial situation of both the Member States and the EU, and contributing to budgetary surveillance.

Economic and Monetary Union (EMU): the process that led to the single currency, the euro, and the single monetary policy in the **euro area**, as well as to the coordination of the economic policies of the EU Member States. This process, as laid down in the **Treaty**, took place in three stages. Stage Three, the final stage, started on 1 January 1999 with the transfer of monetary competence to the ECB and the introduction of the euro. The cash changeover on 1 January 2002 completed the process of setting up EMU.

Effective exchange rate (EER) of the euro (nominal/real): a weighted average of the bilateral euro exchange rates against the currencies of the **euro area's** main trading partners. The ECB publishes nominal EER indices for the euro against two groups of trading partners: the EER-20 (comprising the ten non-euro area EU Member States and ten trading partners outside the EU) and the EER-40 (composed of the EER-20 and 20 additional countries). The weights used reflect the share of each partner country in the euro area's trade in manufactured goods and account for competition in third markets. Real EERs are nominal EERs deflated by a weighted average of foreign, relative to domestic, prices or costs. They are thus measures of price and cost competitiveness.

EONIA (euro overnight index average): a measure of the effective interest rate prevailing in the euro interbank overnight market. It is calculated as a weighted average of the interest rates on unsecured overnight lending transactions denominated in euro, as reported by a panel of contributing banks.

Equities: securities representing ownership of a stake in a corporation. They comprise shares traded on stock exchanges (quoted shares), unquoted shares and other forms of equity. Equities usually produce income in the form of dividends.

ERM II (exchange rate mechanism II): a mechanism which provides the framework for exchange rate policy cooperation between the **euro area** countries and the non-euro area EU Member States. ERM II is a multilateral arrangement with fixed, but adjustable, central rates and a standard fluctuation band of $\pm 15\%$. Decisions concerning central rates and, possibly, narrower fluctuation bands are taken by mutual agreement between the EU Member State concerned, the euro area countries, the ECB and the other EU Member States participating in the mechanism. All participants in ERM II, including the ECB, have the right to initiate a confidential procedure aimed at changing the central rates (realignment).

EU Council (Council of the European Union): the institution of the EU made up of representatives of the governments of the EU Member States, normally the ministers responsible for the matters under consideration, and the relevant European Commissioner (see also **ECOFIN Council**).

EURIBOR (euro interbank offered rate): the rate at which a prime bank is willing to lend funds in euro to another prime bank, as reported by a panel of contributing banks, computed daily for interbank deposits with different maturities of up to 12 months.

Euro area: the area formed by the EU Member States whose currency is the euro and in which a single monetary policy is conducted under the responsibility of the **Governing Council** of the ECB. The euro area currently comprises Belgium, Germany, Estonia, Ireland, Greece, Spain, France, Italy, Cyprus, Latvia, Luxembourg, Malta, the Netherlands, Austria, Portugal, Slovenia, Slovakia and Finland.

Eurogroup: an informal gathering of the ministers of economics and finance of the EU Member States whose currency is the euro. Its status is recognised under Article 137 of the **Treaty** and in Protocol No 14. The European Commission and the ECB are regularly invited to take part in its meetings.

Europe 2020 strategy: the EU's strategy for employment and smart, sustainable and inclusive growth. It was adopted by the **European Council** in June 2010. Building on the earlier Lisbon strategy, it is intended to provide a coherent framework for EU Member States to implement structural reforms aimed at raising potential growth and for mobilising EU policies and instruments.

European Council: the institution of the EU consisting of the Heads of State or Government of the EU Member States and, as non-voting members, the President of the European Commission and the European Council's own President. It provides the EU with the necessary impetus for its development and defines the general political directions and priorities thereof. It does not have a legislative function.

European Financial Stabilisation Mechanism (EFSM): an EU facility, based on Article 122(2) of the **Treaty**, that allows the European Commission to raise up to €60 billion on behalf of the EU for lending to EU Member States experiencing, or being threatened with, exceptional circumstances beyond their control. EFSM lending is subject to strong conditionality in the context of joint EU-IMF programmes.

