OPINION OF THE EUROPEAN MONETARY INSTITUTE

on a consultation under Article 109f(6) of the Treaty establishing the European Community (the "Treaty") and Article 5.3 of the Statute of the EMI, as elaborated in Council Decision 93/717/EC of 22nd November 1993, from the Institut Monétaire Luxembourgeois on a draft legislative provision concerning the implementation of the prohibition of monetary financing as laid down in Article 104 of the Treaty.

(CON/95/14)

1. The present consultation was initiated on 31st August by the Institut Monétaire Luxembourgeois (the "Institute") and received by the EMI on 6th September 1995. With a view to this consultation, the Institute submitted a draft legislative provision to be included in the Budget Law of Luxembourg for 1996 and an explanatory memorandum to the EMI. Pursuant to Article 4 of Council Decision 93/717/EC of 22nd November 1993, the EMI has been asked to deliver its opinion one month after the receipt of the consultation.

2. The EMI's competence to deliver an opinion in this consultation is based on Article 1.1, second indent, of Council Decision 93/717/EC of 22nd November 1993, as the draft legislative provision aims at the implementation of the prohibition of monetary financing as laid down in Article 104 of the Treaty and thus affects the powers of the Institute.

3. The countervalue of the issuance of notes and coins by the Institute - which is subject to a quantitative ceiling under the monetary association between Belgium and Luxembourg - is currently represented by a non-callable, non-interest bearing claim of the Institute on the Luxembourg Government. Consequently, any increase in the currency circulation automatically provides the Government with liquid funds. This procedure implies lending to the Government which is in violation with Article 104 of the Treaty and Article 1, Section 1(b) of Council Regulation (EC) No. 3603/93 of 13th December 1993. The Luxembourg legislative authorities originally intended to remedy this situation in a draft law on the Institute which was submitted to Parliament in December 1993. This draft (Law No. 3862) aimed at the implementation of all Treaty provisions concerning Stage Two and also at the introduction of institutional features with a view to Stage Three of EMU. The draft law was submitted to the EMI for consultation on 18th February 1994 and the EMI delivered its opinion (CON/94/1) on 12th March 1994. However, as the adoption of this law is taking more time than originally envisaged, the Luxembourg legislative authorities have now decided, as a provisional solution for this problem in

timing, to implement the prohibition of lending to the Government through the Budget Law for 1996 in order to ensure an end to the above form of lending at the latest by the 1st of January 1996. The EMI welcomes these measures (albeit delayed), which are purported to comply with Article 104 of the Treaty.

4. The total claim of the Institute on the Government, resulting from its net currency issuance from 1985 (when it started with these activities) until the end of this year, will be fixed at the level of the day when the Budget Law for 1996 enters into force (it being recognised that the Institute has not issued banknotes and coins beyond the level of end 1993). Although from that moment on new lending to the Government has no longer occurred, compliance with Article 104 also requires conversion of the total outstanding claim into a repayable claim with a fixed maturity. According to Article 1, Section 1(b), of Council Regulation (EC) No. 3603/93 of 13th December 1993, any claim against the public sector already existing at 1st January 1994 (when Article 104 came into force) must be repayable and have a fixed maturity. Since the above draft Law No. 3862 does not deal with procedures for ultimate repayment by the Luxembourg Government, the provision to be inserted in the Budget Law for 1996 deals with this issue as well. In particular, it is proposed that the outstanding claim be made repayable, while it continues to be non-interest bearing. The Government will assign for repayments 50% of its share in the annual profits of the Institute (without prejudice to its right to repay at a faster rate). If after 40 years there still remains a balance, the Government will repay the remainder of the claim in full. Should the currency circulation at some point in time fall below the remaining balance of the claim, then the Government would maintain a deposit at the Institute to cover the gap. Since the proposed solution is not inconsistent with Article 104 and Council Regulation (EC) No. 3603/93 of 13th December 1993, the draft legislative provision does not, in principle, give rise to any objections from the side of the EMI.

5. Notwithstanding the above, the EMI should like to recall that the existence of non-negotiable, non-interest bearing claims of a significant size on the Government may be a cause of concern for two reasons. Firstly, there may be implications for the distribution of monetary income in Stage Three. Secondly, the flexibility of monetary policy in Stage Three might be adversely affected (e.g. in case the opportunities for open-market operations are constrained by the claim of the Institute on the Luxembourg Government). These considerations are also mirrored in the fourth recital of the Council Regulation (EC) No. 3603/93 of 13th December 1993 and support the view that it is desirable - albeit not legally required - for such claims to be repaid as soon as possible, or at least before Stage Three, or to be converted into negotiable fixed maturity securities under market conditions.

In defending the maximum repayment period of 40 years, the explanatory memorandum to the draft provision points to a similar period accepted for Germany for certain claims of the

Bundesbank on the German public sector, thereby suggesting that such a long period may be regarded as normal for compliance with Article 104 of the Treaty. However, several other EU countries with similar claims have settled for much shorter repayment periods. Moreover, the claim of the Bundesbank (0.3% of GDP) is substantially smaller than that of the Institute (1.4% of GDP; situation as at end-March 1995). Furthermore, the explanatory memorandum states that if future Institute profits would be similar to the realised profits in the past eleven years, the Government would be able to repay the claim within roughly 35 years. Although it must be admitted that profits of the past are no guarantee for the future, the final date of repayment could thus have been advanced.

6. Finally, a comment can be made regarding the provisions to guarantee the liquidity of the Institute in case the currency circulation would drop below the balance of outstanding claims (viz. the Government will cover the gap through a special deposit at the Institute). The need for such provisions arises from the proposal to disconnect the currency circulation from the claims on the Government which until now have served as the countervalue. Such provisions would not be necessary if the Government were to repay the outstanding claim at a faster pace in full before the start of Stage Three. This would allow the Institute to rapidly build up its own reserve asset position as the countervalue for its currency circulation, instead of only gradually over a period of 40 years, during which the Government would continuously have to stand guard against the eventuality of liquidity problems.

7. The EMI agrees that this opinion may be made public by the competent Luxembourg authorities at their discretion.

5th October 1995