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Report on progress towards convergence and recommendation with a view to the transition to the third stage of economic and monetary union

(presented by the Commission)

1 January 1999: creation of the euro area

Foreword

1. In a few months from now, the euro will be a reality. By creating the single currency, Europe will be offering its citizens, its children and its partners in the wider world a more concrete symbol of the common destiny it has freely chosen: that of building a community based on peace and prosperity.

2. On 1 January 1999 Member States will for the first time be embracing a single currency, at the end of a long process involving sovereign political decisions on the part of the Heads of State or Government and culminating in fulfilment of the economic conditions necessary for its success.

3. The introduction of the euro confirms the advent of a genuine culture of stability in Europe that is essential to the establishment of a stable, sound and efficiently managed economic framework. It is also a response to globalisation and current developments in the world economy. While the euro will not, on its own, enable the scourge of unemployment to be swept away, without the euro the priority assigned to the jobs struggle would be deprived of a key instrument. Economic and monetary union (EMU) will revitalise the European economy and the single market, foster investment, boost business competitiveness, benefit consumers and savers, and make life easier for citizens where both work and travel are concerned.

4. The repercussions of this major event will be felt beyond the boundaries of the Union: use of the euro will spread on the international scene. The euro will gradually come to be one of the world's leading transaction, investment and reserve currencies. It will demonstrate the existence and the unity of Europe to its partners and will help to make the international monetary system more stable.

5. On the eve of the arrival of the euro, an economic recovery conducive to employment is under way, now that inflation has been brought under control and public finances are being placed on a sounder footing in Europe. Progress towards economic and monetary union is beginning to yield tangible results. The Commission's convergence report bears witness to this: in the space of a few years, the Member States have made great strides in bringing their economies closer together and improving their economic performances. The Commission therefore recommends to the Council that eleven Member States adopt the euro on 1 January 1999: Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland.

6. The decisions taken by the governments and the instruments laid down in the Treaty require the Member States to press ahead: only the achievement of budgetary balance in the medium term will restore some room for manoeuvre in steering their economic policies. Budget consolidation and a balanced policy mix will facilitate the smooth management of economic and monetary union. The maintenance of price stability, thanks to an independent European Central Bank and to the closer coordination at Community level of national economic policies, will ensure that it functions harmoniously and effectively.

7. Europe will, however, reap full benefit from economic and monetary union if it proves capable at the same time of making significant progress in other areas of policy, be it employment or taxation.

8. Concern for the well-being of future generations should prompt us to make the necessary efforts. And the need to adapt Europe's economic and social structures, on the threshold of the 21st century, leaves us no alternative. On this condition alone will the cyclical upturn discernible today and the impetus given by the creation of the euro usher in an era of lasting progress and sustainable growth in Europe.

THE EURO, A CURRENCY WITH LASTING STABILITY

9. By ratifying the Maastricht Treaty, the Member States opted for stability after learning from experience that high levels of inflation, the accumulation of public deficits and high long-term interest rates distort business decisions and expectations, shift the burden of a short-lived recovery onto future generations and deter investment, slow down growth and hold back job creation.

10. The achievement of a high degree of convergence between Member States' economies lays the foundations for a stable economic framework in the European Union. This framework now has to be safeguarded and solidly underpinned.

Convergence is now an established fact in Europe

11. Creation of the single currency satisfies the need for stability on which growth depends: the collapse of the international monetary system in 1971 and the lack of tools for economic and monetary cooperation between the Member States caused inflation to soar out of control, growth to fall sharply and unemployment to surge in Europe.

12. Europe responded to this challenge by putting in place machinery for ensuring economic and financial solidarity. From 1979 onwards, the establishment of the European Monetary System and the creation of the ecu thus gave birth to an area of stability which helped to curb inflation and to stabilise exchange rates between most of the Member States.

13. But the globalisation of the economy and the turbulent international environment called for a response commensurate with what is at stake in European integration: it had become essential, in order to secure a deeper single market, to shelter it from erratic exchange-rate fluctuations. By signing the Treaty on European Union in 1992, the Member States confirmed their determination to ensure that goods, services, people and capital can move freely, to facilitate genuine convergence of economic policies and to provide Europe with a single currency before the year 2000.

14. Often put to the test in recent years, that political resolve has never faltered. Its credibility is founded on a deep-seated and oft-repeated conviction that, in the interests of Europe and of its Member States, the objectives, conditions and timetable for achieving economic and monetary union as laid down in the Maastricht Treaty must be scrupulously adhered to. The record of the last few years is impressive:

    - the outstanding progress made by Member States demonstrates the extent to which their economies have converged. The average rate of inflation in the Community has fallen substantially and is now under the 2% mark in nearly all Member States. The average general government deficit in the Community fell from 6.1% of GDP in 1993 to 2.4% in 1997, allowing a structural reduction in the government debt ratio. These achievements have enabled long-term interest rates to fall sharply, thereby benefiting investment and growth, and have strengthened exchange-rate stability within the EMS. On the basis of the analysis set out in this report, the Commission therefore recommends to the Council that eleven Member States adopt the euro on 1 January 1999 since they fulfil the necessary conditions;

    - the institutional stages of the process have been in line with the provisions of the Treaty as spelled out in the reference scenario adopted by the Madrid European Council in December 1995: the legal and technical framework (stability and growth pact, legal status of the euro, new European monetary system, etc.) crucial to the smooth operation of EMU is now in place;

    - since publication of the Commission's Green Paper in May 1995, the necessary preparations for introducing the euro on 1 January 1999 have been carried out with determination, precision and vigour by the Community institutions, the Member States and economic agents, who are awaiting the decision of the Heads of State or Government to launch EMU in order to reap the fruit of their labours. The Commission recommendation provides the legal basis for that decision to be taken at the European Council on 2 May.

15. Even before the single currency is introduced, confidence is being restored in Europe. The fact that inflation has been brought under control, that public finances have been placed on a sounder footing and that interest rates have fallen to all-time lows are the reasons behind the present economic recovery, which is creating jobs, and the stable monetary conditions in Europe despite the Asian crisis. Growth is back: it has risen from 1.8% of GDP in 1996 to 2.7% in 1997. And the forecasts are for 2.8% in 1998 and 3.0% in 1999. Europe is expected to create 3.4 million jobs over the three years between 1997 and 1999.

16. These encouraging economic achievements augur well for the success of the euro. The large number of Member States which fulfil from the outset the necessary conditions for the changeover to the single currency demonstrates that the European Union has satisfactorily prepared the ground for this new phase of European integration. It has found the way back to stability, the lasting nature of which should enable it to reap the substantial benefits that will flow from the credibility of the euro.

The Union has started out on the road to lasting stability

17. For this purpose, the Treaty offers a number of essential guarantees:

- the independence of the European Central Bank (ECB), the main objective being to maintain price stability. Without prejudice to this objective, the ECB will lend its support to general policies within the Community with a view to contributing to lasting growth, a high degree of convergence and a high level of employment;

- the maintenance of sound public finances: the pooling of the currency imposes an obligation on everyone to observe strict economic and budgetary discipline. The Commission intends to play its full part and in particular to ensure compliance with the provisions of the stability and growth pact;

- the instruments necessary for strengthening surveillance and coordinating the economic policies of the Member States in the euro area: the Commission will assume all its responsibilities with regard to the permanent operation of the relevant procedures.

18. The political resolve of governments is essential for the success of EMU. Reasonable and responsible behaviour on the part of the national authorities and economic agents is even more important than mere compliance with the rules of procedure. It determines the future of the European economies. The determination of governments has enabled all the Member States to reduce their government deficits and to reap the initial positive results. The same attitude should commit them, in the medium term, to pursue the objective of a budget which is close to balance or in surplus. This commitment forms part of the stability and growth pact.

19. The Member States, having learnt from past experience and errors, must seize the opportunity that the euro now offers to exploit their improved economic environment in order to further consolidate public finances and to conduct their budgetary policies in such a way as to restore the room for manoeuvre which they still lack. Expenditure must, sooner or later, be paid for: the objective of a balanced budget in the medium term must be attained, if only to enable Europe to prepare for the consequences of the inevitable ageing of its population as the next millennium dawns. To act otherwise would mean bequeathing to future generations the burden of deficits accumulated by their parents.

20. All the Member States are concerned, whether or not they take part in EMU on 1 January 1999, since they are all potential members. Progress towards convergence will be facilitated by the consultations on economic, budgetary and financial matters provided for in the Treaty, by the provisions of the stability and growth pact that apply to the non-euro countries and by the option they have of joining the new exchange-rate mechanism.

21. The political resolve of those in power, the progress made towards convergence, the guarantees offered by the Treaty and the coordination and surveillance mechanisms established by the conclusions and resolutions of the Amsterdam European Council will all confer on the euro a measure of credibility equal to that enjoyed today by the currencies of the best-performing Member States. The euro represents an opportunity for the future of Europe; it is up to Europe to seize it.

THE EURO, A FRESH IMPETUS FOR EUROPE

22. Since the Communities were established, economic cooperation and monetary cooperation have taken it in turns to strengthen European integration: the determination to complete the customs union and the dismantling of barriers between the Member States set the scene for the EMS. This permitted and then spurred on completion of the single market, which will be consolidated by the euro. EMU will impart fresh impetus to the construction of Europe. But, for this, its full potential must be exploited.

EMU: an opportunity for employment-friendly policies

23. The foundations of an employment-friendly economic policy are a balanced policy mix, sustained convergence and monetary stability. EMU will lay these foundations. But their full impact on employment will not be felt unless they are accompanied by significant progress in the area of structural adjustment.

24. The room for manoeuvre within the budget must be devoted to reducing social security contributions on wages, and especially low wages. If the cost of labour is reduced, firms will be encouraged to take on more workers. Job creation will be fostered by more flexible goods, services and labour markets and by a reorganisation of work within industries and firms as part of negotiations between management and unions. Lastly, the near-disappearance of inflation means that a closer link can be established between pay levels and worker productivity which will make it easier for management and unions to conduct a responsible wage policy conducive to employment.

25. The European Union must from now on obey the imperatives of (i) encouraging entrepreneurship, in particular in small and medium-sized businesses, by reducing red tape and providing easier access to capital markets, (ii) according research the priority it should enjoy under any future-oriented policy, and (iii) undertaking the efforts needed to educate and train individuals.

26. The early implementation of the new title on employment in the Treaty of Amsterdam was reflected in the conclusions of the Extraordinary European Council meeting held in Luxembourg in November 1997, which opens up new prospects in the struggle for jobs. Objectives were jointly agreed, a working method was devised and multilateral surveillance of results was introduced. Once EMU is launched, the Member States will have available more effective instruments to promote employment policies and structural reforms at national level. In this respect, the euro presents an outstanding opportunity to sever the link between deficit and unemployment and to trigger the dynamics of stability and employment.

EMU: a deepening of the single market

27. The euro is an essential complement of the single market. It will bring to an end the exchange-rate fluctuations between the participating Member States, which, in the past, have managed in one fell swoop to wipe out the productivity gains achieved by businesses and their workers with considerable effort. Low inflation and interest rates and more predictable growth will reduce the uncertainties that impede investment decisions. Lastly, by eliminating the exchange risk, the euro will make firms more competitive and will - if they put preparations swiftly in hand - give them the springboard from which to withstand competition in the global economy. At Community level, the remaining barriers to trade must be dismantled and progress made towards tax harmonisation so that the benefits are maximised.

28. For consumers, as well as for the enterprises which buy, sell, work or invest in another Member State, the euro will improve the transparency of trade, will sharpen competition and will enable consumers to purchase goods at better prices and firms to become more competitive. Combined with the freedom of movement provided for in the Treaty, the single currency will thus promote unification of the goods and services markets, improvements in investment quality and integration within the single market. The euro will lastly herald the birth of the "European consumer", whose purchasing power will be guaranteed by the stability of the single currency. But in order to benefit from keener competition, which will now be felt even in the most outlying areas of the Union, the arrangements for providing consumers with better information will have to be strengthened.

29. The creation of a large euro capital market in 1999 will radically alter financial markets for the benefit of firms and households through increased competition and an improvement in the quality of service. This development is already discernible as financial institutions prepare for the euro. All economic agents will ultimately benefit from the availability of loans or borrowings in one and the same currency on a larger and more liquid market and under conditions of transparency, equality of access and cost that are similar to those prevailing for the dollar. This will lead to permanently low interest rates that will benefit households and firms. Under these conditions, the introduction of the euro must be accompanied by an acceleration in the reforms needed to improve the efficiency of financial markets.

30. Finally, the introduction of euro notes and coins on 1 January 2002 will constitute the final stage of EMU. Thanks to the complete elimination of foreign-exchange transaction costs, it will lead to savings and simplifications in the lives of European citizens. The general public must be prepared now for this change so as to pre-empt any fears it might arouse. In addition to its economic and monetary aspects, the introduction of euro notes and coins should provide hundreds of millions of Europeans with a material and concrete symbol of their common identity.

EMU: a European presence on the international scene

31. In adopting the euro, the peoples of Europe have decided to occupy a place on the international scene that is commensurate with their history and their economic and commercial strength. In so doing, they are demonstrating their unity to the rest of the world and are asserting their presence in the monetary sphere.

32. At the heart of an integrated international economic system in which trade and financial flows are becoming increasingly mobile, they are establishing a wide area of stability and prosperity which will minimise uncertainty for economic agents.

33. At the same time, with better use of the complementarities between Member States' economies, the single currency will enable Europe to become more outward-looking by reinforcing its global position and role. The euro is suited to taking on the mantle of one of the leading international currencies. Firstly, it will rapidly become a currency in which world trade is conducted and invoiced, reflecting Europe's huge importance in this sphere. Secondly, the euro's credibility, allied to a large and very liquid financial market, will attract foreign investment. Lastly, the euro's development will increasingly confer on it the status of an international reserve currency.

34. More fundamentally, the euro, through its recognised stability and widespread use, will help establish a better balance in international monetary relations, offering Europe the opportunity, together with its principal partners, to find ways of making the international monetary system more stable. But, in order for Europe to derive all the external benefits it is entitled to expect from the creation of the euro and in order for it to play its rightful role on the international scene, it must be able to speak with one voice. This is essential if it is to defend its interests as effectively as possible.

35. Lastly, the single currency will consolidate the achievements of more than forty years of cooperation at a time when Europe is embarking on a new era in its history, namely enlargement to include the countries of central and eastern Europe, Cyprus and the Baltic countries. The prosperity brought about by the economic integration of the present Member States and the attraction of the euro will give the prospective member countries the incentive to take the rapid steps necessary for them to become full members of the European Union. The extension of European integration throughout the continent will guarantee stability and peace in the future.

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36. The attached report takes stock of the progress made by the Member States in fulfilling their obligations regarding the achievement of economic and monetary union. In accordance with the Treaty, this assessment examines whether a high degree of sustainable convergence has been achieved by analysing the extent to which each Member State has satisfied the convergence criteria laid down in Article 109j of the Treaty. The other conditions and factors provided for in that Article are also examined. On the basis of its assessment and of the report by the European Monetary Institute, the Commission recommends to the Council that the following Member States adopt the euro on 1 January 1999: Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland.

37. Greece and Sweden have also made progress towards convergence. They are urged to continue their efforts so as to enable them to join the first group of participants in the euro following a further review of progress in two years' time, or sooner if one of them so requests.

38. The United Kingdom and Denmark will be assessed when they notify the Council of their intention to participate in the third stage, in accordance with the protocols annexed to the Treaty.

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39. The picture painted in this report is one of collective success: drawing on past experience and availing themselves of the instruments put in place by the Treaty on European Union, all the Member States have for several years now been engaged in efforts to promote convergence that are now beginning to bear fruit in the form of a resumption of growth. Adoption of the euro will crown those endeavours by giving Europeans an instrument which will consolidate the stability of their economic framework, foster trade within the single market, strengthen their competitiveness and bolster their position on the international scene.

40. This is also the picture of an economy which has reached maturity. The European Central Bank will be responsible for safeguarding price stability. The Commission and the Council will make determined efforts to improve economic-policy coordination. The Member States, for their part, will have to press ahead with their convergence efforts, strengthen the responsibility of all economic actors and carry out structural reforms in order to restore healthy and sustainable growth to Europe. It is only through the exercise of this collective responsibility that the euro, the common property of all citizens of the Union, will guarantee prosperity and promote employment.

EUROPEAN COMMISSION

Commission recommendation for a Council recommendation in accordance with article 109j(2)

EXPLANATORY MEMORANDUM

Article 109j of the Treaty lays down the procedure and timetable for taking decisions on the passage to the third stage of EMU. The Council, meeting in Dublin on 13 December 1996 in the composition of Heads of State or Government decided that there was not a majority of Member States fulfilling the necessary conditions for the adoption of a single currency, that the Community would not enter the third stage of EMU in 1997 and that the procedure laid down in Article 109j(4) of the Treaty should be applied as early as possible in 1998. According to paragraph 4 of Article 109j the procedure provided for in paragraphs 1 and 2 of that same article, with the exception of the second indent of paragraph 2, have to be repeated. The Commission and the EMI must therefore present to the Council a report on the *progress made in the fulfilment by the Member States of their obligations regarding the achievement of economic and monetary union*; subsequently and based on these reports the Commission submits to the Council a recommendation on which Member States fulfil the necessary conditions to adopt the single currency.

The Commission convergence report has been adopted by the college on 25 March 1998. The EMI has adopted its report on 24 March. The Commission and the EMI reports include an examination of the compatibility between each Member State's national legislation, including the statutes of its national central bank, and Articles 107 and 108 of the Treaty and the Statute of the ESCB. The reports also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the convergence criteria. The reports of the Commission and EMI also take account of the development of the ECU, the results of the integration of markets, the situation and development of the balance of payments on current account and an examination of the development of unit labour costs and other price indices.

In its report the Commission presents its arguments showing that Belgium, Germany, Spain, France, Italy, Austria, Portugal, Sweden and the United Kingdom, have corrected their excessive deficit situation. Consequently, the Commission is adopting and sending to the Council on 25 March 1998, for each of these Member States, a recommendation for the Council to abrogate, in accordance with Article 104c(12), its previous decisions on the existence of an excessive deficit in those Member States. If the Council acts upon the Commission recommendations than the said Member States, in the terms of the Treaty, are considered to have fulfilled the convergence criterion on the budgetary position.

The Commission, after examining, in its convergence report, the fulfilment by each Member State of the convergence criteria, considers that a high degree of sustainable convergence has been achieved in Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland; because they are exercising their opt-outs, it is not necessary to assess whether Denmark and the United Kingdom fulfil the other necessary conditions for the adoption of a single currency.

On the basis of its report and that of EMI the Commission is recommending to the Council that Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland fulfil the conditions for adopting a single currency.