European Financial Stability Facility (EFSF): a limited liability company established by the **euro area** countries, on an intergovernmental basis, for the purpose of providing loans to euro area countries in financial difficulties. Such financial assistance is subject to strong conditionality in the context of joint EU-IMF programmes. The EFSF has an effective lending capacity of €440 billion, and its loans are financed through the issuance of **debt securities**, guaranteed by euro area countries on a pro rata basis. As of 1 July 2013 the EFSF may no longer engage in new financing programmes or enter into new loan facility agreements.

European Monetary Institute (EMI): a temporary institution established at the start of Stage Two of **Economic and Monetary Union** on 1 January 1994. It went into liquidation following the establishment of the ECB on 1 June 1998.

European Semester: the first phase of the EU's annual cycle of economic policy guidance and surveillance. It enables the European Commission and the Council to discuss the Member States' budgetary and economic plans and give policy guidance before decisions are made at the national level. In the second phase of the annual cycle of economic policy guidance and surveillance (National Semester), Member States implement the policies that they have agreed.

European Stability Mechanism (ESM): an intergovernmental organisation established by the **euro area** countries on the basis of the Treaty establishing the European Stability Mechanism. It is a permanent crisis management mechanism for the euro area which issues debt instruments in order to finance loans and other forms of financial assistance to euro area countries. The ESM entered into force on 8 October 2012. It has an effective lending capacity of €500 billion and replaced both the **European Financial Stability Facility** and the **European Financial Stabilisation Mechanism**. ESM lending is subject to strict conditionality.

European System of Accounts 1995 (ESA 95): a comprehensive and integrated system of macroeconomic accounts based on a set of internationally agreed statistical concepts, definitions, classifications and accounting rules aimed at achieving a harmonised quantitative description of the economies of the EU Member States. The ESA 95 is the EU's version of the world System of National Accounts 1993 (SNA 93).

European System of Central Banks (ESCB): composed of the ECB and the NCBs of all 28 EU Member States, i.e. it includes, in addition to the members of the **Eurosystem**, the NCBs of those Member States whose currency is not the euro. The ESCB is governed by the **Governing Council** and the **Executive Board** of the ECB, and, as a third decision-making body of the ECB, by the **General Council**.

European System of Financial Supervision (ESFS): the group of institutions in charge of ensuring the supervision of the EU's financial system. It comprises the **European Systemic Risk Board**, the three European Supervisory Authorities, the Joint Committee of the European Supervisory Authorities, and the national supervisory authorities of the EU Member States.

European Systemic Risk Board (ESRB): an independent EU body responsible for the macro-prudential oversight of the financial system within the EU. It contributes to the prevention or mitigation of **systemic risks** to **financial stability** that arise from developments within the financial system, taking into account macroeconomic developments, so as to avoid periods of widespread financial distress.

Eurosystem: the central banking system of the **euro area**. It comprises the ECB and the NCBs of the EU Member States whose currency is the euro.

Eurosystem credit assessment framework (ECAF): procedures, rules and techniques which ensure that the Eurosystem requirement of high credit standards for all eligible assets is met.

Excessive deficit procedure: the provision set out in Article 126 of the **Treaty** and specified in Protocol (No 12) on the excessive deficit procedure requires EU Member States to maintain budgetary discipline, defines the criteria for a budgetary position to be considered an excessive deficit and regulates steps to be taken following the observation that the requirements for the budgetary balance or government **debt** have not been fulfilled. Article 126 is supplemented

by Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, which is one element of the **Stability and Growth Pact**.

Excess liquidity: the amount of central bank reserves held by banks in excess of the aggregate needs of the banking system, which are determined by **reserve requirements** and autonomous factors.

Executive Board: one of the decision-making bodies of the ECB. It comprises the President and the Vice-President of the ECB and four other members appointed by the **European Council**, acting by a qualified majority, on a recommendation from the **EU Council**, after it has consulted the European Parliament and the ECB.

Financial stability: the condition in which the financial system – comprising financial intermediaries, markets and market infrastructures – is capable of withstanding shocks and the unravelling of financial imbalances, thereby mitigating the likelihood of disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities.

Fine-tuning operation: an **open market operation** executed by the **Eurosystem** in order to deal with unexpected liquidity fluctuations in the market. The frequency and maturity of fine-tuning operations are not standardised.

Forward guidance: communication by a central bank on the orientation of monetary policy with respect to the future path of policy interest rates.

GDP deflator: **gross domestic product** (GDP) expressed in current prices (nominal GDP) divided by the volume of GDP (real GDP). It is also known as the implicit price deflator of GDP.