COMMISSION RECOMMENDATION FOR A COUNCIL RECOMMENDATION IN ACCORDANCE WITH ARTICLE 109J (2) OF THE TREATY

The Council of the European Union,

Having regard to the Treaty establishing the European Community, and in particular Article 109j, paragraph 2 thereof,

Having regard to the recommendation from the Commission,

Having regard to the report from the Commission[1],

Having regard to the report from the European Monetary Institute[2],

Having regard to the opinion of the European Parliament,

1. Whereas the procedure and timetable for taking decisions on the passage to the third stage of economic and monetary union (EMU) are laid down in Article 109j; whereas the Council, meeting in Dublin on 13 December 1996 in the composition of Heads of State or Government decided that there was not a majority of Member States fulfilling the necessary conditions for the adoption of a single currency, that the Community would not enter the third stage of EMU in 1997 and that the procedure laid down in Article 109j(4) of the Treaty should be applied as early as possible in 1998;

2. Whereas in accordance with paragraph 4 of Article 109j the procedure provided for in paragraphs 1 and 2 of that same article, with the exception of the second indent of paragraph 2, have to be repeated;

3. Whereas Article 109j(1) lays down that the reports prepared by the Commission and the European Monetary Institute shall include an examination of the compatibility between each Member State's national legislation, including the statutes of its national central bank, and Articles 107 and 108 of the Treaty and the Statute of the European System of Central Banks and shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criteria:

   - the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability;

   - the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104c(6);

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[1] COM (....)

[2] Reference

- the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State;

- the durability of convergence achieved by the Member State and of its participation in the exchange-rate mechanism of the European Monetary System being reflected in the long-term interest-rate levels;

Whereas these four criteria and the relevant periods over which they are to be respected are developed further in Protocol No 6; whereas the reports of the Commission and the EMI shall also take account of the development of the ecu, the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices;

4. Whereas according to the first indent of Article 109j(2), on the basis of these reports, the Council shall assess, for each Member State, whether it fulfils the necessary conditions for the adoption of a single currency and shall recommend its findings to the Council meeting in the composition of the Heads of State or Government which, after having consulted the European Parliament, in accordance with Article 109j(4), shall confirm which Member States fulfil the necessary conditions for the adoption of a single currency; whereas for Denmark and the United Kingdom one such necessary condition is the notification to the Council in accordance with Protocols No 12 and 11 respectively, that their country intends to participate in the third stage of EMU;

5. Whereas Member States' national legislation including the statutes of national central banks shall as necessary be adapted with a view to ensuring compatibility with Articles 107 and 108 of the Treaty and the Statute of the ESCB; whereas such adaptations need to ensure compatibility with the Treaty at the latest at the date of the establishment of the ESCB; whereas the reports of the Commission and the EMI provide a detailed assessment of the compatibility of the legislation of each Member State with Articles 107 and 108 of the Treaty and the statute of the ESCB;

6. Whereas according to Article 1 of Protocol No 6 the criterion on price stability referred to in the first indent of Article 109j(1) shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1½ percentage points that of, at most, the three best performing Member States in terms of price stability; whereas for the purpose of the criterion on price stability inflation will be measured by harmonised indices of consumer price (HICPs) defined in Council Regulation (EC) n° 2494/95; whereas in order to assess the price stability criterion a Member State's inflation has been measured by the percentage change in the arithmetic average of twelve monthly indices relative to the arithmetic average of twelve monthly indices of the previous period; whereas in the one year period ending in January 1998 the three best performing Member States in terms of price stability were France, Ireland and Austria, with inflation rates of, respectively 1.2%, 1.2% and 1.1%; whereas a reference value calculated as the simple arithmetic average of the inflation rates of the three best performing Member States in terms of price stability plus 1.5 percentage points was considered in the reports of the Commission and the EMI; whereas the reference value in the one year period ending in January 1998 was 2.7%;

7. Whereas according to Article 2 of Protocol No 6 the criterion on the government budgetary position referred to in the second indent of Article 109j(1) shall mean that at the time of the examination the Member State is not the subject of a Council decision under Article 104c(6) of this Treaty that an excessive deficit exists;

8. Whereas according to Article 3 of Protocol No 6 the criterion on participation in the exchange-rate mechanism of the European Monetary System referred to in the third indent of Article 109j(1) shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism (ERM) of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period. Whereas in assessing the fulfilment of this criterion in their reports, the Commission and the EMI have examined the two year period ending in February 1998 and have taken into account the fact that the decision taken in August 1993 by the ministers and central bank governors of the Member States to widen temporarily the fluctuation margins of the ERM from

± 2.25% to ± 15% around the bilateral central rates has modified the framework for assessing the exchange rate stability of Member State currencies;

9. Whereas according to Article 4 of Protocol No 6 the criterion on the convergence of interest rates referred in the fourth indent of Article 109j(1) shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best performing Member States in terms of price stability; whereas for the purpose of the criteria on the convergence of interest rates comparable interest rates on 10-year benchmark government bonds were used; whereas in order to assess the fulfilment of the interest rate criterion a reference value calculated as the simple arithmetic average of the nominal long-term interest rates of the three best performing Member States in terms of price stability plus two percentage points was considered in the reports of the Commission and the EMI; whereas the reference value in the one year period ending in January 1998 was 7.8%;

10. Whereas, in accordance with Article 5 of Protocol No 6 the data used in the current assessment of the fulfilment of the convergence criteria will be provided by the Commission; whereas for the preparation of this recommendation the Commission provided data; whereas budgetary data were provided by the Commission after reporting by the Member States by 1 March 1998 in accordance with Regulation (EC) n° 3605/93;

11. Whereas during the second stage of EMU no Council Decision on the existence of an excessive deficit existed for Ireland and Luxembourg; whereas according to its Decision of 27 June 1996 under Article 104c(12) the Council abrogated its previous Decision on the existence of an excessive deficit in Denmark; whereas according to its Decision of 30 June 1997 under Article 104c(12) the Council abrogated its previous Decisions on the existence of an excessive deficit in the Netherlands and Finland; whereas according to its Decisions of 1 May 1998 under Article 104c(12) the Council abrogated its previous Decisions on the existence of an excessive deficit in Belgium, Germany, Spain, France, Italy, Austria, Portugal, Sweden and the United Kingdom;

12. Whereas, on the basis of the present recommendations, the Council meeting in the composition of Heads of State or Government shall confirm which Member States fulfil the necessary conditions for the adoption of a single currency;

HAS ADOPTED THE FOLLOWING RECOMMENDATIONS:

Article 1

Assessment

1. In Belgium national legislation, including the statute of the national central bank, is compatible with Articles 107 and 108 of the Treaty and the Statute of the ESCB;

   the average inflation rate in Belgium in the year ending in January 1998 stood at 1.4% which is below the reference value;

   Belgium is not the subject of a Council Decision on the existence of an excessive government deficit;

   Belgium has been a member of the ERM during the last two years; in that period the Belgian franc (BEF) has not been subject to severe tensions and Belgium has not devalued, on its own initiative, the BEF bilateral central rate against any other Member State's currency;

   in the year ending in January 1998 the long-term interest rate in Belgium was, on average, 5.7% which is below the reference value.

   Belgium has fulfilled its legal obligations regarding the achievement of economic and monetary union. Belgium fulfils all the convergence criteria mentioned in the four indents of Article 109j(1) and has therefore achieved a high degree of sustainable convergence. Consequently, Belgium fulfils the necessary conditions for the adoption of a single currency.

2. Denmark, in accordance with paragraph 1 of Protocol No 12 and the Decision taken by the Heads of State or Government in Edinburgh in December 1992[3], has notified the Council that it will not participate in the third stage of economic and monetary union; the assessment of the fulfilment by Denmark of the other necessary conditions for the adoption of a single currency is therefore not necessary; in accordance with paragraph 2 of Protocol No 12, Denmark will have an exemption once the third stage has started;

3. In Germany national legislation, including the statute of the national central bank, is compatible with Articles 107 and 108 of the Treaty and the Statute of the ESCB;

the average inflation rate in Germany in the year ending in January 1998 stood at 1.4% which is below the reference value;

Germany is not the subject of a Council Decision on the existence of an excessive government deficit;

Germany has been a member of the ERM during the last two years; in that period the German mark (DEM) has not been subject to severe tensions and Germany has not devalued, on its own initiative, the DEM bilateral central rate against any other Member State's currency

in the year ending in January 1998 the long-term interest rate in Germany was, on average, 5.6% which is below the reference value.

Germany has fulfilled its legal obligations regarding the achievement of economic and monetary union. Germany fulfils all the convergence criteria mentioned in the four indents of Article 109j(1) and has therefore achieved a high degree of sustainable convergence. Consequently, Germany fulfils the necessary conditions for the adoption of a single currency.

4. In Greece national legislation, including the statute of the national central bank, is compatible with Articles 107 and 108 of the Treaty and the Statute of the ESCB;

the average inflation rate in Greece in the year ending in January 1998 stood at 5.2% which is above the reference value;

the Council has decided on 26 September 1994 that an excessive government deficit exists in Greece and this Decision has not been abrogated;

the currency of Greece did not participate in the ERM in the two years ending in February 1998; during this period the Greek drachma (GRD) has been relatively stable against the ERM currencies but it has experienced, at times, tensions which have been counteracted by temporary increases in domestic interest rates and by foreign exchange intervention. The GRD joined the ERM in March 1998.

in the year ending in January 1998 the long-term interest rate in Greece was, on average, 9.8% which is above the reference value.

Greece has fulfilled its legal obligations regarding the achievement of economic and monetary union. Greece does not fulfil any of the convergence criteria mentioned in the four indents of Article 109j(1). Consequently, Greece does not fulfil the necessary conditions for the adoption of a single currency.

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[3] OJ C 348 of 31.12.92, p. 1.

5. In Spain national legislation, including the statute of the national central bank, is compatible with Articles 107 and 108 of the Treaty and the Statute of the ESCB [4];

the average inflation rate in Spain in the year ending in January 1998 stood at 1.8% which is below the reference value;

Spain is not the subject of a Council Decision on the existence of an excessive government deficit;

Spain has been a member of the ERM during the last two years; in that period the Spanish peseta (ESP) has not been subject to severe tensions and Spain has not devalued, on its own initiative, the ESP bilateral central rate against any other Member State's currency;

in the year ending in January 1998 the long-term interest rate in Spain was, on average, 6.3% which is below the reference value.

Spain has fulfilled its legal obligations regarding the achievement of economic and monetary union. Spain fulfils all the convergence criteria mentioned in the four indents of Article 109j(1) and has therefore achieved a high degree of sustainable convergence. Consequently, Spain fulfils the necessary conditions for the adoption of a single currency.

6. In France national legislation, including the statute of the national central bank, is compatible with Articles 107 and 108 of the Treaty and the Statute of the ESCB[5];

the average inflation rate in France in the year ending in January 1998 stood at 1.2% which is below the reference value;

France is not the subject of a Council Decision on the existence of an excessive government deficit;

France has been a member of the ERM during the last two years; in that period the French franc (FRF) has not been subject to severe tensions France has not devalued, on its own initiative, the FRF bilateral central rate against any other Member State's currency;

in the year ending in January 1998 the long-term interest rate in France was, on average, 5.5% which is below the reference value.

France has fulfilled its legal obligations regarding the achievement of economic and monetary union. France fulfils all the convergence criteria mentioned in the four indents of Article 109j(1) and has therefore achieved a high degree of sustainable convergence. Consequently, France fulfils the necessary conditions for the adoption of a single currency.

7. In Ireland national legislation, including the statute of the national central bank, is compatible with Articles 107 and 108 of the Treaty and the Statute of the ESCB;

the average inflation rate in Ireland in the year ending in January 1998 stood at 1.2% which is below the reference value;

during the second stage of EMU Ireland was not the subject of a Council Decision on the existence of an excessive government deficit;

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[4] Provided that the current government proposals have been enacted at the date of the establishment of the ECB.

[5] Provided that the current government proposals have been enacted at the date of the establishment of the ECB.

Ireland has been a member of the ERM during the last two years; in that period the Irish pound (IEP) has not been subject to severe tensions and the IEP bilateral central rate has not been devalued against any other Member State's currency; on 16 March 1998 at a request of the Irish authorities the bilateral central rates of the IEP against all other ERM currencies were revalued by 3%.

in the year ending in January 1998 the long-term interest rate in Ireland was, on average, 6.2% which is below the reference value.

Ireland has fulfilled its legal obligations regarding the achievement of economic and monetary union. Ireland fulfils all the convergence criteria mentioned in the four indents of Article 109j(1) and has therefore achieved a high degree of sustainable convergence. Consequently, Ireland fulfils the necessary conditions for the adoption of a single currency.

8. In Italy national legislation, including the statute of the national central bank, is compatible with Articles 107 and 108 of the Treaty and the Statute of the ESCB;

the average inflation rate in Italy in the year ending in January 1998 stood at 1.8% which is below the reference value;

Italy is not the subject of a Council Decision on the existence of an excessive government deficit;

Italy rejoined the ERM in November 1996; in the period from March 1996 to November 1996 the Italian lira (ITL) appreciated vis-à-vis the ERM currencies; since it re-entered the ERM the ITL has not been subject to severe tensions and Italy has not devalued, on its own initiative, the ITL bilateral central rate against any other Member State's currency;

in the year ending in January 1998 the long-term interest rate in Italy was, on average, 6.7% which is below the reference value.

Italy has fulfilled its legal obligations regarding the achievement of economic and monetary union. Italy fulfils the convergence criteria mentioned in the first, second and fourth indents of Article 109j(1); as regards the criterion mentioned in the third indent of Article 109j(1), the currency of Italy, although having rejoined the ERM only in November 1996, has displayed sufficient stability in the last two years. For these reasons Italy has achieved a high degree of sustainable convergence. Consequently, Italy fulfils the necessary conditions for the adoption of a single currency.

9. In Luxembourg national legislation, including the statute of the national central bank, is compatible with Articles 107 and 108 of the Treaty and the statute of the ESCB[6];

the average inflation rate in Luxembourg in the year ending in January 1998 stood at 1.4% which is below the reference value;

during the second stage of EMU Luxembourg was not the subject of a Council Decision on the existence of an excessive government deficit;

Luxembourg has been a member of the ERM during the last two years; in that period the Luxembourg franc (LUF) has not been subject to severe tensions and Luxembourg has not devalued, on its own initiative, the LUF bilateral central rate against any other Member State's currency;

in the year ending in January 1998 the long-term interest rate in Luxembourg was, on average, 5.6% which is below the reference value.

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6 Provided that the current government proposals have been enacted at the date of the establishment of the ECB.

Luxembourg has fulfilled its legal obligations regarding the achievement of economic and monetary union. Luxembourg fulfils all the convergence criteria mentioned in the four indents of Article 109j(1) and has therefore achieved a high degree of sustainable convergence. Consequently, Luxembourg fulfils the necessary conditions for the adoption of a single currency.

10 In the Netherlands national legislation, including the statute of the national central bank, is compatible with Articles 107 and 108 of the Treaty and the Statute of the ESCB;

the average inflation rate in the Netherlands in the year ending in January 1998 stood at 1.8% which is below the reference value;

The Netherlands is not the subject of a Council Decision on the existence of an excessive government deficit;

the Netherlands has been a member of the ERM during the last two years; in that period the Netherlands Guilder (NLG) has not been subject to severe tensions and the Netherlands has not devalued, on its own initiative, the NLG bilateral central rate against any other Member State's currency;

in the year ending in January 1998 the long-term interest rate in the Netherlands was, on average, 5.5% which is below the reference value.

The Netherlands has fulfilled its legal obligations regarding the achievement of economic and monetary union. The Netherlands fulfils all the convergence criteria mentioned in the four indents of Article 109j(1) and has therefore achieved a high degree of sustainable convergence. Consequently, the Netherlands fulfils the necessary conditions for the adoption of a single currency.

11. In Austria national legislation, including the statute of the national central bank, is compatible with Articles 107 and 108 of the Treaty and the Statute of the ESCB[7];

the average inflation rate in Austria in the year ending in January 1998 stood at 1.1% which is below the reference value;

Austria is not the subject of a Council Decision on the existence of an excessive government deficit;

Austria has been a member of the ERM during the last two years; in that period the Austrian schilling (ATS) has not been subject to severe tensions and Austria has not devalued, on its own initiative, the ATS bilateral central rate against any other Member State's currency;

in the year ending in January 1998 the long-term interest rate in Austria was, on average, 5.6% which is below the reference value;

Austria has fulfilled its legal obligations regarding the achievement of economic and monetary union. Austria fulfils all the convergence criteria mentioned in the four indents of Article 109j(1) and has therefore achieved a high degree of sustainable convergence. Consequently, Austria fulfils the necessary conditions for the adoption of a single currency.

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7 Provided that the current government proposals have been enacted at the date of the establishment of the ECB.

12. In Portugal national legislation, including the statute of the national central bank, is compatible with Articles 107 and 108 of the Treaty and the Statute of the ESCB;

the average inflation rate in Portugal in the year ending in January 1998 stood at 1.8% which is below the reference value;

Portugal is not the subject of a Council Decision on the existence of an excessive government deficit;

Portugal has been a member of the ERM during the last two years; in that period the Portuguese escudo (PTE) has not been subject to severe tensions and Portugal has not devalued, on its own initiative, the PTE bilateral central rate against any other Member State's currency;

in the year ending in January 1998 the long-term interest rate in Portugal was, on average, 6.2% which is below the reference value.

Portugal has fulfilled its legal obligations regarding the achievement of economic and monetary union. Portugal fulfils all the convergence criteria mentioned in the four indents of Article 109j(1) and has therefore achieved a high degree of sustainable convergence. Consequently, Portugal fulfils the necessary conditions for the adoption of a single currency.

13. In Finland national legislation, including the statute of the national central bank, is compatible with Articles 107 and 108 of the Treaty and the Statute of the ESCB;

the average inflation rate in Finland in the year ending in January 1998 stood at 1.3% which is below the reference value;

Finland is not the subject of a Council Decision on the existence of an excessive government deficit;

Finland has been a member of the ERM since October 1996; in the period from March 1996 to October 1996 the Finnish markka (FIM) appreciated vis-à-vis the ERM currencies; since it entered the ERM the FIM has not been subject to severe tensions and Finland has not devalued, on its own initiative, the FIM bilateral central rate against any other Member State's currency;

in the year ending in January 1998 the long-term interest rate in Finland was, on average, 5.9% which is below the reference value.

Finland has fulfilled its legal obligations regarding the achievement of economic and monetary union. Finland fulfils the convergence criteria mentioned in the first, second and fourth indents of Article 109j(1); as regards the convergence criterion mentioned in the third indent of Article 109j(1), the currency of Finland, although having entered the ERM only in October 1996, has displayed sufficient stability in the last two years. For these reasons Finland has achieved a high degree of sustainable convergence. Consequently, Finland fulfils the necessary conditions for the adoption of a single currency.

14. In Sweden national legislation, including the statute of the national central bank, is not compatible with Articles 107 and 108 of the Treaty and the Statute of the ESCB;

the average inflation rate in Sweden in the year ending in January 1998 stood at 1.9% which is below the reference value;

Sweden is not the subject of a Council Decision on the existence of an excessive government deficit;

the currency of Sweden has never participated in the ERM; in the two years under review the Swedish krona (SEK) fluctuated against the ERM currencies reflecting among others the absence of an exchange rate target;

in the year ending in January 1998 the long-term interest rate in Sweden was, on average, 6.5% which is below the reference value.

Sweden has made insufficient progress in the fulfilment of its legal obligations regarding the achievement of economic and monetary union. Sweden fulfils the convergence criteria mentioned in the first, second and fourth indents of Article 109j(1) but does not fulfil the convergence criterion mentioned in the third indent of Article 109j (1). Consequently, Sweden does not fulfil the necessary conditions for the adoption of a single currency.

15. The United Kingdom, in accordance with paragraph 1 of Protocol No 11, has notified the Council that it does not intend to move to the third stage of economic and monetary union on 1 January 1999; the assessment of the fulfilment by the United Kingdom of the other necessary conditions for the adoption of a single currency is therefore not necessary; by virtue of the notification made by the United Kingdom articles 4 to 9 of Protocol No 11 lay down the rules applicable to the United Kingdom during the third stage;

Article 2

Findings

In the light of the above, the findings of the Council are that Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland fulfil the necessary conditions for the adoption of a single currency. The Council recommends to the Council, meeting in the composition of Heads of State or Government, to confirm that the said Member States fulfil the necessary conditions for the adoption of a single currency on 1 January 1999.

EUROPEAN COMMISSION

Brussels, 25 March 1998

CONVERGENCE REPORT 1998

(prepared in accordance with Article 109j(1) of the Treaty)

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ABBREVIATIONS USED IN THE REPORT

Countries		*Currencies*	
B	Belgium	BEF	Belgian franc
DK	Denmark	DKK	Danish krone
D	Germany	DEM	German mark
EL	Greece	GRD	Greek drachma
E	Spain	ESP	Spanish peseta
F	France	FRF	French franc
IRL	Ireland	IEP	Irish punt
I	Italy	ITL	Italian lira
L	Luxembourg	LUF	Luxembourg franc
NL	Netherlands	NLG	Dutch guilder
A	Austria	ATS	Austrian schilling
P	Portugal	PTE	Portuguese escudo
FIN	Finland	FIM	Finnish markka
S	Sweden	SEK	Swedish krona
UK	United Kingdom	GBP	pound sterling
EUR, EC	European Community (15 Member States)	ECU	European currency unit
EUR 12	European Community (12 Member States, excluding Austria, Finland and Sweden)		
US(A)	United States (of America)	USD	US dollar

Other abbreviations

CPI	(national) consumer price index
ECB	European Central Bank
EEAICP	European Economic Area Index of Consumer Prices
EIB	European Investment Bank
EICP	European Index of Consumer Prices
EMI	European Monetary Institute
EMS	European Monetary System
EMU	economic and monetary union
ERM	exchange-rate mechanism (of the European Monetary System)
ESA-1979	European System of Integrated Economic Accounts, 1979 edition
ESCB	European System of Central Banks
Eurostat	Statistical Office of the European Communities
GDP	gross domestic product
HFMCE	household final monetary consumption expenditure
HICP	harmonised index of consumer prices
IICP	interim index of consumer prices
MUICP	Monetary Union Index of Consumer Prices
NCB	national central bank
PPI	producer price index
PPS	purchasing power standards
VAT	value added tax

1. INTRODUCTION AND CONCLUSIONS

1.1. Role of the report

This report has been prepared in accordance with Article 109j(1) of the Treaty which requires the Commission to report to the Council on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of economic and monetary union (EMU). The European Monetary Institute (EMI) is similarly required to report to the Council.

These reports are the first steps of the procedure set out in Article 109j which will lead to the decision by the Council, meeting (on 2 May 1998) in the composition of the Heads of State or Government, on which Member States fulfil the necessary conditions for the adoption of a single currency.

In November 1996 the Commission already presented a report[1] in accordance with Article 109j(1). This examination of the progress towards convergence by Member States was followed by the formal decision[2] in accordance with Article 109j(3) by the Council, meeting in the composition of Heads of State and Government in Dublin in December 1996, that, at that time, a majority of the Member States did not fulfil the necessary conditions for the adoption of a single currency. As a consequence the starting date for the third stage of EMU was set for 1 January 1999, as determined by the Treaty and confirmed on several occasions by the European Council.

As recorded in the Edinburgh agreement of 1992, Denmark has given notification, in accordance with paragraph 1 of Protocol No 12 of the Treaty, that it will not participate in the third stage of EMU. Similarly, the United Kingdom has notified the Council, in accordance with paragraph 1 of Protocol No 11 of the Treaty, that it does not intend to move to the third stage in 1999. Although Denmark and the United Kingdom will not participate in the single currency in 1999, the convergence performance of these two countries is examined in this report along with the other Member States.

1 COM(96)560, "Report on Convergence in the European Union in 1996".

2 Council Decision of 13 December 1996 (96/736/EC), OJ L 335, 24.12.1996, p. 48.

On the basis of this report and that of the EMI, the Commission is separately submitting to the Council a recommendation for the assessment to be made by the Council in accordance with Article 109j(2); the Council (of Ecofin ministers) will assess for each Member State whether it fulfils the necessary conditions for the adoption of a single currency and will recommend its findings to the Council, meeting in the composition of Heads of State or Government.

In the following sections of this opening chapter the key results and conclusions of the report are summarised, first by subject in the order dealt with in the main body of the report and then for each Member State. The structure of the rest of the report follows that established by Article 109j(1). Chapter 2 examines the compatibility between each Member State's national legislation (including the statutes of its national central bank) and Articles 107 and 108 of the Treaty and the Statute of the European System of Central Banks (ESCB). The following four chapters (Chapters 3-6) examine in turn the performance of the Member States in relation to each of the four convergence criteria, concerning price stability, the government budgetary position, exchange rates and long-term interest rates. Chapter 7 looks at several other areas that are to be taken account of in the Commission and EMI reports: development of the ECU, the results of the integration of markets, the balances of payments on current account, and unit labour costs and other price indices.

The report makes use of economic data and information available up to 16 March 1998 and takes account of developments concerning relevant national legislation up to the date of adoption of the report.

1.2. Compatibility of legislation and convergence

Remarkable progress towards the achievement of a high degree of sustainable convergence has been made in all Member States since the beginning of the second stage of EMU. This progress gathered greater momentum during 1996 and 1997 and in the early part of 1998, when efforts to achieve convergence (especially in the budgetary field) were intensified in many Member States. Other necessary preparations for the third stage have also advanced at both national and Community levels.

Compatibility between national legislation, including the statutes of national central banks, and Articles 107 and 108 of the Treaty and the Statute of the ESCB is examined in Chapter 2 of this report. Compatibility has to be ensured, in particular, concerning the objectives of national central banks and their independence and in respect of provisions affecting the integration of the national central banks in the ESCB and other monetary matters. Member States are required to ensure the compatibility of their legislation at the latest at the date of the establishment of the European Central Bank (ECB). Most Member States have already enacted necessary changes in legislation, or are in the process of legislating on government proposals for changes. The situation in eight Member States (Belgium, Germany, Greece, Ireland, Italy, the Netherlands, Portugaland Finland) can be considered as compatible with Treaty requirements, while in a further four Member States compatibility will be ensured provided that the existing government proposals are enacted (in Spain, Luxembourg and Austria) or the present draft government proposal is submitted to and adopted by Parliament (in France). In the case of Sweden, the requirements of the constitution will prevent adoption of the government's proposals before late in 1998, and there remain some incompatibilities between the present draft laws and the Treaty. By virtue of their opt-outs, Denmark and the United Kingdom are under no obligation to make their legislation compatible, except for central bank independence in the case of Denmark, for which this legislation is compatible.

The report examines the achievement of a high degree of sustainable convergence by reviewing in detail (in Chapters 3-6) the progress made by Member States in fulfilling each of the four convergence criteria of Article 109j(1).

The steady progress made in the Community as a whole and by individual Member States in moving towards or maintaining a high degree of price stability continued in 1997 and into 1998. The assessment of price stability and inflation convergence in the Member States (described in Chapter 3) has been made using the recently available harmonised indices of consumer prices (HICPs), which provide a better and more comparable basis for the assessment than national consumer price indices. The average rate of inflation for each Member State has been calculated as the percentage change in the average HICP in the latest 12 months relative to the average index in the preceding 12 months. The reference value has been calculated for the purpose of this report as the simple arithmetic average of the average inflation rates in the three best performing Member States plus 1.5 percentage points. Calculated in this way and according to the latest available information (January 1998), the three best inflation performers were France, Ireland and Austria, and the reference value was 2.7% (see Table 1.1 and Graph 1.1). Fourteen Member States (Belgium, Denmark, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, Finland, Sweden and the United Kingdom) had average inflation rates below this reference value. In view of the structural changes (both institutional and behavioural) which have played an important role in achieving price stability and given the developments in unit labour costs and other price indices, there are strong reasons for believing that the current inflation performance in all these 14 Member States is sustainable. Greece has also had success in bringing the inflation rate down but it still remains much higher than the reference value.

The assessment of the convergence criterion on the government budgetary position (see Chapter 4) is linked to decisions made in accordance with the excessive deficit procedure in Article 104c of the Treaty. At present five Member States (Denmark, Ireland, Luxembourg, the Netherlands and Finland) are not the subject of a Council decision under Article 104c(6) on the existence of an excessive government deficit and so already fulfil the criterion. The Commission is initiating the 1998 implementation of the excessive deficit procedure in parallel with this report. Government deficits have generally been brought down significantly during the second stage of EMU from the levels reached in 1993, when they were swollen by the effects of recession. Substantial further progress was made by Member States in 1997. The deficits in 14 Member States in 1997 were either below or equal to the 3% of gross domestic product (GDP) reference value, and further declines in deficits are expected in 1998. While the government debt ratio was below the 60% of GDP reference value in 1997 in only four Member States (France, Luxembourg, Finland and the United Kingdom), almost all the other Member States with higher debt ratios have succeeded in reversing the earlier upward trend. Only in Germany, where the debt ratio is just above 60% of GDP and the exceptional costs of unification continue to bear heavily, was there a further small rise in the debt ratio in 1997. In the current year, 1998, falls in the debt ratio are expected in all the Member States where the ratio is above the reference value. Conditions are in place for a sustained decline in debt ratios in future years. The Commission is recommending to the Council the abrogation of the excessive deficit decisions for Belgium, Germany, Spain, France, Italy, Austria, Portugal, Sweden and the United Kingdom. While Greece has made substantial progress in reducing public finance imbalances in recent years, its deficit in 1997 was still well above the reference value but is expected to be below it in 1998.

The Treaty refers to the exchange rate criterion as the observance of the normal fluctuation margins of the exchange-rate mechanism (ERM) of the European Monetary System (EMS) for at least two years without severe tensions and without devaluing against the currency of any other Member State. The operational framework used in Chapter 5 to interpret the criterion verifies participation in the ERM for at least two years and assesses exchange rate behaviour with respect to a ±2.25% fluctuation range around each currency's central rate against the median currency in the ERM grid. The two-year period under review is from March 1996 to February 1998. Ten currencies - the Belgian franc, the Danish krone, the German mark, the Spanish peseta, the French franc, the Irish punt, the Luxembourg franc, the Dutch guilder, the Austrian schilling and the Portuguese escudo - have been in the ERM for more than two years at the time of this examination. The Finnish markka entered the ERM in October 1996, while the Italian lira re-entered the mechanism in November 1996, i.e. less than two years ago. The ERM has been generally stable and the vast majority of participating currencies have been clustered close to their ERM central rates in the period under review. Among these currencies, only the Irish punt has deviated from its central rate against the median currency for an extended period of time; however, the deviation of the punt has been mostly above its central rate. The Irish punt was revalued by 3% against the other ERM currencies in March 1998 after the close of the review period. All in all, these 12 currencies can be considered not to have experienced severe tensions in the two years under review. The Greek drachma, the Swedish krona and the pound sterling did not participate in the ERM during the review period. However, the Greek drachma entered the ERM in March 1998, after the close of the review period.

The fourth criterion, on the durability of convergence as reflected in long-term interest rates, is examined in Chapter 6. Long-term interest rates are forward-looking indicators which reflect the financial markets' assessment of underlying economic conditions, including the sustainability of inflation performance and budgetary positions. Developments in bond markets during the last two years as the third stage of EMU approaches have resulted in a significant narrowing in interest rate differentials, especially for the previously higher-yielding countries. The assessment of the criterion is based on the interest rates on comparable 10-year benchmark bonds (not fully comparable for Greece), using an average rate over the latest 12 months. The reference value has been calculated as the simple arithmetic average of the long-term interest rates of the three best performing Member States in terms of price stability plus 2 percentage points. In January 1998 the reference value was 7.8%. Fourteen Member States (Belgium, Denmark, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, Finland, Sweden and the United Kingdom) had average long-term interest rates below the reference value. Greece has also experienced declining interest rates over recent years, but the level of the long-term interest rate still remains higher than the reference value.

The Treaty also requires that this report should examine developments in several other areas relevant to economic integration and convergence. These are dealt with in Chapter 7. The scale of and activity in financial markets in ECU have tended to decline in importance during the second stage. The spread between the private and public ECU has become very narrow as the certainty of the one-to-one convertibility between the ECU and the euro has been incorporated by the markets. The Single Market programme has been having a significant impact on economic integration, particularly on the structure of trade between Member States, on foreign direct investment flows, on competition conditions and on price convergence for certain categories of goods and services. The current account of the balance of payments reflects the national saving and investment balance in each Member State; the Community as a whole and 10 Member States are estimated to have been in surplus in 1997. Additional indicators for unit labour costs, import prices and other prices confirm the picture of a satisfactory and soundly based price performance in most Member States.

Table 1.1

Current performance of the Member States in relation to convergence

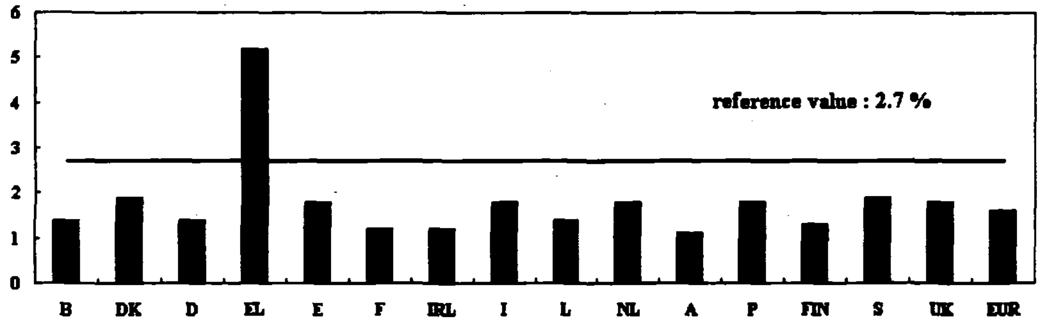
	Inflation	Government budgetary position						Exchange rates	Long-term interest rates
	HICP (a)	Existence of an excessive deficit (b)	Deficit (% of GDP) (c)	Debt (% of GDP)				ERM participation	(d)
	January 1998		1997	1997	Change from previous year			March 1998	January 1998
					1997	1996	1995		
Reference value	2.7 (e)		3	60					7.8 (f)
B	1.4	yes (g)	2.1	122.2	-4.7	-4.3	-2.2	yes	5.7
DK	1.9	no	-0.7	65.1	-5.5	-2.7	-4.9	yes	6.2
D	1.4	yes (g)	2.7	61.3	0.8	2.4	7.8	yes	5.6
EL	5.2	yes	4.0	108.7	-2.9	1.5	0.7	yes (h)	9.8 (i)
E	1.8	yes (g)	2.6	68.8	-1.3	4.6	2.9	yes	6.3
F	1.2	yes (g)	3.0	58.0	2.4	2.9	4.2	yes	5.5
IRL	1.2	no	-0.9	66.3	-6.4	-9.6	-6.8	yes	6.2
I	1.8	yes (g)	2.7	121.6	-2.4	-0.2	-0.7	yes (j)	6.7
L	1.4	no	-1.7	6.7	0.1	0.7	0.2	yes	5.6
NL	1.8	no	1.4	72.1	-5.0	-1.9	1.2	yes	5.5
A	1.1	yes (g)	2.5	66.1	-3.4	0.3	3.8	yes	5.6
P	1.8	yes (g)	2.5	62.0	-3.0	-0.9	2.1	yes	6.2
FIN	1.3	no	0.9	55.8	-1.8	-0.4	-1.5	yes (k)	5.9
S	1.9	yes (g)	0.8	76.6	-0.1	-0.9	-1.4	no	6.5
UK	1.8	yes (g)	1.9	53.4	-1.3	0.8	3.5	no	7.0
EUR	1.6		2.4	72.1	-0.9	2.0	3.0		6.1

(a) Percentage change in arithmetic average of the latest 12 monthly harmonized indices of consumer prices (HICP) relative to the arithmetic average of the 12 HICP of the previous period.
(b) Council decisions of 26.09.94, 10.07.95 , 27.06.96 and 30.06.97
(c) A negative sign for the government deficit indicates a surplus.
(d) Average maturity 10 years ; average of the last 12 months.
(e) Definition adopted in this report: simple arithmetic average of the inflation rates of the three best performing Member States in terms of price stability plus 1.5 percentage points.
(f) Definition adopted in this report: simple arithmetic average of the 12-month average of interest rates of the three best performing Member States in terms of price stability plus 2 percentage points.
(g) Commission is recommending abrogation.
(h) Since March 1998.
(i) Average of available data during the past 12 months.
(j) Since November 1996.
(k) Since October 1996.

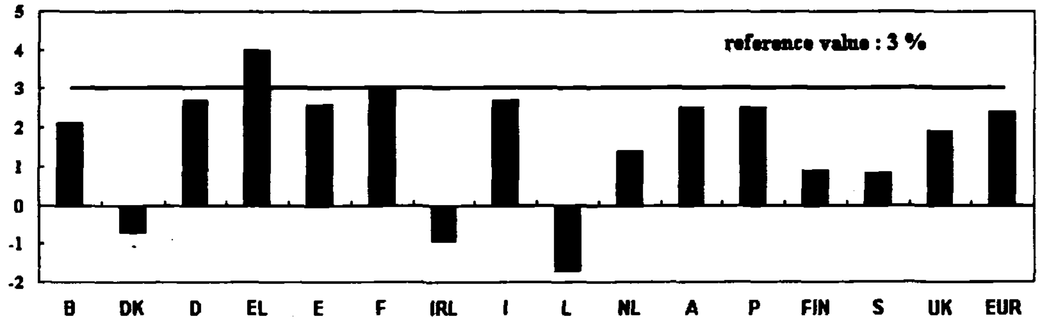
Source: Commission services.