General Council: one of the decision-making bodies of the ECB. It comprises the President and the Vice-President of the ECB and the governors of all the NCBs of the **European System of Central Banks**.

General Documentation: refers to the ECB publication entitled “The implementation of monetary policy in the euro area: General documentation on Eurosystem monetary policy instruments and procedures”, which presents the operational framework chosen by the **Eurosystem** for the single monetary policy in the **euro area**.

General government: a sector defined in the **European System of Accounts 1995** as comprising resident entities that are engaged primarily in the production of non-market goods and services intended for individual and collective consumption and/or in the redistribution of national income and wealth. Included are central, regional and local government authorities, as well as social security funds. Excluded are government-owned entities that conduct commercial operations, such as public enterprises.

Governing Council: the supreme decision-making body of the ECB. It comprises all the members of the **Executive Board** of the ECB and the governors of the NCBs of the EU Member States whose currency is the euro.

Gross domestic product (GDP): a measure of economic activity, namely the value of an economy's total output of goods and services, less intermediate consumption, plus net taxes on products and imports, in a specified period. GDP can be broken down by output, expenditure or income components. The main expenditure aggregates that make up GDP are household final consumption, government final consumption, gross fixed capital formation, changes in inventories, and imports and exports of goods and services (including intra-euro area trade).

Harmonised Index of Consumer Prices (HICP): a measure of the development of consumer prices that is compiled by Eurostat and harmonised for all EU Member States.

Implied volatility: the expected volatility (i.e. standard deviation) in the rates of change of the price of an asset (e.g. a share or a bond). It can be derived from the asset's price, its maturity date and the exercise price of its options, as well as from a riskless rate of return, using an option pricing model such as the Black-Scholes model.

Key ECB interest rates: the interest rates set by the **Governing Council**. They are the rates on the **main refinancing operations**, the **marginal lending facility** and the **deposit facility**.

Longer-term refinancing operation: a credit operation with a maturity of more than one week that is executed by the **Eurosystem** in the form of **reverse transactions**. The regular monthly operations have a maturity of three months. During the financial market turmoil that started in August 2007, supplementary operations with maturities ranging from one **maintenance period** to three years were conducted, the frequency of which varied.

M1: a narrow monetary aggregate that comprises currency in circulation plus overnight deposits held with **MFIs** and **central government** (e.g. at the post office or treasury).

M2: an intermediate monetary aggregate that comprises **M1** plus deposits redeemable at a period of notice of up to and including three months (i.e. short-term savings deposits) and deposits with an agreed maturity of up to and including two years (i.e. short-term time deposits) held with **MFIs** and **central government**.

M3: a broad monetary aggregate that comprises **M2** plus marketable instruments, in particular **repurchase agreements**, **money market** fund shares/units, and **debt securities** with a maturity of up to and including two years issued by **MFIs**.

Main refinancing operation: a regular **open market operation** executed by the **Eurosystem** in the form of **reverse transactions**. Such operations are carried out through a weekly standard tender procedure and normally have a maturity of one week.

Maintenance period: the period over which **credit institutions'** compliance with **reserve requirements** is calculated. The maintenance period begins on the settlement day of the first **main refinancing operation** following the meeting of the **Governing Council** at which the monthly assessment of the monetary policy stance is pre-scheduled. The ECB publishes a calendar of the reserve maintenance periods at least three months before the start of the year.

Marginal lending facility: a **standing facility** of the **Eurosystem** which **counterparties** may use to receive overnight credit from an NCB at a pre-specified interest rate against eligible assets (see also **key ECB interest rates**).

Market risk: the risk of losses (in both on and off-balance-sheet positions) arising from movements in market prices.

Maximum bid rate: the upper limit to the interest rates at which **counterparties** may submit bids in variable rate liquidity-absorbing tender operations.

MFIs (monetary financial institutions): financial institutions which together form the money-issuing sector of the **euro area**. These include the **Eurosystem**, resident **credit institutions** (as defined in EU law) and all other resident financial institutions whose business is to receive deposits and/or close substitutes for deposits from entities other than MFIs and, for their own account (at least in economic terms), to grant credit and/or invest in securities. The latter group consists predominantly of **money market** funds, i.e. funds that invest in short-term and low-risk instruments, usually with a maturity of one year or less.

Minimum bid rate: the lower limit to the interest rates at which **counterparties** may submit bids in variable rate liquidity-providing tender operations.

Monetary analysis: one pillar of the ECB's framework for conducting a comprehensive analysis of the risks to **price stability**, which forms the basis for the **Governing Council's** monetary policy decisions. The monetary analysis helps to assess medium to long-term trends in inflation, in view of the close relationship between money and prices over extended horizons. The monetary analysis takes into account developments in a wide range of monetary indicators, including **M3**, its components and counterparts, notably credit, and various measures of excess liquidity (see also **economic analysis**).

Monetary income: income accruing to the NCBs in the performance of the **Eurosystem's** monetary policy function, derived from assets earmarked in accordance with guidelines established by the **Governing Council** and held against banknotes in circulation and deposit liabilities to **credit institutions**.

Money market: the market in which short-term funds are raised, invested and traded, using instruments which generally have an original maturity of up to and including one year.

Non-standard measures: temporary measures taken by the **Governing Council** to support the effectiveness of interest rate decisions and their transmission to the wider **euro area** economy in the context of a dysfunctional situation in some financial market segments and the financial system more broadly.

OFIs (other financial intermediaries): corporations or quasi-corporations (other than insurance corporations or pension funds) that are engaged mainly in financial intermediation by incurring liabilities in forms other than currency, deposits and/or close substitutes for deposits from institutional entities other than **MFIs**. OFIs include in particular corporations engaged primarily in long-term financing (such as financial leasing), securitised asset holdings, other financial holdings, securities and derivatives dealing (on their own account), venture capital and development capital.

Open market operation: an operation executed on the initiative of the central bank in the financial market. With regard to their aims, regularity and procedures, **Eurosystem** open market operations can be divided into four categories: **main refinancing operations**; **longer-term refinancing operations**; **fine-tuning operations**; and structural operations. As for the instruments used, **reverse transactions** are the main open market instrument of the Eurosystem and can be employed in all four categories of operation. In addition, the issuance of debt certificates and outright transactions are available for structural operations, while outright transactions, foreign exchange swaps and the collection of fixed-term deposits are available for the conduct of fine-tuning operations.

Outright Monetary Transactions (OMTs): transactions that aim to safeguard an appropriate monetary policy transmission and the singleness of the monetary policy in the **euro area** through purchases of euro area government bonds in the secondary market based on strict and effective conditionality.

Over-the-counter (OTC) trading: a method of trading that does not involve a regulated market. In over-the-counter markets, such as those for OTC derivatives, participants trade directly with each other, typically through telephone or computer links.

Price stability: the maintenance of price stability is the primary objective of the **Eurosystem**. The **Governing Council** defines price stability as a year-on-year increase in the **Harmonised Index of Consumer Prices** for the **euro area** of below 2%. The Governing Council has also made it clear that, in the pursuit of price stability, it aims to maintain inflation rates below, but close to, 2% over the medium term.

Projections: the results of exercises conducted four times a year to project possible future macroeconomic developments in the **euro area**. **Eurosystem** staff projections are published in June and December, whereas ECB staff projections are published in March and September. They form part of the **economic analysis** pillar of the monetary policy strategy of the ECB and are thus one of several inputs into the **Governing Council**'s assessment of the risks to **price stability**.

Real-time gross settlement (RTGS) system: a settlement system in which processing and settlement take place on a transaction-by-transaction basis in real time (see also **TARGET**).

Reference value for M3 growth: the annual growth rate of **M3** over the medium term that is consistent with the maintenance of **price stability**. At present, the reference value for annual M3 growth is 4½%.

Repurchase agreement: the process of borrowing money by combining the sale of an asset (usually a fixed income security) with the subsequent repurchase of that same asset on a specified date for a slightly higher specified price (which reflects the borrowing rate).

Reserve base: the sum of the eligible balance sheet items (in particular liabilities) that constitute the basis for calculating the **reserve requirement** of a **credit institution**.

Reserve requirement: the minimum amount of reserves a **credit institution** is required to hold with the **Eurosystem** over a predefined **maintenance period**. Compliance with the requirement is determined on the basis of the average of the daily balances in the reserve accounts over the maintenance period.