Graph 1.1 Key convergence indicators

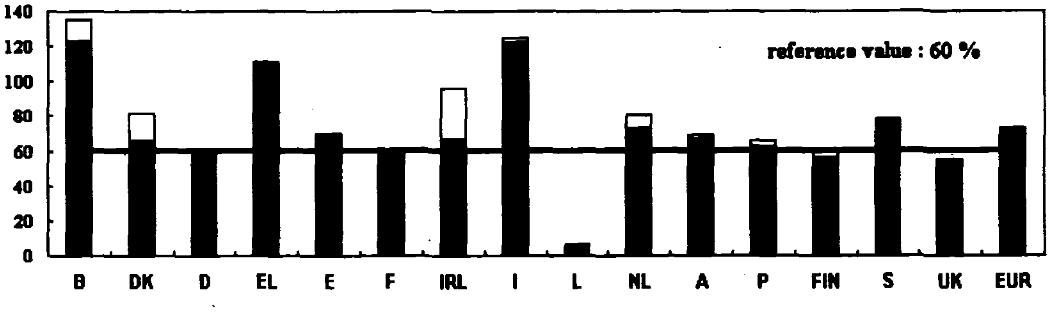
Average inflation rate (%) - January 1998



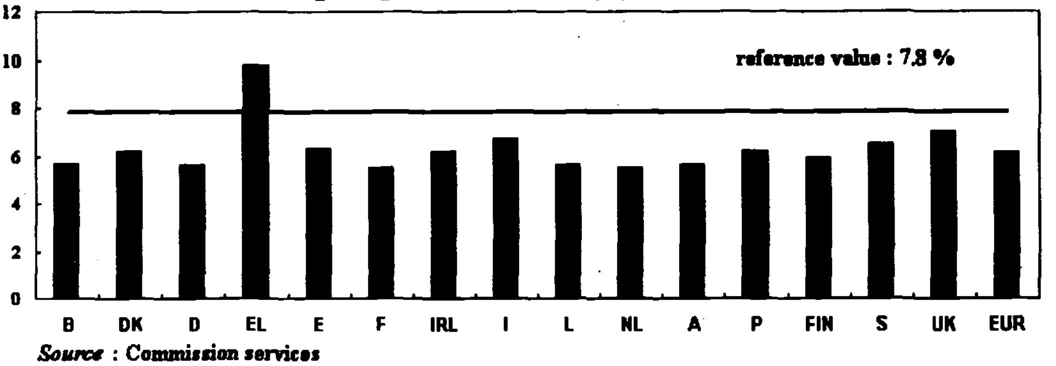
Government deficit (% of GDP) : 1997



Government debt (% of GDP): 1997 (and peak value in period 1993-97)



Average long - term interest rate (%) - January 1998



Source : Commission services

1.3. Assessment for each Member State

1.3.1. Belgium

The Belgian government proposed substantial amendments to central bank legislation in 1996 which were adopted by Parliament in February 1998. Amendments related to independence enter into force on the day of the establishment of the ECB; provisions on the integration of the central bank in the ESCB will become applicable when Belgium adopts the euro. Legislation in Belgium is compatible with the Treaty and the ESCB Statute.

The average inflation rate in Belgium during the 12 months to January 1998 was 1.4%, below the reference value of 2.7%. The Belgian inflation rate has been below the reference value throughout the period from December 1996[3]. Belgium fulfils the criterion on price stability.

Belgium is at present the subject of a decision on the existence of an excessive deficit (Council Decision of 26 September 1994). However, the government deficit has been reduced substantially and continuously during the second stage from 7.1% of GDP in 1993 to 2.1% in 1997, below the reference value. A further decline in the deficit is expected in 1998. The government debt ratio peaked in 1993 at 135.2% of GDP and has since declined every year to reach 122.2% in 1997; the level reached by the primary surplus, amounting to more than 5% of GDP since 1994, contributed to put the debt ratio on a sustainable downward path. The debt ratio is expected to continue to decline in 1998 and in future years; the Belgian government has recently confirmed its commitment to maintain the primary surplus at a high level over the medium term. The Commission is recommending to the Council the abrogation of the excessive deficit decision for Belgium; if the Council acts on this recommendation then Belgium will be considered as fulfilling the criterion on the government budgetary position.

The Belgian franc has participated in the ERM for longer than two years at the time of this examination and has not experienced severe tensions during the two-year period under review. The Belgium franc has always traded well within the ±2.25% band around the central rate against the median currency in the ERM. Belgium fulfils the exchange rate criterion.

3 The average rate of inflation using the HICP is only available from December 1996.

The average long-term interest rate in Belgium in the year to January 1998 was 5.7%, below the reference value of 7.8%. The reference value has been respected by Belgium throughout the period since December 1996[4]. The differential of the Belgian long-term interest rate from those of the Member States with the lowest interest rates has narrowed further. Belgium fulfils the criterion on the convergence of interest rates.

In the light of its assessment on the fulfilment of the convergence criteria the Commission considers that Belgium has achieved a high degree of sustainable convergence.

1.3.2. Germany

The Bundesbank Act of 1957 ensured a comparatively high level of independence for the central bank already at the start of Stage Two of EMU. In view of Stage Three of EMU, the German government put forward a proposal amending the Bundesbank Act which was adopted by Parliament in December 1997. The Act amending the Bundesbank Act of 1957 will come into force on the date Germany adopts the single currency. However, the provisions relating to the independence of the Bank became effective on the day following its promulgation, i.e. on 30 December 1997. Legislation in Germany is compatible with the Treaty and the ESCB Statute.

The average inflation rate in Germany during the 12 months to January 1998 was 1.4%, below the reference value of 2.7%. The German inflation rate has been below the reference value throughout the period from December 1996. Germany fulfils the criterion on price stability.

The 1994 decision on the existence of an excessive deficit in Germany (Council Decision of 26 September 1994) was abrogated in 1995 (Council Decision of 10 July 1995). An unexpected deterioration in the public finances in 1995 led to the adoption of a new decision on the existence of an excessive deficit in Germany (Council Decision of 27 June 1996) which has not yet been abrogated. The government deficit has been reduced from 3.4% of GDP in 1996 to 2.7% in 1997, below the reference value. A further decline in the deficit is expected in 1998. The government debt ratio has been rising; it climbed just above the reference value of 60% of GDP in 1996 and increased again in 1997 to 61.3%. However, the debt ratio is expected to start declining in 1998 and it remains close to the 60% of GDP reference value. Moreover, the exceptional costs of German unification continue to place a heavy burden on the public finances. The Commission is recommending to the Council the abrogation of the excessive deficit decision for Germany; if the Council acts on this recommendation then Germany will be considered as fulfilling the criterion on the government budgetary position.

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4 The reference value based on the interest rates of the three best performers in terms of price stability selected using the HICP is only available from December 1996

The German mark has participated in the ERM for longer than two years at the time of this examination and has not experienced severe tensions during the two-year period under review. The German mark has always traded well within the ±2.25% band around the central rate against the median currency in the ERM. Germany fulfils the exchange rate criterion.

The average long-term interest rate in Germany in the year to January 1998 was 5.6%, below the reference value of 7.8%. The reference value has been respected by Germany throughout the period since December 1996; indeed, Germany has been one of the Member States with the lowest long-term interest rates. Germany fulfils the criterion on the convergence of interest rates.

In the light of its assessment on the fulfilment of the convergence criteria the Commission considers that Germany has achieved a high degree of sustainable convergence.

1.3.3. Greece

The Greek government introduced a draft law in order to comply with the Treaty and Statute requirements in Summer 1997. This law was adopted by Parliament in November 1997 and became effective in December 1997. The provisions on independence entered into force in December 1997. The timing of the Bank's integration in the ESCB is not fully satisfactory. Notwithstanding this imperfection, legislation in Greece is compatible with the Treaty and the ESCB Statute.

The average inflation rate in Greece during the 12 months to January 1998 was 5.2%, well above the reference value of 2.7%. The Greek inflation rate has exceeded the reference value throughout the period from December 1996, but there has been some narrowing of the differential. Greece does not fulfil the criterion on price stability.

Greece is at present the subject of a decision on the existence of an excessive deficit (Council Decision of 26 September 1994). There has been a very large reduction in the government deficit from 13.8% of GDP in 1993 to 4.0% in 1997, but the deficit is still well above the reference value. The government debt ratio is high; while it has been relatively stable during the second stage, it reached a peak of 111.6% of GDP in 1996 before declining to 108.7% in 1997. Greece does not fulfil the criterion on the government budgetary position.

The Greek drachma entered the ERM in March 1998 but did not participate in the mechanism during the two years under review; the drachma was relatively stable against the ERM currencies in the review period but at times experienced tensions which were counteracted by increases in domestic interest rates and by foreign exchange intervention. Greece does not fulfil the exchange rate criterion.

The average long-term interest rate in Greece in the year to January 1998 was 9.8%, above the reference value of 7.8%. The interest rate data for Greece, which related until May 1997 to bonds with original maturity of less than 10 years, are not strictly comparable with those for other Member States. The differential between interest rates in Greece and those in the Member States where interest rates are lowest has been declining but still remains large. Greece does not fulfil the criterion on the convergence of interest rates.

1.3.4. Spain

Spain reformed its central bank legislation already in 1994. Law 13/1994 granted the central bank autonomy from the administration and established price stability as the primary objective of monetary policy. This Law was amended by two consecutive acts in recent months. A law amending the Law of 1994 with regard to certain aspects relating to independence was adopted on 31 December 1997. With a view to the Bank's objectives, its integration in the ESCB and other legislation the government submitted another draft law amending Law 13/1994 in February 1998. Provided that the draft law is adopted by Parliament in its present form, legislation in Spain is compatible with the Treaty and the ESCB Statute.

The average inflation rate in Spain during the 12 month to January 1998 was 1.8%, below the reference value of 2.7%. The reduction in inflation in Spain in 1996 and 1997 brought the average inflation rate down to and then below the reference value from July 1997 onwards. Spain fulfils the criterion on price stability.

Spain is at present the subject of a decision on the existence of an excessive deficit (Council Decision of 26 September 1994). However, the government deficit has been reduced substantially from 7.3% of GDP in 1995 to 2.6% in 1997, below the reference value. A further decline in the deficit is expected in 1998. The government debt ratio rose from 60.0% of GDP in 1993 to 70.1% in 1996 and then declined to 68.8% in 1997; the debt ratio is expected to decline again in 1998 and in future years. The Commission is recommending to the Council the abrogation of the excessive deficit decision on Spain; if the Council acts on this recommendation then Spain will be considered as fulfilling the criterion on the government budgetary position.

The Spanish peseta has participated in the ERM for longer than two years at the time of this examination and has not experienced severe tensions during the two-year period under review. The Spanish peseta has almost always traded within the ±2.25% band around the central rate against the median currency in the ERM. Spain fulfils the exchange rate criterion.

The average long-term interest rate in Spain in the year to January 1998 was 6.3%, below the reference value of 7.8%. The narrowing of interest rate differentials in 1996 brought the average rate in Spain down such that it has been below the reference value throughout the period from December 1996. The differential of the long-term interest rate in Spain from those in the Member States where interest rates are lowest has continued to narrow. Spain fulfils the criterion on the convergence of interest rates.

In the light of its assessment on the fulfilment of the convergence criteria the Commission considers that Spain has achieved a high degree of sustainable convergence.

1.3.5. France

France revised its central bank statute with a view to EMU already in 1993. The government intends to submit to Parliament a draft law amending the Law of 1993 in the last week of March 1998. The amendment related to independence is planned to enter into force on the date of establishment of the ECB, the other amendments on 1 January 1999. Provided that the draft government proposal is submitted to and adopted by Parliament in its present form, legislation in France is compatible with the Treaty and the ESCB Statute.

The average inflation rate in France during the 12 months to January 1998 was 1.2%, below the reference value of 2.7%; indeed, France was one of the three best performing Member States used for the calculation of this reference value. The French inflation rate has been below the reference value throughout the period from December 1996. France fulfils the criterion on price stability.

France is at present the subject of a decision on the existence of an excessive deficit (Council Decision of 26 September 1994). However, the government deficit has been reduced substantially from 5.8% of GDP in 1994 to 3.0% in 1997, equal to the reference value. A further decline in the deficit is expected in 1998. The government debt ratio, although it has been rising during the second stage and reached 58.0% of GDP in 1997, remains below the reference value. The Commission is recommending to the Council the abrogation of the excessive deficit decision for France; if the Council acts on this recommendation then France will be considered as fulfilling the criterion on the government budgetary position.

The French franc has participated in the ERM for longer than two years at the time of this examination and has not experienced severe tensions during the two-year period under review. The French franc has almost always traded within the ±2.25% band around the central rate against the median currency in the ERM. France fulfils the exchange rate criterion.

The average long-term interest rate in France in the year to January 1998 was 5.5%, below the reference value of 7.8%. The reference value has been respected by France throughout the period since December 1996; indeed, France has been one of the Member States with the lowest long-term interest rates. France fulfils the criterion on the convergence of interest rates.

In the light of its assessment on the fulfilment of the convergence criteria the Commission considers that France has achieved a high degree of sustainable convergence.

1.3.6. Ireland

The Central Bank Act 1998 which was adopted by Parliament in March 1998 amends the earlier Central Bank Acts 1942-1997 by various provisions related to EMU. This Act will come into operation on such day or days as the minister may appoint. Legislation in Ireland is compatible with the Treaty and the ESCB Statute.

The average inflation rate in Ireland during the 12 months to January 1998 was 1.2%, below the reference value of 2.7%; indeed, Ireland was one of the three best performing Member States used for the calculation of this reference value. The Irish inflation rate has been below the reference value throughout the period from December 1996. Ireland fulfils the criterion on price stability.

Ireland has never been the subject of an excessive deficit decision. Throughout the second stage the government deficit has been well below the reference value and a surplus of 0.9% of GDP was achieved in 1997. An improvement in the surplus is expected in 1998. The government debt ratio has been declining very rapidly, from 96.3% of GDP in 1993 to 66.3% in 1997; it is expected to fall below the reference value in 1998. Ireland fulfils the criterion on the government budgetary position.

The Irish punt has participated in the ERM for longer than two years at the time of this examination and has not experienced severe tensions during the two-year period under review. The Irish punt was revalued against the other ERM currencies in March 1998, after the close of the review period. During the review period, the Irish punt exhibited a higher variability than other ERM currencies, and traded beyond a ±2.25% fluctuation range around its central rate against the median currency for an extended period of time. However, the deviation of the Irish punt was mostly above its central rate and reflected the favourable conditions in the Irish economy. Therefore, the higher variability is not indicative of severe tensions in the examination period. Ireland fulfils the exchange rate criterion.

The average long-term interest rate in Ireland in the year to January 1998 was 6.2%, below the reference value of 7.8%. The reference value has been respected by Ireland throughout the period since December 1996. The differential of the Irish long-term interest rate from those of the Member States with the lowest interest rates has narrowed further. Ireland fulfils the criterion on the convergence of interest rates.

In the light of its assessment on the fulfilment of the convergence criteria the Commission considers that Ireland has achieved a high degree of sustainable convergence.

1.3.7. Italy

In October 1997 the Parliament mandated the Italian government to adopt legislation by legislative decree in relation to EMU. The Italian government introduced a draft legislative decree in December 1997 with a view to adapting Italian legislation to the requirements of the Treaty and the Statute. This legislative decree was adopted by government in March 1998. The provisions concerning independence enter into force upon publication of the legislative decree, provisions on integration on the date established by the minister or on the date when Italy adopts the euro. Legislation in Italy is compatible with the Treaty and the ESCB Statute.

The average inflation rate in Italy during the 12 months to January 1998 was 1.8%, below the reference value of 2.7%. The reduction in inflation in Italy in 1996 and 1997 brought the average inflation rate down to and then below the reference value from June 1997 onwards. Italy fulfils the criterion on price stability.

Italy is at present the subject of a decision on the existence of an excessive deficit (Council Decision of 26 September 1994). However, there has been a very large and continuous reduction in the government deficit during the second stage from 9.5% of GDP in 1993 to 2.7% in 1997, below the reference value. A further decline in the deficit is expected in 1998. The government debt ratio peaked in 1994 at 124.9% of GDP and has since declined every year to reach 121.6% in 1997; the steady rise in the primary surplus, which reached over 6% of GDP in 1997, contributed to put the debt ratio on a sustainable downward path. The debt ratio is expected to decline at a faster pace in 1998 and in future years; the Italian government recently renewed its commitment to maintain the primary surplus at an appropriately high level over the medium term. The Commission is recommending to the Council the abrogation of the excessive deficit decision for Italy; if the Council acts on this recommendation then Italy will be considered as fulfilling the criterion on the government budgetary position.

The Italian lira has participated in the ERM since November 1996. For the preceding part of the period under review, the lira appreciated trend vis-à-vis the ERM currencies. Since it re-entered the ERM, the lira has always traded within the ±2.25% band around the central rate against the median currency in the ERM. Although the lira has participated in the ERM only since November 1996, it has not experienced severe tensions during the review period and has thus, in the view of the Commission, displayed sufficient stability in the last two years.

The average long-term interest rate in Italy in the year to January 1998 was 6.7%, below the reference value of 7.8%. The narrowing of interest rate differentials in 1996 and 1997 brought the average rate in Italy down below the reference value from February 1997 onwards. The differential of the long-term interest rate in Italy from those in the Member States where interest rates are lowest has continued to narrow. Italy fulfils the criterion on the convergence of interest rates.

In the light of its assessment on the fulfilment of the convergence criteria the Commission considers that Italy has achieved a high degree of sustainable convergence.

1.3.8. Luxembourg

Based on an earlier proposal, the government submitted to Parliament a revised draft law on the Institut Monétaire Luxembourgeois in December 1997. The draft is intended to be adopted by Parliament in April and to enter into force on 1 May 1998. Several provisions in this draft law linked to independence and integration in the ESCB are not fully satisfactory. Provided that the draft law is adopted by Parliament in its present form and notwithstanding these imperfections, legislation in Luxembourg is compatible with the Treaty and the ESCB Statute.

The average inflation rate in Luxembourg during the 12 months to January 1998 was 1.4%, below the reference value of 2.7%. The inflation rate in Luxembourg has been below the reference value throughout the period from December 1996. Luxembourg fulfils the criterion on price stability.

Luxembourg has never been the subject of an excessive deficit decision. Throughout the second stage the government accounts have been in surplus; the surplus was 1.7% of GDP in 1997. The government debt ratio is very low and far below the reference value; in 1997 it was only 6.7% of GDP. Luxembourg fulfils the criterion on the government budgetary position.

The Luxembourg franc has participated in the ERM for longer than two years at the time of this examination and has not experienced severe tensions during two-years period under review. The Luxembourg franc has always traded well within the ±2.25% band around the central rate against the median currency in the ERM. Luxembourg fulfils the exchange rate criterion.

The average long-term interest rate in Luxembourg in the year to January 1998 was 5.6%, below the reference value of 7.8%. The reference value has been respected by Luxembourg throughout the period since December 1996; indeed, Luxembourg has been one of the Member States with the lowest long-term interest rates. Luxembourg fulfils the criterion on the convergence of interest rates.