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

Securities Markets Programme (SMP): a programme for conducting interventions in the **euro area** public and private **debt securities** markets to ensure depth and liquidity in dysfunctional market segments with a view to restoring an appropriate monetary policy transmission mechanism. The SMP was terminated when the technical features of the **Outright Monetary Transactions** were announced on 6 September 2012.

Securities settlement system (SSS): a system which allows the transfer of securities, either free of payment or against payment (delivery versus payment).

Securitisation: the pooling of financial assets, such as residential mortgage loans, and their subsequent sale to a special-purpose vehicle, which then issues fixed income securities for sale to investors. The principal and interest of these securities depend on the cash flows produced by the pool of underlying financial assets.

Settlement risk: the risk that settlement in a transfer system will not take place as expected, usually owing to a party defaulting on one or more settlement obligations. This risk includes, in particular, operational risks, **credit risks** and liquidity risks.

Single Resolution Mechanism (SRM): a mechanism proposed by the European Commission, which establishes uniform rules and a uniform procedure for the resolution of credit institutions established in the **banking union**. It is envisaged that it will be composed of a single resolution board and national resolution authorities in participating Member States, with ultimate decision-making power at the European level. For the purposes of resolution, the SRM will have at its disposal a single resolution fund. The SRM is a necessary complement to the **Single Supervisory Mechanism** in order to achieve a well-functioning banking union.

Single Supervisory Mechanism (SSM): a mechanism composed of the ECB and national competent authorities in participating Member States for the exercise of the supervisory tasks conferred upon the ECB. The ECB will be responsible for the effective and consistent functioning of this mechanism, which will form part of the **banking union**.

Stability and Growth Pact (SGP): intended to serve as a means of safeguarding sound government finances in the EU Member States in order to strengthen the conditions for **price stability** and for strong, sustainable growth conducive to employment creation. The SGP has two arms – a preventive arm and a corrective arm. The preventive arm prescribes that Member States specify medium-term budgetary objectives, while the corrective arm contains concrete specifications on the **excessive deficit procedure**.

Standing facility: a central bank credit facility available to **counterparties** at their own initiative. The **Eurosystem** offers two overnight standing facilities: the **marginal lending facility** and the **deposit facility**.

Straight-through processing (STP): the automated end-to-end processing of trades/payment transfers – including, where relevant, the automated completion of confirmation, matching and generation of orders, clearing and settlement.

Structural fiscal balance (general government): the actual budget balance corrected for cyclical factors (i.e. the cyclically adjusted balance) and one-off fiscal measures.

Systemic risk: the risk that the inability of one participant to meet its obligations in a system will cause other participants to be unable to meet their obligations when they become due, potentially with spillover effects (e.g. significant liquidity or credit problems) threatening the stability of or confidence in the financial system. That inability to meet obligations can be caused by operational or financial problems.

TARGET (Trans-European Automated Real-time Gross settlement Express Transfer system): the Eurosystem's real-time gross settlement system for the euro. The first-generation TARGET system was replaced by **TARGET2** in May 2008.

TARGET2: the second-generation **TARGET** system. It settles payments in euro in central bank money and functions on the basis of a single shared IT platform, to which all payment orders are submitted for processing.

TARGET2-Securities (T2S): the Eurosystem's single technical platform enabling central securities depositories and NCBS to provide core, borderless and neutral securities settlement services in central bank money in Europe.

Treaties: unless stated otherwise, all references in this report to the "Treaties" refer to both the **Treaty** on the Functioning of the European Union and the Treaty on European Union.

Treaty: unless stated otherwise, all references in this report to the "Treaty" refer to the Treaty on the Functioning of the European Union, and the references to article numbers reflect the numbering in effect since 1 December 2009.

Treaty of Lisbon (Lisbon Treaty): amends the EU's two core treaties: the Treaty on European Union and the Treaty establishing the European Community. The latter has been renamed the **Treaty** on the Functioning of the European Union. The Treaty of Lisbon was signed in Lisbon on 13 December 2007 and entered into force on 1 December 2009.

Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG): an intergovernmental treaty, which was signed in Brussels on 2 March 2012 and entered into force on 1 January 2013. It contains a "fiscal compact", which complements and, in some areas, enhances key provisions of the **Stability and Growth Pact**. Inter alia, it requires the Member States having ratified this Treaty to enshrine in national law a balanced budget and increases the role of independent fiscal monitoring bodies.