In the light of its assessment on the fulfilment of the convergence criteria the Commission considers that Luxembourg has achieved a high degree of sustainable convergence.

1.3.9. Netherlands

In September 1997 the Dutch government submitted to Parliament a proposal for a new Act amending the Bank Act 1948 governing the central bank of the Netherlands. Parliament adopted this Act on 24 March 1998. The provisions relating to the central bank's independence will enter into force on the date of establishment of the ECB, those relating to the bank's integration in the ESCB at the beginning of Stage Three. One provision related to the integration of the Bank in the ESCB is not fully satisfactory. Notwithstanding this imperfection, legislation in the Netherlands is compatible with the Treaty and the ESCB Statute.

The average inflation rate in the Netherlands during the 12 months to January 1998 was 1.8%, below the reference value of 2.7%. The Dutch inflation rate has been below the reference value throughout the period from December 1996. The Netherlands fulfils the criterion on price stability.

The decision on the existence of an excessive deficit in the Netherlands (Council Decision of 26 September 1994) was abrogated in 1997 (Council Decision of 30 June 1997). The government deficit was brought down from 4.0% of GDP in 1995 to 1.4% in 1997, below the reference value. The government debt ratio reached its highest level in 1993 at 81.2% of GDP and has since declined to 72.1% in 1997; the debt ratio is expected to continue declining in 1998 and future years. The Netherlands fulfils the criterion on the government budgetary position.

The Dutch guilder has participated in the ERM for longer than two years at the time of this examination and has not experienced severe tensions during the two-year period under review. The Dutch guilder has always traded well within the ±2.25% band around the central rate against the median currency in the ERM. The Netherlands fulfils the exchange rate criterion.

The average long-term interest rate in the Netherlands in the year to January 1998 was 5.5%, below the reference value of 7.8%. The reference value has been respected throughout the period since December 1996; indeed, the Netherlands has been one of the Member States with the lowest long-term interest rates. The Netherlands fulfils the criterion on the convergence of interest rates.

In the light of its assessment on the fulfilment of the convergence criteria the Commission considers that the Netherlands has achieved a high degree of sustainable convergence.

1.3.10. Austria

In view of the requirements of the Treaty, the Austrian government submitted draft laws to Parliament in Autumn 1997 and in March 1998. According to the proposals, the provisions ensuring the independence of the central bank will enter into force at the date of establishment of the ESCB; the remaining provisions will enter into force when Austria adopts the single currency. Provided that the draft law is adopted in its present form, legislation in Austria is compatible with the Treaty and the ESCB Statute.

The average inflation rate in Austria during the 12 months to January 1998 was 1.1%, below the reference value of 2.7%; indeed, Austria was one of the three best performing Member States used for the calculation of this reference value. The Austrian inflation rate has been below the reference value throughout the period from December 1996. Austria fulfils the criterion on price stability.

Austria is at present the subject of a decision on the existence of an excessive deficit (Council Decision of 10 July 1995). However, the government deficit has been reduced from 5.2% of GDP in 1995 to 2.5% in 1997, below the reference value. A further decline in the deficit is expected in 1998. The government debt ratio rose from 62.7% of GDP in 1993 to 69.5% in 1996 and then declined to 66.1% in 1997; the debt ratio is expected to decline again in 1998 and in future years. The Commission is recommending to the Council the abrogation of the excessive deficit decision for Austria; if the Council acts on this recommendation then Austria will be considered as fulfilling the criterion on the government budgetary position.

The Austrian schilling has participated in the ERM for longer than two years at the time of this examination and has not experienced severe tensions during the two-year period under review. The Austrian schilling has always traded well within the ±2.25% band around the central rate against the median currency in the ERM. Austria fulfils the exchange rate criterion.

The average long-term interest rate in Austria in the year to January 1998 was 5.6%, below the reference value of 7.8%. The reference value has been respected throughout the period since December 1996; indeed, Austria has been one of the Member States with the lowest long-term interest rates. Austria fulfils the criterion on the convergence of interest rates.

In the light of its assessment on the fulfilment of the convergence criteria the Commission considers that Austria has achieved a high degree of sustainable convergence.

1.3.11. Portugal

In January 1998 a Law was adopted amending the Organic Law of the central bank of Portugal with a view to the requirements of the Treaty. Provisions in the new law regarding independence have already entered into force, while the other provisions will come into force when Portugal adopts the euro. Legislation in Portugal is compatible with the Treaty and the ESCB Statute.

The average inflation rate in Portugal during the 12 months to January 1998 was 1.8%, below the reference value of 2.7%. The reduction in inflation in Portugal in 1996 and 1997 brought the average inflation rate down to and then below the reference value from June 1997 onwards. Portugal fulfils the criterion on price stability.

Portugal is at present the subject of a decision on the existence of an excessive deficit (Council Decision of 26 September 1994). However, the government deficit has been reduced substantially and continuously during the second stage from 6.1% of GDP in 1993 to 2.5% in 1997, below the reference value. A further decline in the deficit is expected in 1998. The government debt ratio reached a peak of 65.9% of GDP in 1995 and has since declined to 62.0% in 1997; a further decline in the debt ratio to the reference value is expected in 1998. The Commission is recommending to the Council the abrogation of the excessive deficit decision for Portugal; if the Council acts on this recommendation then Portugal will be considered as fulfilling the criterion on the government budgetary position.

The Portuguese escudo has participated in the ERM for longer than two years at the time of this examination and has not experienced severe tensions during the two-year period under review. The Portuguese escudo has almost always traded within a ±2.25% band around the central rate against the median currency in the ERM. Portugal fulfils the exchange rate criterion.

The average long-term interest rate in Portugal in the year to January 1998 was 6.2%, below the reference value of 7.8%. The narrowing of interest rate differentials in 1996 brought the average rate in Portugal down such that it has been below the reference value throughout the period from December 1996. The differential of the long-term interest rate in Portugal from those in the Member States with the lowest interest rates has continued to narrow. Portugal fulfils the criterion on the convergence of interest rates.

In the light of its assessment on the fulfilment of the convergence criteria the Commission considers that Portugal has achieved a high degree of sustainable convergence.

1.3.12. Finland

The review of Finnish central bank legislation started in 1993, leading up to the adoption of an amended Central Bank Act by Parliament in June 1997. This Act, which entered into force on 1 January 1998, established the independence of the Bank but did not clarify its integration in the ESCB. The government put forward in February 1998 a new bill comprising amendments of the Bank of Finland Act, the Currency Act and the Coin Act; this bill was adopted by Parliament on 20 March 1998. The provisions on independence will enter into force shortly, the other provisions of the Bank of Finland Act will enter into force when Finland adopts the single currency. Legislation in Finland is compatible with the Treaty and the ESCB Statute.

The average inflation rate in Finland during the 12 months to January 1998 was 1.3%, below the reference value of 2.7%. The Finnish rate has been below the reference value throughout the period from December 1996. Finland fulfils the criterion on price stability.

The decision on the existence of an excessive deficit in Finland (Council Decision of 10 July 1995) was abrogated in 1997 (Council Decision of 30 June 1997). The government deficit was reduced significantly from 8.0% of GDP in 1993 to 0.9% in 1997, below the reference value. A surplus is expected in 1998. The government debt ratio peaked in 1994 at 59.6% of GDP, below the reference value, and has since declined to reach 55.8% in 1997. Finland fulfils the criterion on the government budgetary position.

The Finnish markka has participated in the ERM since October 1996. For the preceding part of the period under review, the markka appreciated vis-à-vis the ERM currencies. Since it entered the ERM, the markka has for most of the time traded within the ±2.25% band around the central rate against the median currency in the ERM. Although the markka has participated in the ERM only since October 1996, it has not experienced severe tensions during the review period and has thus, in the view of the Commission, displayed sufficient stability in the last two years.

The average long-term interest rate in Finland in the year to January 1998 was 5.9%, below the reference value of 7.8%. The reference value has been respected by Finland throughout the period since December 1996. The differential of the Finnish long-term interest rate from those of the Member States with the lowest interest rates has narrowed further. Finland fulfils the criterion on the convergence of interest rates.

In the light of its assessment on the fulfilment of the convergence criteria the Commission considers that Finland has achieved a high degree of sustainable convergence.

1.3.13. Sweden

The government put forward to Parliament a proposal to amend the Constitution, the Riksdag Act and the Riksbank Act in November 1997. Parliament adopted the amendments to the Constitution in March 1998 in a first vote. The second vote confirming the amendments to the Constitution can only be taken by the next Parliament after the general elections scheduled for September 1998. The amendments to the other two Acts are planned to be adopted by Parliament together with the second vote on the Constitution in October 1998. All amendments would enter into force on 1 January 1999. The present drafts include some incompatibilities with respect to the integration of the central bank in the ESCB.. Also, the foreseen date of adoption of the proposals is not in accordance with the timetable specified in the Treaty. Legislation in Sweden is not compatible with the Treaty and the ESCB Statute.

The average inflation rate in Sweden during the 12 months to January 1998 was 1.9%, below the reference value of 2.7%. The Swedish inflation rate has been below the reference value throughout the period from December 1996. Sweden fulfils the criterion on price stability.

Sweden is at present the subject of a decision on the existence of an excessive deficit (Council Decision of 10 July 1995). However, there has been a very large and continuous reduction in the government deficit from 12.2% of GDP in 1993 to 0.8% in 1997, below the reference value. A surplus is expected in 1998. The government debt ratio peaked in 1994 at 79.0% of GDP and has since declined every year to reach 76.6% in 1997; the debt ratio is expected to continue to decline in 1998 and in future years. The Commission is recommending to the Council the abrogation of the excessive deficit decision for Sweden; if the Council acts on this recommendation then Sweden will be considered as fulfilling the criterion on the government budgetary position.

The Swedish krona has never participated in the ERM; in the two years under review the krona has fluctuated against the ERM currencies, reflecting among others the absence of an exchange rate target. Sweden does not fulfil the exchange rate criterion.

The average long-term interest rate in Sweden in the year to January 1998 was 6.5%, below the reference value of 7.8%. The narrowing of interest rate differentials in 1996 brought the average rate in Sweden down such that it has been below the reference value throughout the period since December 1996. The differential of the long-term interest rate in Sweden from those in the Member States with the lowest interest rates has continued to narrow. Sweden fulfils the criterion on the convergence of interest rates.

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Because they are exercising their opt-outs, Denmark and the United Kingdom will not be included in the first group of Member States participating in the single currency. It will, therefore, not be necessary for the Council to assess whether Denmark and the United Kingdom fulfil the other conditions for the adoption of a single currency. Nevertheless, these two countries are closely involved in the deepening of economic integration and the enhancement of economic policy cooperation in the successive stages of EMU. Just as for the other Member States, this report gives information on the state of central bank legislation in Denmark and the United Kingdom and examines the convergence performance of these two countries.

2. COMPATIBILITY OF NATIONAL LEGISLATION WITH THE TREATY AND THE STATUTE OF THE EUROPEAN SYSTEM OF CENTRAL BANKS

2.1. Introduction

According to the second sentence of Article 109j(1) of the Treaty, the report drawn up under this article *"shall include an examination of the compatibility between each Member State's national legislation, including the statutes of its national central bank, and Articles 107 and 108 of this Treaty and the Statute of the ESCB* (European System of Central Banks)".

The present chapter is devoted to this examination. The first section describes the scope of the adaptations that are necessary to bring national legislation in line with the Treaty and the Statute. The second section is on timing. The third section is a country-by-country assessment of the compatibility of national legislation with the Treaty and the Statute, with a particular focus on national legislation regarding the central bank.

2.2. Scope of necessary adaptation of national legislation

2.2.1. General

As from 1 January 1999, the competence for monetary policy, exchange rate policy and monetary law is transferred from participating Member States to the Community level. Naturally, provisions referring to national competence in these fields and setting up national rules are numerous in any jurisdiction. Article 108 reads:

"Each Member State shall ensure, at the latest at the date of the establishment of the ESCB, that its national legislation including the statutes of its national central bank is compatible with this Treaty and the Statute of the ESCB."

The method by which compatibility is to be achieved is not specified in the Treaty. Possible methods are deletion of national provisions, incorporation in national law of language reflecting Treaty or ESCB Statute provisions, reference to such provisions, or a mixture thereof.

The examination can be divided into three areas:

- objectives of national central banks (NCBs)
- independence
- integration in the ESCB and other legislation

2.2.2. Objectives

The objectives of a NCB must be compatible with the objectives of the ESCB as formulated in Article 105(1) of the Treaty (and Article 2 of the Statute of the ESCB):

"The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2."

References in national law to the policy of the government or to specific macroeconomic objectives are not incompatible provided that the primacy of the first and second objectives of Article 105 of the Treaty is respected.

2.2.3. Independence

Article 107 of the Treaty ensures that the ESCB will operate free from instructions from third parties. It reads as follows:

"When exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and the Statute of the ESCB, neither the ECB nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. The Community institutions and bodies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks."

The features which make up independence may be grouped as follows:

- Institutional
  This group includes for instance the absence of any right of a body external to the NCB, as far as ESCB-related tasks are concerned,
  - to give instructions to a NCB;
  - to approve, suspend, annul or defer a decision of a NCB;
  - to censor decisions of a NCB on legal grounds;
  - to participate in decision-making bodies of a NCB with a right to vote;
  - to be consulted before a NCB takes a decision.

- Personal
  - certain rules are imposed on national legislation by virtue of Article 14.2 of the Statute of the ESCB:
    - ♦ the term of office for the Governor must be at least five years;
    - ♦ a Governor may be relieved from office only if he no longer fulfils the conditions required for the performance of his duties or if he has been guilty of serious misconduct.

    With a view to Article 107, which covers all members of decision-making bodies, it is desirable that these rules not only apply the Governor, but also to the other members who are involved in the performance of ESCB-related tasks. However, it may be justified under certain conditions to appoint members of decision-making bodies for a period of less than five years. Two cases are at stake: appointment of new members for the remainder of the term of the predecessor in case of a vacancy; and staggered initial appointment, where one or several members are appointed for less than five years. In the first case, the shorter term of office may be warranted by the perspective that the respect of a pre-determined rhythm of replacements strengthens collective independence. In the second case, which is a once-for-all deviation from the minimum term, the benefit may be seen in enhanced continuity in the management of the central bank;
  - where a member of a decision-making body with ESCB-related tasks exercises functions outside this body, his or her independence may, depending on the nature of such functions, be jeopardised.
- Financial

  A NCB must, of course, be financially accountable. However, a right to control ex ante the budget may, depending on the context, create a situation where a NCB is unable to fulfil its ESCB-related tasks independently.

2.2.4. Integration of NCBs in the ESCB and other legislation

According to Article 9.2 of the Statute of the ESCB, the ECB shall ensure that the tasks conferred upon the ESCB are implemented either by its own activities or through the NCBs. Furthermore, according to Article 14.3, the NCBs are an integral part of the ESCB and shall act in accordance with the guidelines and instructions of the ECB. Therefore, provisions in the statutes of NCBs which stand in the way of the NCBs assuming their role need to be adapted under Article 108.

The following is a list of examples of incompatibilities:
- a provision which assigns to the NCB the competence. to set interest rates for credit operations or to impose minimum reserves;
- rules which constrain the Governor in his voting behaviour in the ECB's Governing Council;
- provisions which prevent the decision-making body of a NCB from complying with the ECB's guidelines or instructions;
- rules which do not respect the financial provisions of the Statute of the ESCB;
- rules which prevent a NCB from holding and managing the official foreign reserves.

Certain other provisions should be brought into line with the provisions of the Treaty as well. Examples are any provisions which attribute the competence for exchange rate policy to the government or which assign competence to national authorities for determining the volume of coins to be issued without referring to the ECB's right of approval.

2.2.5. Legislation outside the scope of Article 108

The elements of national legislation which are addressed above can be compared directly with provisions of the Treaty and the ESCB statute. Any necessary adjustments in these areas are to be made by virtue of Article 108.

A country adopting the single currency will have to make further adjustments which can only be specified when the ECB has laid down detailed rules, or because secondary legislation is still to be adopted by the Council. Points at issue are the details of the confidentiality regime of national central banks, the competence of NCBs to make regulations for clearing and payment systems, or the definition of the national currency as the lawful currency of a Member State. These adaptations, which are not the subject of the examination under Article 109j, fall under the general obligation of Member States to remove incompatibilities with EC law from their national legislation. This legislation should be brought into line at the date specified in secondary legislation or when the ECB specifies the respective rules.

Nor does this report examine whether national legislation complies with the Treaty in general, i.e. with any obligation of Member States to adapt their legislation to Community law other than those obligations which follow from the transfer of competences in the context of EMU.

2.3. Timing of adaptation

Article 108 requires Member States to "ensure" that their legislation is compatible with EC law at the date of the establishment of the ESCB at the latest. Compatibility is only ensured when the legislative process is completed. This conclusion applies to all three areas identified above, i.e. legislation related to the definition of a NCB's objectives, independence as well as integration into the ESCB and other legislation. However, the distinction between the three areas is important when it comes to determining the date from which legislation must be applicable.

Many decisions which the ECB will take between its establishment and the end of 1998 will pre-determine the monetary policy of the euro area. Therefore, incompatibilities which belong to the independence of a NCB need to be effectively removed at the date of establishment of the ECB, i.e. the relevant changes in legislation must not only be adopted, but must be in force at this date.

Other areas of legislation, in particular those which belong to the integration of a NCB into the ESCB, need to become effective at the latest when a country adopts the single currency and the responsibility of its central bank for monetary policy is transferred to the ECB.

A point of particular importance is the definition of the objectives of a NCB. This definition belongs to the integration of a NCB into the ESCB, with the consequence that amendments of the objectives need not become effective before a country adopts the single currency.

The examination of legislation in this report is based on the situation on 24 March 1998. In a few Member States, legislation is being adapted but has at present not yet been formally adopted by Parliament. In these cases, the assessment is based on the assumption that the draft proposals will be adopted in their present form.

2.4. Situation in the Member States

The following country-by-country examination starts with a summary of legislative action taken since the beginning of the second stage of EMU (January 1994) or shortly before.[1] This is followed by an assessment of compatibility which starts with a general statement and goes on, where appropriate, by enumerating specific outstanding points.

The general statement concludes that a country's legislation either is or is not compatible with the Treaty and the ESCB Statute. Legislation is not compatible where incompatibilities exist which infringe upon principles of the Treaty. In a number of cases, imperfections have been identified which are either of a technical nature, or concern the transitional period up to the end of 1998 only, or are ambiguities rather than obvious inconsistencies. Where outstanding points enumerated after the general statement are limited to such imperfections, the country's legislation is judged to be compatible with the Treaty and the ESCB Statute.

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1 According to Article 109e(5) of the Treaty, Member States were invited, as appropriate, to start the process leading to the independence of their central bank during the second stage, in accordance with Article 108.

2.4.1. Belgium

2.4.1.1. Overview and legislative action taken since 1994

Until recently, the legal provisions governing the central bank of Belgium were laid down in the Organic Law of 1939 and the Statutes of 1939 - both as amended. The government proposed amendments to the Organic Law already in 1996, which were ultimately adopted by Parliament in February 1998.

The Bank is a limited liability company; the Belgian State owns a controlling stake with 50% of the shares. Company law only supplements the Law and the Statute. The Bank is managed by the Governor and the Board of Directors which comprises the Governor and five to seven Directors. The Bank's structure also includes the Council of Regency (which consists of the members of the Board and ten non-executive members) and a Government Commissioner. Under the previous legislation, the Council of Regency supervised the Board and had the power to fix certain key rates and terms of operation; no explicit provision on the Bank's objective existed; the Commissioner was entitled to oppose the Bank's decision on ESCB-related matters on grounds of legality.

Under the new Organic Law the following changes were introduced which are relevant with a view to Article 108 of the Treaty:

- *Objectives*

The Bank's objectives are derived from a general reference in Article 2 of the Law pursuant to which the Bank shall form an integral part of the ESCB.

- *Independence*

The powers of the Council of Regency in ESCB-related matters were shifted to the Board; the Council of Regency has only advisory functions; it does not have to be consulted ex ante on decisions to be taken.

The Government Commissioner's power to review the legality of the Bank's activities in the field of ESCB-related tasks has been abolished.

Grounds for dismissal of the members of the Board have been adjusted to Article 14.2 of the ESCB Statute.

- *Integration in the ESCB and other legislation*

Article 2 of the new Organic Law stipulates that "*the Bank shall be an integral part of the ESCB the Statutes of which have been fixed in the respective Protocol annexed to the Treaty establishing the European Community*". All provisions which had given the Bank the power to define monetary policy, i.e. to fix interest rates or to impose the maintenance of minimum reserves, and to issue banknotes were deleted.

- *Timing*

The provisions of the Organic Law will be put into force by decision of the King at different dates. Amendments related to independence enter into force at the date of the establishment of the ECB. Provisions on integration become effective at the latest when Belgium adopts the euro with the exception of the provision relating to banknotes which will come into force when banknotes denominated in euro are introduced.

2.4.1.2. Assessment of compatibility

Legislation in Belgium is compatible with the requirements of the Treaty and the ESCB Statute.

It is expected that the provisions on the transfers of powers in ESCB-related matters from the Council of Regency to the Board will be put into force at the date of the establishment of the ESCB.

2.4.2. Denmark

The legal provisions governing the central bank of Denmark are set out in the National Bank of Denmark Act of 1936 (Act No 116). The Bank is a self-governing institution.

The governing bodies of the Bank are the Board of Governors, the Board of Directors and the Committee of Directors. Authority for monetary policy rests with the Board of Governors, consisting of three members with the Chairman appointed by the Crown. The core provisions of the Act of 1936 are: the primary objective of the Bank is to maintain a safe and secure currency system and to facilitate and regulate payment flows and the extension of credit; the Board of Governors has full freedom in formulating and implementing monetary policy, including setting interest rates and deciding on other monetary policy instruments.

The members of the Board of Governors are appointed for an indefinite term of office with a retirement age of seventy. They may, according to the Bank's bye-laws, be dismissed by the Crown (for the Chairman) or by two-thirds majority of the members of the Board of Directors (for the other members) with no grounds for dismissal being specified.

The Minister of Economic Affairs supervises the Bank's fulfilment of its obligations under the National Bank of Denmark Act.

Protocol No 12 of the Treaty on certain provisions relating to Denmark states that the Danish government shall notify the Council of its position concerning participation in the third stage before the Council makes its assessment under Article 109j(2) of the Treaty. Denmark has given its notification that it will not participate in Stage Three and, in accordance with Article 2 of the Protocol, Denmark will be treated as a country with a derogation. Implications thereof were elaborated in a Decision taken at the Edinburgh Summit in December 1992. This Decision states that Denmark will retain its existing powers in the field of monetary policy according to its national laws and regulations, including powers of the national bank of Denmark in the field of monetary policy.

In the light of the situation described above, the assessment of compatibility of Danish legislation with the requirement of the Treaty and the ESCB Statute is limited to the independence of the central bank[2]. This assessment leads to the conclusion that legislation in Denmark is compatible with the Treaty and the ESCB Statute.

2.4.3. Germany

2.4.3.1. Overview and legislative action taken since 1994

The legal provisions governing the central bank of Germany are set out in the Bundesbank Act of 1957 and its Statute of 1958 as amended. The Bundesbank Act ensured a comparatively high level of independence for the German central bank already at the start of Stage Two of EMU.

The core provisions of the Act of 1957 are: the primary objective of the Bank is to safeguard the currency; the Bank is independent from instructions of the government in carrying out its tasks. Decisions on monetary policy have up to now been taken by the Central Bank Council which consists of the President and the Deputy President of the Bank, up to six other members of the Directorate and the Presidents of the Land Central Banks.

In view of EMU, the Bundesbank Act was amended by the 6th Act amending the Bundesbank Act in December 1997. This Act covers the following areas:

- *Objectives*

The tasks and objectives of the Bank were adapted by a revision of Section 3 to state that *"The Deutsche Bundesbank... shall participate in the fulfilment of its* (the ESCB's) *tasks with the primary objective of maintaining price stability . . .".*

Section 12 providing for the support of the Bank to the general economic policy of the government was amended to take account of the fact that such support can only be given as far as this is compatible with the Bank's tasks as an integral part of the ESCB.

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2 Member States with a derogation are obliged to make their central bank independent at the date of the establishment of the ECB at the latest.

- *Independence*

The minimum term of office for the President and other members of the Central Bank Council has been extended to five years[3]. The possibility for the government to defer the decisions by the Central Bank Council for two weeks has been repealed.

- *Integration in the ESCB and other legislation*

Section 6 was amended to state that the Central Bank Council shall act in accordance with guidelines and instructions of the ECB when assuming ESCB-related tasks.

The provisions on the Bank's power to fix interest rates in monetary policy operation and to impose minimum reserves were repealed. The provisions on banknote issuance and on participation in international institutions were amended in order to reflect the ECB's prerogatives in these areas.

- *Timing*

The 6th Act amending the Bundesbank Act will come into force on the date from which Germany participates in Stage Three of EMU pursuant to Article 109j of the Treaty. However, the provisions relating to the independence of the Bank became effective on the day following its promulgation, i.e. on 30 December 1997.

2.4.3.2. Assessment of compatibility

Legislation in Germany is compatible with the requirements of the Treaty and the ESCB Statute.

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3 Already under the previous Act, the President and the Deputy President of the Bank, the other members of the Directorate and the Presidents of the Land Central Banks had to be appointed for eight years; in exceptional cases, however, appointments were possible for a shorter period but not for less than two years. The minimum period in exceptional cases will now be raised to five years.

2.4.4. Greece

2.4.4.1. Overview and legislative action taken since 1994

Until recently the legal provisions governing the central bank of Greece were laid down in the Statute of the Bank of Greece of 1928 as amended. The Bank's legal form, unaltered by recent legislation, is a corporation; the holding of the Greek State is limited to no more than 10 per cent of the share capital of the Bank. The principal organs of the Bank are the General Council and the Monetary Policy Council. The Monetary Policy Council consists of the Governor, two Deputy Governors and three other members. The terms of office of the members of the Monetary Policy Council are six years.

Legislation in order to comply with the Treaty and Statute requirements for Stage Three was adopted by Parliament in November 1997 and became effective in December 1997. The new law introduced the following major amendments:

- *Objectives*

The primary objective of the Bank is to ensure price stability. Without prejudice to this objective, the Bank shall support the general economic policy of the government. As from when Greece adopts the single currency, the Bank shall pursue the primary objective of maintaining price stability in accordance with the terms set out in Article 105(1) of the Treaty.

- *Independence*

The Monetary Policy Council will *"define and implement monetary policy and decide on matters pertaining to the conduct of exchange rate policy, the operation of payment systems and the issue of banknotes"*. The General Council retains the other tasks conferred upon it by the Statute of the Bank, except for matters falling within the duties of the ESCB for which the Governor is responsible.

The grounds for dismissal of the Governor and the Deputy Governors have been adjusted to Article 14.2 of the ESCB Statute. When the first Monetary Policy Council is established, exceptionally, the term of office of the other three members will be four, three, and two years respectively. A person who is replacing one of the other three members of the Monetary Policy Council prior to the expiry of their term of office will be appointed for the remainder of the term of office if this is more than two years.

Article 3 stipulates that *". . neither the Bank of Greece nor any member of its decision-making bodies shall seek or take instructions from the government or any organisation. Neither the government nor any other political authority shall seek to influence the decision-making organs of the Bank . . ."*

- *Integration in the ESCB*

As from when Greece adopts the single currency, the Bank shall act in accordance with the guidelines and instructions of the ECB as stipulated in Article 105(2) and (3) of the Treaty and Articles 3 and 14.3 of the ESCB Statute.

Article 12.17 of the new law states that *" As from the date of adoption of the euro as the national currency, every legal provision which contravenes primary or secondary EU legislation on the operation of the ESCB and/or of the ECB shall cease to be valid."*

Company law will only apply to the Bank to the extent that this is compatible with the specific provisions of law applying to the Bank.

- *Timing*

The provisions on independence entered into force in December 1997.

2.4.4.2. Assessment of compatibility

Legislation in Greece is compatible with the requirements of the Treaty and the ESCB Statute.

However, an imperfection to be noted is that the new law includes some powers of the Bank of Greece which the Bank will only have as long as Greece has not adopted the euro and the Bank is not an integral part of the ESCB. This concerns the power to impose minimum reserves and the participation of the Bank in international monetary and economic organisations without the ECB's right of approval.

2.4.5. Spain

2.4.5.1. Overview and legislative action taken since 1994

Spain substantially reformed its central bank legislation already in 1994 with a view to EMU. Law 13/1994 of June 1994 granted the central bank of Spain autonomy from the administration and established price stability as the primary objective of monetary policy.

The Bank's governing bodies comprise the Governor and the Deputy Governor, the Governing Council and the Executive Commission.

The Governing Council is made up of the Governor, the Deputy Governor, six elected members and two ex officio members (the Director General of the Treasury and the Deputy Chairman of the Stock Exchange Commission). It lays down general guidelines for the Bank's activities and supervises the implementation of monetary policy to be carried out by the Executive Commission.

The Executive Commission comprises the Governor, the Deputy Governor and two elected members. Its main task is the implementation of monetary policy, subject to the Governing Council's guidelines.

The Bank's objectives reads as follows: *"The Bank shall define and implement monetary policy with the primary objective of achieving price stability. Without prejudice to this objective, monetary policy shall support the general economic policy of the Government"* (cf. Article 7.2 of the Law 13/1994).

Spain undertook to amend the Law of 1994 by two consecutive acts in recent months. A law amending the Law of 1994 with regard to certain aspects relating to independence was adopted and published on 31 December 1997. With a view to the Bank's objectives, its integration in the ESCB and other legislation the government submitted another draft law amending Law 13/1994 in February 1998.

- *Objectives*

Concerning the Bank's objectives, the draft law provides that without prejudice to the primary objective of maintaining price stability and to the functions which the Bank exercises as a member of the ESCB pursuant to Article 105(1) of the Treaty, the Bank shall support the general economic policy of the government.

- *Independence*

The law of 31 December 1997 stipulates that the two ex officio members of the Governing Council are barred from voting on all ESCB-related matters. Furthermore, the terms of office of the elected members of the Governing Council are extended to six years; this also applies to members substituting for elected members who have left office before the expiry of their six years' term.

- *Integration and other legislation*

The draft law includes provisions stating that the Bank will form part of the ESCB and will be subject to the ECB's guidelines and instructions in the exercise of ESCB-related functions. Provisions vesting power in the Bank and its decision-making bodies to define and implement monetary policy or to impose the maintenance of minimum reserves will be repealed or amended to reflect the ECB's competence in this area. Similarly, provisions establishing competence of the government in the area of exchange rate policy will be abrogated. Rules on banknotes will be restricted to peseta-denominated banknotes, and the Bank's monopoly of issuance will be repealed. The Bank's obligation to pay to the government interim instalments on the annual profit will also be abolished.

- *Timing*

The Law of 1997 enters into force on the date of establishment of the ECB. The draft law of February 1998 is intended to enter into force when Spain adopts the single currency.

2.4.5.2. Assessment of compatibility

Legislation in Spain is compatible with the requirements of the Treaty and the ESCB Statute. This assessment is based on the assumption that the draft law of February 1998 is adopted in its present form.

2.4.6. France

2.4.6.1. Overview and legislative action taken since 1994

The legal provisions governing the central bank of France are enshrined in Law 93-980 of 1993 as amended. Under that Law the Bank's objectives, structure and relationship with government were substantially revised with a view to the requirements of the Treaty. The Bank's capital is held by the State. Its decision-making bodies are the Governor, the Monetary Policy Council and the General Council.

The Governor, assisted by two Deputy Governors, is responsible for the management of the Bank.

The Monetary Policy Council consists of the Governor, the two Deputy Governors and six other members. It is responsible for monetary policy decisions.

The General Council consists of the members of the Monetary Policy Council plus one staff representative. Within the present legal framework, the General Council administers the Bank and takes decisions in all other areas outside monetary policy. A censor appointed by the Minister of Economic Affairs and Finance attends the meetings of the General Council and may oppose any of its decisions.

The government intends to submit to Parliament a draft law amending the Law of 1993 in the last week of March. With respect to this draft, the following points are relevant in the context of Article 108 of the Treaty:

- *Objectives*
The Bank's objectives will be redefined as follows: it shall "... *participate in carrying out the tasks and complying with the objectives conferred upon the ESCB by the Treaty. Within this framework, and without prejudice to the primary objective of price stability, the Banque de France shall support the general economic policy of the government*".

- *Independence*
Competence for ESCB-related matters will be shifted from the General Council to the Monetary Policy Council. The Governor's right and obligation to appear before parliamentary committees will be placed under the reserve of Article 107 of the Treaty.

- *Integration into the ESCB and other legislation*
The new law will state that the Bank forms an integral part of the ESCB. Similarly, the provision on the competence of Monetary Policy Council will be amended to reflect that the Bank will be subject to the instructions and guidelines of the ECB.

Provisions giving the Bank and its Monetary Policy Council power to formulate and implement monetary policy will be deleted. Provisions on banknote issuance, participation in international agreements and the government's power to determine the exchange rate policy will be amended.

- *Timing*
The new law is planned to enter into force on 1 January 1999 or at another date when France adopts the euro. However, the provision according which the members of the Monetary Policy Council shall not seek or accept instructions from the government or any other person is planned to enter into force at the date of establishment of the ECB.

2.4.6.2. Assessment of compatibility:

Legislation in France is compatible with the requirements of the Treaty and the ESCB Statute. This assessment is based on the assumption that the draft government proposal for the amendment of the Law 93-980 is adopted by the government and subsequently by Parliament in its present form. It is to be understood that the General Council will have no competence to decide on issues related to the conduct of the Bank's activities which derive from the tasks of the ESCB.

2.4.7. Ireland

2.4.7.1. Overview and legislative action taken since 1994

The Central Bank Act 1998, which was adopted by Parliament in March 1998, amends the earlier Central Bank Acts 1942–1997 by various provisions related to EMU.

The central bank of Ireland is governed by a Board of Directors made up of the Governor and up to nine non-executive Directors. Two Directors (the "Service Directors") can at the same time be officials of the Ministry of Finance. Prior to the Act of 1998, the Board was responsible for monetary policy although the daily exercise of such powers had largely been delegated to the Governor; the Minister of Finance was entitled to oblige the Governor or the Board to consult or advise him on matters which fall within the Bank's competence although in practice such a right had never been used.

The main amendments introduced by the Central Bank Act 1998 with a view to Article 108 of the Treaty are the following:

- *Objectives*

The Bank's objectives have been redefined by stating that in discharging its functions as part of the ESCB, *"the primary objective of the Bank shall be to maintain price stability"* and, without prejudice to this objective, *"the Bank shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2 of the Treaty";* the Bank shall assume other functions under the Treaty, Statute and national law without prejudice to the objective of price stability.

- *Independence*

The performance of all ESCB-related tasks has been shifted from the Board to the Governor; the Governor must inform the Board and may discuss the performance of such tasks with it, subject to Treaty and ESCB Statute requirements.

The Governor's obligation to consult the Minister of Finance was abolished as far as ESCB-related matters are concerned; the Governor informs the Minister upon request, subject to Treaty and ESCB Statute requirements;

The grounds for dismissal of the Governor and his right of appeal were amended.

- *Integration in the ESCB and other legislation*

A general provision was inserted making it clear that the Bank "*shall perform any function or duty or exercise any power required by or under the provisions of the Treaty or the ESCB Statute*";

A further provision was introduced allowing a flow of information between the Bank and the EMI/ECB; the provisions on banknote issuance were amended to reflect Article 105a of the Treaty; provisions giving the Minister power in the area of foreign exchange policy have been deleted; the provision authorising the Minister to suspend private undertakings' activities on macroeconomic grounds has been reworded to reflect that concerns about the value of the currency may no longer motivate such measure.

- *Timing*

The Central Bank Act 1998 shall come into operation on such day or days as the Minister may appoint.

2.4.7.2. Assessment of compatibility

Legislation in Ireland is compatible with the requirements of the Treaty and the ESCB Statute.

It is expected that the Minister will exercise the power to put the Act into force in accordance with the timetable envisaged by Article 108 of the Treaty.

2.4.8. Italy

2.4.8.1. Overview and legislative action taken since 1994

The statute of the central bank of Italy is contained in Royal Decree No 1067 of 1936 as amended. The Bank's structure reflects its original status as a joint stock company.

The Bank is directed by the Governor, assisted by the General Manager. The Bank is administered by the Board of Directors, composed of the Governor and 13 non-executive members, i.e. members who hold positions outside the Bank. The Board has some limited competence in certain ESCB-related matters other than monetary policy.

In October 1997 the Parliament granted the government the power to adopt legislation by legislative decree in relation to the introduction of the euro and Article 108 of the Treaty. Making use of this power, the Italian government introduced a draft legislative decree in December 1997 with a view to adapting Italian legislation to the requirements of the Treaty and the Statute. The legislative decree was adopted by government on 4 March 1998. Necessary amendments of the "statuto della Banca d'Italia" following from this legislative decree were adopted by the General Meeting of Shareholders on 19 March 1998; approval of this decision by Presidential Decree is expected to be given in the first half of April.

- *Objectives*

The new legislative decree states in Article 2 that the Bank shall *"pursue the objectives assigned to the ESCB in conformity with Article 105(1) of the Treaty."*

- *Independence*

The term of office of members of the Board other than the Governor is extended to five years. As before the introduction of the new law, the term of office of the Governor is not specified. Persons holding positions outside the Bank with potentially conflicting interest can no longer be appointed as members of the Board.

The power of the Ministry of the Treasury to fix certain deposit interest rates and to suspend and annul decisions of the Board in ESCB-related matters is abolished.

- *Integration in the ESCB and other legislation*

Provisions regarding the definition of monetary policy, the management of official foreign reserves, banknote issuance and the distribution of monetary income are amended to respect the prerogatives of the ESCB in these fields. In particular, decision-making or supervisory powers of the Ministry of the Treasury and other authorities in these areas are repealed.

- *Timing*

The provisions concerning independence entered into force upon publication of the legislative decree on 14 March 1998, provisions on integration will enter into force on the date established by the minister or on the date when Italy adopts the euro.

2.4.8.2. Assessment of compatibility

Legislation in Italy is compatible with the Treaty and the ESCB Statute.

It is expected that the minister will put into force at the date of the establishment of the ESCB the provisions which transfer the management of foreign reserves to the central bank.

Given that the Governor can only be dismissed on the grounds specified in Article 14.2 of the ESCB Statute, the absence of a fixed term of office can be considered as compatible.

2.4.9. Luxembourg

2.4.9.1. Overview and legislative action taken since 1994

Based on an earlier proposal, the government submitted a revised draft law to Parliament in December 1997 amending the Statute of the monetary institute of Luxembourg (the "Institute") which is at present laid down in the Law of 1983.

The Institute is an entity under public law whose capital is held by the Grand Duchy. Its decision-making bodies are the Management and the Council. The Management, which is in charge of the fulfilment of the Institute's tasks, consists of the Director General and two Directors who are appointed for a term of office of six years. The Council consists of six non-executive members, i.e. members who hold positions outside the Institute; they are appointed for a period of office of four years. In the draft law it is envisaged to alter the Council's composition. Once the law is in force, the Council will comprise the members of the management plus six non-executive members.

Up to the present, the Institute has never fully exercised monetary tasks due to the Monetary Union with Belgium existing since 1922. The National Bank of Belgium assumes a number of central bank functions for Luxembourg.

The draft law includes the following main elements:

- *Objectives*

The Institute's principal objective will be to maintain price stability. Without prejudice to this objective, it will support the general economic policy.

- *Independence*

Institutional independence in ESCB-related matters will be explicitly provided for; grounds for dismissal of members of the Management will be amended; the government's right to dismiss the Management in its entirety on grounds of fundamental disagreement will be repealed; it will be clarified that the government's decision on the annual discharge has to be taken without prejudice to the Institute's independence in ESCB-related tasks.

- *Integration in the ESCB and other legislation*

A general provision will be inserted saying that the Institute *"shall be the central bank of Luxembourg in the framework of the ESCB"*. Its name will be changed to "Banque Centrale du Luxembourg". The provisions on monetary income will be amended to reflect the ESCB Statute.

- *Timing*

Entry into force will be on the first day of the month following the date of publication.

2.4.9.2. *Assessment of compatibility*

Legislation in Luxembourg is compatible with the requirements of the Treaty and the ESCB Statute. This assessment is based on the assumption that the proposed law amending the law of 1983 will be adopted by Parliament in its present form. However, the following imperfections are to be noted:

- the draft law fails to ensure that no conflicts of interest arise for the six non-executive members of the Board in the performance of their functions inside and outside the Bank;

- the Institute's secondary objective of supporting the general economic policy fails to reflect unambiguously the secondary objective of the ESCB as formulated in Article 105 of the Treaty;
- the provisions vesting in the Institute and its Council the power to *"define and implement monetary policy at the national level"* do not reflect the ECB's competences;
- the same remark applies to the provision according to which the Institute may provide credit facilities to ensure the efficiency and stability of payment systems.

2.4.10. Netherlands

2.4.10.1. *Overview and legislative action taken since 1994*

In September 1997 the government submitted to Parliament a proposal for a new Act replacing the Bank Act 1948 governing the central bank of the Netherlands. This Act was finally adopted by Parliament on 24 March 1998.

The Bank is a limited company subject to company law and specific public law rules. All shares are held by the State. The Bank's internal structure (Governing and Supervisory Board) reflects this legal form. The Governing Board consists of the Governor and three to five Executive Directors. It is competent for all policy decisions and for the management of the Bank. The Supervisory Board consists of nine to 12 members. It supervises the Bank's management. One of its members is the Royal Commissioner.

Under the Bank Act 1948 the Ministry of Finance was empowered to issue directions to the Governing Board[4]; the Royal Commissioner supervised the Bank on behalf of the government; the Bank's objective was defined as to regulate the value of the currency in a way "most conducive to the nation's prosperity and wealth".

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[4] In the case of objections presented by the Bank, the Bank is only obliged to comply if the government has confirmed the directions and after the different positions have been published. In practice these rights have never been used.

The new Act introduces the following changes with a view to Article 108 of the Treaty:

- *Objectives*

The former definition of the Bank's objectives has been replaced by a language identical to Article 105(1).

- *Independence*

The Royal Commissioner's supervisory powers will be abolished.

The grounds for dismissal of a member of the Governing Board have been brought into line with the grounds mentioned in Article 14.2 of the ESCB Statute.

- *Integration in the ESCB*

Section 1 expressly states that the Bank will constitute an integral part of the ESCB as far as ESCB-related tasks are concerned. Section 3 provides that *" in carrying out the* (ESCB) *tasks and duties ....the Bank shall seek and take instructions exclusively from the ECB".*

The ESCB-related tasks of the Bank have been defined in accordance with Article 3 of the ESCB Statute; similarly, the provisions on operations and banknote issuance have been adjusted to acknowledge the articles of the Statute; they are placed under the general reserve of "due observation of the provisions of the Treaty".

- *Timing*

The provisions relating to *independence* will come into force at the date of establishment of the ECB, those relating to *integration* at the beginning of Stage Three.

2.4.10.2. Assessment of compatibility

Legislation in the Netherlands is compatible with the requirements of the Treaty and the ECB Statute.

One imperfection to be noted is the provision in the Act according to which the Bank has the task to "co-define" monetary policy; this should be read as referring to the governor's role as member of the Governing Council of the ECB.

2.4.11. Austria

2.4.11.1. Overview and legislative action taken since 1994

In view of Article 108 of the Treaty, the government transmitted a draft law to Parliament on 10 March 1998. At present, the legal provisions governing the Central Bank of Austria are set out in the Central Bank Act of 1984 as amended.

The Bank is a joint stock company; half of its capital is subscribed by the Republic. The Bank's structure (General Meeting of shareholders, General Council and Board of Executive Directors) reflects this legal form. The General Council consists of its chairman (the "President"), two Vice-Presidents and 11 non-executive members. It directs the Bank and takes all basic decisions on monetary policy. The Board of Executive Directors which comprises the Governor as its chairman, the Vice-Governor and two to four other members, is in charge of the management of the Bank; it reports to the General Council and acts in accordance with the latter's guidance.

A state commissioner exercises control over the Bank's activities to ensure compliance with the Central Bank Act.

The draft Law includes the following main elements:

- *Objectives*

Section 4 of the Central Bank Act of 1984 stipulating that the Bank shall pay due regard to the economic policy of the government when determining monetary and credit policy will be replaced by a provision stating that *"Within the framework of Community law, notably Articles 2 and 105 of the Treaty, the Bank will be obliged to pursue the objective of price stability with all the means which are at its disposal. Without prejudice to the aim of price stability, the general macroeconomic requirements concerning economic growth and the development of employment shall be taken account of and the general economic policies in the Community shall be supported".*

- *Independence*

When assuming ESCB-related tasks the Bank and the members of its decision-making bodies will be explicitly prohibited from seeking or taking instructions from any Community or national institution or body or from any other body.

Decision-making power in all ESCB-related matters will be transferred from the General Council to the Board of Executive Directors, thus solving the problem of the General Council members acting only on an honorary basis. There will be only one Vice-President in the General Council, while the number of members will not change.

The minimum term of office of the Governor, the Vice-Governor and the other two members of the Board of Executive Directors will be extended to five years; the grounds for their dismissal will be adjusted to conform with Article 14.2 of the ESCB Statute; any activity raising doubts as to their personal independence will be prohibited.

A provision will be introduced stating that the Governor and Vice-Governor when acting as members of the ECB Governing and General Councils are not bound by any decisions of the Bank's General Council or Board of Executive Directors.

The state commissioner's powers will be reduced; the only remaining right will be to attend the shareholders' General Meeting and the General Council meetings in an advisory capacity.

- *Integration in the ESCB and other legislation*

Provisions will be introduced stipulating that the Bank is *"an integral part of the ESCB"* and that, when fulfilling ESCB-related tasks, *"it shall act in accordance with guidelines and instructions of the ECB"*.

Furthermore, provisions on participation in international monetary institutions and banknote issuance will be amended.

- *Timing*

The provisions of the Act ensuring the personal independence of the members of the Board of Executive Directors will enter into force at the date of establishment of the ECB. A transitional rule will be introduced for the remainder of Stage Two protecting the Board against interference from the General Council in matters relating to the Bank's preparation for Stage Three.

The remaining provisions will enter into force when Austria adopts the single currency.

2.4.11.2. Assessment of compatibility

Legislation in Austria is compatible with the requirements of the Treaty and the ESCB Statute. This assessment is based on the assumption that the proposed Act amending the Central Bank Act of 1984 is adopted by Parliament in its present form.

2.4.12. Portugal

2.4.12.1. Overview and legislative action taken since 1994

In January 1998 a Law was adopted amending the Organic Law of the central bank of Portugal with a view to Article 108 of the Treaty.

The Bank is managed by the Governor and the Board of Directors. Supervisory functions are exercised by the Board of Auditors, advice can be requested from the Advisory Board. The Board of Directors is made up of the Governor, one or two Vice-Governors and three to five Directors.

The new Law includes the following amendments:

- *Objectives*

The old Article 3 pursuant to which the Bank had to take into account the overall economic policy of the government when pursuing the goal of price stability has been replaced by a provision saying that the Bank *"shall pursue the objectives of and take part in the performance of the tasks entrusted to the ESCB"*.

- *Independence*

The Governor's obligation to submit to the government any vetoes on decisions of the Board has been suppressed; a provision has been inserted according to which decisions of the Board on ESCB-related matters require the consent of the Governor; the provision giving the Minister influence on monetary policy and other ESCB-related tasks has been deleted; likewise, the Minister's signature of notices of the Bank has been abolished.

Grounds for dismissal of the members of the Board have been adapted to Article 14.2 of the ESCB Statute. The members of the Board are not allowed to assume any remunerated activity outside the Bank (except lecturing at universities).

- *Integration in the ESCB*

A new Article 3 has been introduced stipulating that the Bank *"shall be an integral part of the ESCB"* and shall act *"in accordance with the guidelines and instructions of the ECB"*.

In order to respect the ECB's prerogatives, amendments have been made regarding banknote issuance, monetary policy operations, minimum reserves and participation in international monetary institutions.

- *Timing*

All provisions regarding *independence* have entered into force already, while the other provisions will come into force when Portugal adopts the euro.

2.4.12.2. Assessment of compatibility

Legislation in Portugal is compatible with the requirements of the Treaty and the ESCB Statute.

2.4.13. Finland

2.4.13.1. Overview and legislative action taken since 1994

The legal provisions governing the Central Bank of Finland are set out in the Constitution, the Parliament Act and the Central Bank Act.

The governing bodies are the Board and the Parliamentary Supervisory Council. The Board comprises the Governor, who is the chairman, and up to five members, appointed by the President of the Republic on a proposal by the Parliamentary Supervisory Council. The Governor is appointed for seven years and the other members of the Board for five years. The Parliamentary Supervisory Council consists of nine members of Parliament appointed for the parliamentary term.

The process of reviewing central bank legislation started already in 1993 and an amended Central Bank Act was adopted by Parliament in June 1997 and entered into force on 1 January 1998. The new Act established the independence of the Bank but did not address the issue of integration in the ESCB. In order to comply fully with the requirements of the Treaty and the ESCB Statute, the government put forward in February 1998 a new draft bill on the Bank of Finland Act which is intended to replace the recent Central Bank Act. The bill also contains changes to the Currency Act and the Coin Act. The bill was adopted by Parliament on 20 March 1998. The main provisions of the new legislation are:

- *Objectives*

As stated in Article 2 of the draft law, *"the primary objective of the Bank of Finland shall be to maintain price stability. Without prejudice to the objective laid down in paragraph 1, the Bank of Finland shall also support the achievement of other policy objectives in accordance with the Treaty"*.

- *Independence*

The Parliamentary Supervisory Council, which previously had extensive competences, is transformed into a mainly supervisory authority with restricted powers in respect of the Bank's administration. The grounds for dismissal of members of the Board have been be brought in line with Article 14.2 of the ESCB Statute.

- *Integration in the ESCB and other legislation*

The main task of the Bank will be to contribute to the execution of monetary policy as defined by the Governing Council of the ECB. The Bank shall also contribute to the issuance of banknotes, contribute to the management of foreign exchange reserves, participate in maintaining the reliability and efficiency of the payment system and provide for the publication of statistics.

The provision of the Currency Act on decision-making concerning the external value of the Finnish markka will be repealed.

- *Timing*

The provision of the Bank of Finland Act ensuring independence of the Bank will enter into force soon after ratification by the President on 27 March 1998. The remaining provisions of the Bank of Finland Act, the Currency Act and the Coin Act will enter into force when Finland joins Stage Three of EMU.

2.4.13.2. Assessment of compatibility

Legislation in Finland is compatible with the Treaty and the ESCB Statute.

2.4.14. Sweden

2.4.14.1. Overview and legislative action taken since 1994

The legal provisions governing the Central Bank of Sweden are contained in the Constitution, the Riksdag Act and the Riksbank Act of 1988 as amended.

In the perspective of economic and monetary union, the government put forward to Parliament a proposal to amend the Constitution, the Riksdag Act and the Riksbank Act in November 1997. Parliament adopted the amendments to the Constitution in March 1998 in a first vote.

According to the Riksbank Act, the Bank is administered by the Governing Board consisting of eight members. Seven of the members are elected directly by Parliament for four years normally. The Governor is elected for a five-year term by the other seven members. The Governor may be dismissed by the other members of the Governing Board and they in turn may be dismissed by Parliament, with no grounds being stated. The Governing Board is responsible for all important decisions but the Governor is the only member taking part in the day-to-day management of the Bank.

The Bank is responsible for all matters of exchange rate and monetary policy. There is no statutory objective for monetary policy. Prior to taking decisions of importance regarding monetary and exchange rate policy, the Bank must consult the Minister of Finance. The Bank is formally responsible to Parliament. This means that Parliament annually determines whether to discharge the Governing Board from responsibility for its administration during the preceding year.

The government proposal includes the following changes:

- *Objectives*

The implicit objectives for the Bank to maintain price stability will be laid down by law in the Riksbank Act.

- *Independence*

Public authorities will be prohibited from giving the Bank instructions on monetary policy through a provision in the Constitution. The Bank will no longer have to consult with the Minister of Finance prior to taking policy decisions. The Riksbank Act will prohibit higher officials of the Bank from seeking or taking instructions.

An Executive Board will be established with the task of defining monetary policy. The Governing Board will appoint all members of the Executive Board for six-year periods with the Governor of the Bank being one of its members. An amendment to the Constitution will secure the tenure of the members of the Executive Board by stating grounds for dismissal conforming to Article 14.2 of the ESCB Statute. The Governing Board will be given a supervisory function with no monetary policy competence.

- *Integration in the ESCB and other legislation*

The responsibility for exchange rate policy will be transferred from the Bank to the government.

The government proposal does not address issues related to the integration of the Bank in the ESCB.

Current rules regarding confidentiality establish the principle that all documents are public unless they are made secret by law. Chapter 3, Article 1 of the Secrecy Act of 1980 provides for the possibility of applying secrecy on a case-by-case basis to information concerning Sweden's *"central finance policy, monetary policy, or currency policy, if it can be assumed that the aim of decided or anticipated actions would be counteracted should the information be disclosed."*

- *Timing*

The second vote confirming the amendments to the constitution can only be taken by the next Parliament after the general elections in September 1998. The amendments to the Riksdag Act and the Riksbank Act are planned to be adopted by Parliament together with the second vote on the Constitution in October 1998. All amendments would enter into force on 1 January 1999.

2.4.14.2. Assessment of compatibility

Legislation in Sweden is not compatible with the requirements of the Treaty and the ESCB Statute. The following incompatibilities are to be noted:

- the time constraints for the adoption of present draft legislation do not permit to assume that legislation will be adapted in time. As a consequence, the Bank will not be independent at the date of establishment of the ECB;
- the present draft legislation does not ensure full integration of the Bank in the ESCB; in particular, the provisions regarding the Bank's powers in the monetary policy area do not recognise the ESCB's powers in this field.

Furthermore, the present draft legislation includes some imperfections:

- Chapter 9, Article 13, of the Constitution giving the Bank the exclusive right to issue banknotes does not recognise the ESCB's competence in this field. The adaptation of this article requires the endorsement of two consecutive Parliaments;
- the prohibition to seek or take instructions only covers monetary policy issues and does not extend to all ESCB-related tasks.

2.4.15. United Kingdom

In May 1997, the Chancellor of the Exchequer announced reforms concerning the Bank of England. These reforms were transformed into a Bill introduced to Parliament in October 1997, which is expected to come into law in the first half of 1998.

According to the Bill, the Court of Directors, responsible for managing the Bank's affairs (other than the formulation of monetary policy), will consist of the Governor, two Deputy Governors and 16 Directors. The Governor and the two Deputy Governors are required to work exclusively for the Bank. The Governor and the Deputy Governors are appointed for renewable five-year terms and Directors for renewable three-year terms. A Governor, Deputy Governor or Director may be dismissed from office under certain specified conditions.

Other features of the Bill include the following:

- the Bank has a specific monetary policy objective of maintaining price stability and, subject to that, supporting the government's economic policy, including its objectives for growth and employment;.
- the Treasury may specify annually what price stability is to be taken to consist of and what the government's economic policies are to be taken to be for these purposes;
- the establishment of a Monetary Policy Committee, consisting of the Governor, two Deputy Governors, two additional senior Bank officials and four other expert members from outside the Bank is responsible for formulating monetary policy;
- the government retains the right to give the Bank directions with respect to monetary policy in extreme economic circumstances, for a limited period, subject to ratification by Parliament.

By virtue of Paragraph 5 of Protocol No 11 annexed to the Treaty, Article 108 of the Treaty does not apply to the United Kingdom as long as it does not wish to participate in Stage Three of EMU. The United Kingdom has notified the Council that it does not intend to move to the third stage of EMU on 1 January 1999. As a consequence, as long as the United Kingdom does not change its position, it is under no obligation to adapt its legislation with a view to Stage Three of EMU.

In light of the situation described above, no assessment of compatibility is undertaken for the United Kingdom. An assessment will have to be made if and when the United Kingdom decides to participate in Stage Three of EMU.

3. PRICE STABILITY

3.1. Treaty provisions

The price stability criterion is defined in the first indent of Article 109j(1) of the Treaty: *"the achievement of a high degree of price stability [...] will be apparent from a rate of inflation which is close to that of, at most, the three best performing Members States in terms of price stability."*

Protocol No 6 on the convergence criteria develops Article 109j(1), by stipulating in Article 1 that a Member State is convergent in terms of inflation if it "*has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1½ percentage points that of, at most, the three best performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions."*

Since national consumer price indices (CPIs) diverge substantially in terms of concepts, methods and practices, they do not constitute the appropriate means to meet the Treaty requirement that inflation must be measured on a comparable basis. To this end, the Council adopted on 23 October 1995 a framework Regulation (No 2494/95) setting the legal basis for the establishment of a harmonised methodology for compiling consumer price indices in the Member States. This regulation laid down a graduated approach to harmonisation comprised of two steps.

The first step of the harmonisation process consisted in the production by March 1996 of a set of "interim indices of consumer prices" (IICPs). These interim indices were based entirely on existing national CPIs, adjusted solely so as to make the coverage of goods and services as similar as possible. The IICPs were used in the 1996 convergence reports presented by the Commission and the EMI.

The second step of the harmonisation process resulted in the construction of "harmonised indices of consumer prices" (HICPs). They are compiled by the Member States and harmonised in several methodological areas as well as with regard to coverage (for more details see the annex to this chapter). The first set of HICPs was published in March 1997, with historical series dating back to January 1995. Even though certain elements in their construction remain to be fully harmonised, the HICPs in their current shape represent a very substantial advance and clearly constitute much more comparable and reliable data for the assessment of price stability and inflation convergence in the Member States than the national CPIs.

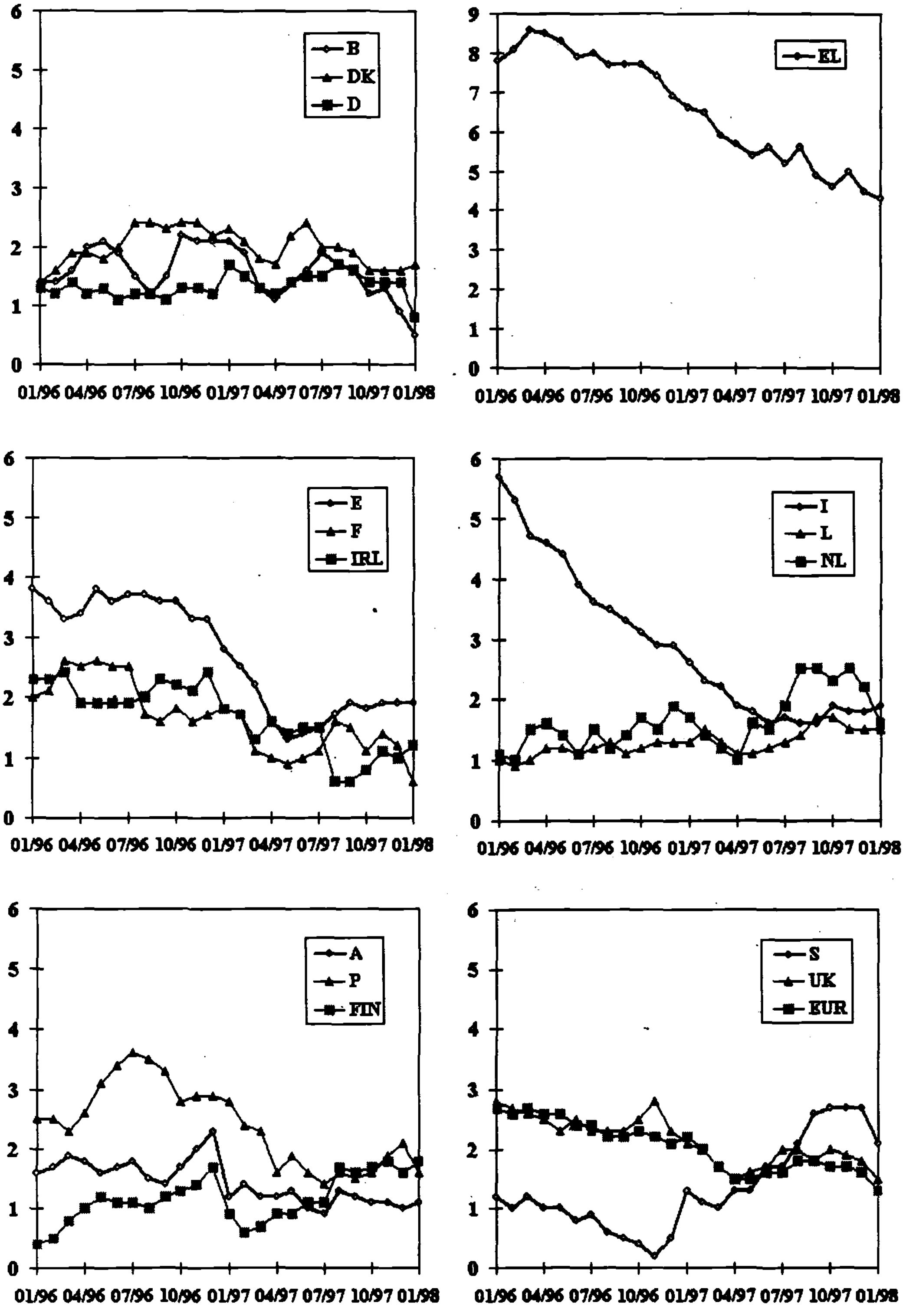
3.2. Price stability as assessed by the HICPs

3.2.1. Recent trends

The time series for the HICPs are available only from January 1995. As a result, the analysis of recent inflation trends based on these indices cannot start before January 1996. Over the last two years, further headway towards price stability and inflation convergence has been made throughout the Community. Inflation in the Community as a whole as measured by the HICP (percentage change on a year earlier) declined steadily from 2.7% in January 1996 to 1.5% in April 1997. It edged up marginally during the summer of 1997 due to temporary factors such as a pick-up in import prices resulting from the effective depreciation of Community currencies as well as increases in indirect taxation and/or administered prices in some countries. Since October 1997, inflation has resumed its downward trend, reaching a low of 1.3% in January 1998.

In the 10 Member States where the annual inflation rate was close to or below 2% in January 1996 (Belgium, Denmark, Germany, France, Ireland, Luxembourg, the Netherlands, Austria, Finland and Sweden) inflation remained generally subdued until January 1998 (see Graph 3.1). However, during the period under review, in some of these countries (Belgium, Denmark, Ireland and Austria) inflation temporarily exceeded 2% but fell back significantly thereafter. Only in the Netherlands and Sweden has there been a more pronounced and sustained rise in inflationary pressure, during the second half of 1997. In the former country, this acceleration basically reflected the combined impact of the continued strong pace of output growth, leading to a closing of the output gap and a gradual tightening of labour market conditions, and the depreciation of the guilder in effective terms. However, under the impact of a marked slowdown in import prices, reflecting both the fading impact of the depreciation of the guilder in effective terms and a fall in the international prices of raw materials, inflation fell sharply during the last couple of months, reaching 1.6% in January 1998. In Sweden, several factors are behind the marked pick-up in price increases over the last 12 months, including: the unwinding of some special factors which sent inflation down to a very low level in 1996 (such as a reduction in VAT on food and a strong appreciation of the krona), increased indirect taxes, higher administered prices and an acceleration in wage increases. However, following the temporary rises due to these specific factors, and under the influence of a tightening of both monetary and budgetary policies, inflation stopped increasing from September 1997 onwards, and even slowed down to just above 2% in January 1998.

Graph 3.1 Inflation rates (HICP) in the Member States and the Community
(percentage change on a year earlier, T/T-12)



Source : Commission services

In the remaining Member States, significant progress has been achieved with inflation performance and, with the exception of Greece, they have succeeded in reducing their rates of inflation to below 2%. In Portugal, where inflation stood at 2.5% in early 1996, a containment of wage increases, continued strong productivity gains and subdued import prices have supported disinflation. Against a background of robust economic growth but helped by sterling appreciation, the United Kingdom has succeeded in achieving a satisfactory degree of price stability and inflation convergence. Having hovered around 3¾% throughout most of 1996, inflation in Spain dropped rapidly in 1997. In Italy, following a blip in 1995, which to a large extent reflected the impact of currency depreciation, inflation has fallen steadily and significantly over the last two years. In Spain and Italy, these favourable developments were brought about under the combined influence of a steadfast stability-oriented monetary policy and structural improvements in the functioning of labour, product and service markets. Finally, in Greece, inflation has shown a further convergence with the other Member States. It declined from about 8% in early 1996 to 4.3% in January 1998 against a background of broad exchange rate stability and further budgetary consolidation. Continued high wage pressure, however, hindered more visible headway towards price stability.

3.2.2. Inflation developments in relation to the reference value

The assessment of the price convergence criterion as laid down in Protocol No 6 of the Treaty requires an operational definition encompassing two elements: first, the definition of *"the average rate of inflation, observed over a period of one year before the examination"*, and, secondly, the calculation of the *reference value* against which Member States' price performance will be assessed.

In this report, in continuation of the practice followed in previous reports[1], the following operational definitions have been used. A Member State's average rate of inflation, observed over a period of one year, is measured by the percentage change in the arithmetic average of the last 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period[2]. The reference value is calculated as the unweighted arithmetic average of the inflation rates of the three best performing Member States plus 1.5 percentage points.

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1 See "Report on convergence in the European Union in 1995", published in *European Economy, Supplement A*, No 1, January 1996, and "Report on convergence in the European Union in 1996", COM(96)560, published in *European Economy, Supplement A*, No 1, January 1997.

2 This measure has been retained as it captures inflation trends over a period of one year as requested by the provisions of the Treaty. The commonly used inflation rate is calculated as the percentage change in the consumer price index of the latest month over the index for the equivalent month of the previous year. However, this inflation rate may vary importantly from month to month because of possible base effects due to exceptional factors such as changes in indirect taxes.

Over the year from February 1997 to January 1998, the three best performances in terms of price stability were seen in France, Ireland and Austria (see Table 3.1). The mean of the three best-performing Member States' inflation rates was 1.2%. This results in a reference value of 2.7%. In January 1998, 14 Member States had an average inflation rate well below the reference value, the exception being Greece. It is worth noting that if the reference value was to be measured by the country with the lowest inflation rate (namely Austria) plus 1.5 percentage points, the strictest possible way in which the reference value could be defined, inflation in all these 14 Member States would still stand below the reference value[3].

Table 3.1

Inflation convergence
(Inflation measured by the percentage change in the HICP) [a)]

January 1998	
Three best performers :	
A	1.1
F	1.2
IRL	1.2
Reference value [b)]	**2.7**
Member States below reference value	
B	1.4
DK	1.9
D	1.4
E	1.8
F	1.2
IRL	1.2
I	1.8
L	1.4
NL	1.8
A	1.1
P	1.8
FIN	1.3
S	1.9
UK	1.8
Member State above reference value	
EL	5.2

a) Measured by the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period.

b) Unweighted arithmetic average of the three best performers in terms of inflation plus 1.5 percentage points.

Source: Commission services.

Over the period for which a reference value can be calculated using the HICPs, the reference value edged up marginally from 2.5% in December 1996 to 2.7% in January 1998 (see Table 3.2). This gradual increase does not reflect signs of any rekindling of inflationary pressures in the Community, but rather a gentle upward movement from the exceptionally low rates of inflation observed in some Member States at the beginning of the period. Over the period under review, the composition of the reference group of the three best performers remained unchanged from December 1996 to September 1997 but changed frequently thereafter. No Member State has belonged unfailingly to the reference group.

Convergence in price inflation, which was already quite remarkable at the end of 1996, has strengthened further over the last 12 months. Whereas 11 Member States recorded an average inflation rate below the reference value in December 1996, this group was extended to 13 in June 1997 and 14 in July 1997, as first Italy and Portugal, and then Spain, succeeded in bringing down their average inflation rate to, or below, the reference value (see Table 3.2. and Graph 3.2).

3 Consequently, alternative methods for calculating the reference value, as detailed in the 1996 Convergence Report, would give an identical number of countries below the reference value.

Table 3.2

Evolution of the inflation reference value and of the group of countries respecting it [a)]

		Three best performers	Reference value [b)]	Number of Member States respecting reference value	
Dec.	96	L, FIN,S	2.5	11	B,DK,D,F,IRL,L,NL,A,FIN,S,UK
Jan.	97	L, FIN,S	2.5	11	" "
Feb.	97	L, FIN,S	2.5	11	" "
Mar.	97	L, FIN,S	2.6	11	" "
Apr.	97	L, FIN,S	2.6	11	" "
May	97	L, FIN,S	2.5	11	" "
Jun.	97	L, FIN,S	2.6	13	B,DK,D,F,IRL,I,L,NL,A,P,FIN,S,UK
Jul.	97	L, FIN,S	2.6	14	B,DK,D,E,F,IRL,I,L,NL,A,P,FIN,S,UK
Aug.	97	L, FIN,S	2.7	14	" "
Sep.	97	L, FIN,S	2.8	14	" "
Oct.	97	F, A, FIN	2.8	14	" "
Nov.	97	F, A, FIN	2.8	14	" "
Dec.	97	IRL, A, FIN	2.7	14	" "
Jan.	98	F, IRL, A	2.7	14	" "

a) Measured by the percentage change in the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period.

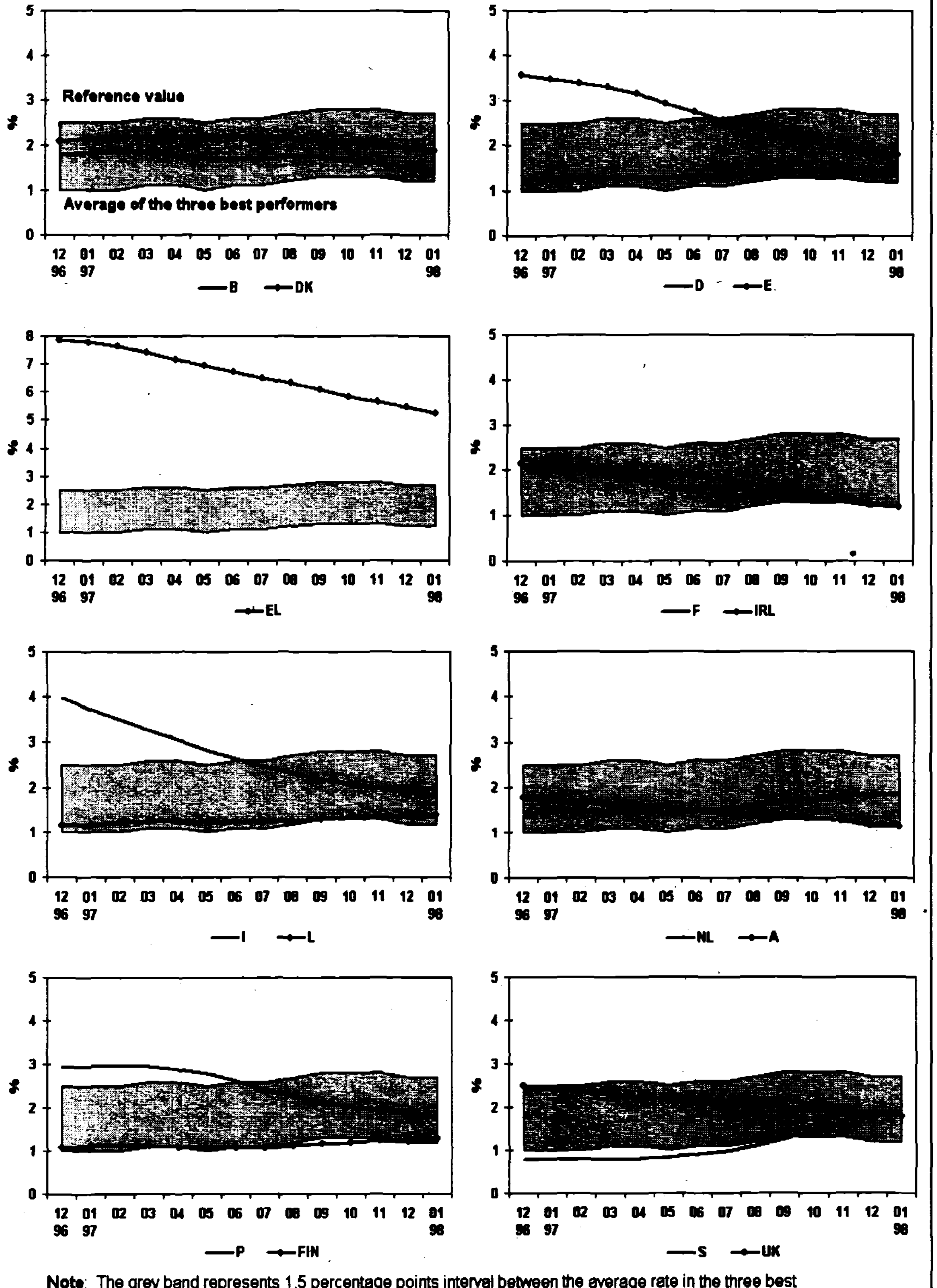
b) Unweighted arithmetic average of the three best performers in terms of inflation plus 1.5 percentage points.

Source: Commission services.

Greece has made substantial progress in reducing inflation and converging towards the low inflation rates reached in the other Member States. Over the past 12 months, the difference from the reference value shrank by 2.8 percentage points. Nevertheless, the average inflation rate of 5.2% in January 1998 still exceeded the reference value by a considerable margin.

Graph 3.2

Comparison of Member States' average inflation rates (HICP) with reference value (%)



Note: The grey band represents 1.5 percentage points interval between the average rate in the three best performers in terms of price stability (bottom of the band) and the reference value (top of the band).

Source: Commission services

3.3. Inflation performance during the second stage of EMU

The limited time-span covered by the HICP series does not allow recent inflation developments to be seen in a medium-term perspective. Accordingly, national private consumption deflators[4] are utilised to examine medium-term trends, as part of the assessment of the sustainability of the inflation performance.

Following a setback during the late 1980s and early 1990s, the inflation performance of the Community improved continuously and substantially in subsequent years. After a peak of 5.6% in 1991, the inflation rate declined to 4.1% in 1993 and decelerated further during the second stage of EMU, reaching an historical low of 2.1% in 1997, as shown in Table 3.3.

Table 3.3

Private consumption deflator
(national currency, annual percentage change)

	1993	1994	1995	1996	1997	1998 *
B	3.5	2.8	1.7	2.3	1.6	1.3
DK	0.6	1.6	2.0	2.1	2.3	2.1
D	4.0	2.8	1.9	1.9	1.9	1.7
EL	14.2	11.0	8.6	8.5	5.5	4.5
E	5.6	4.8	4.7	3.4	2.5	2.2
F	2.2	2.1	1.6	1.9	1.1	1.0
IRL	1.9	2.7	2.0	1.1	1.4	3.3
I	5.4	4.6	5.8	4.3	2.4	2.1
L	4.1	2.3	2.1	1.6	1.4	1.6
NL	2.1	2.8	1.5	1.3	2.2	2.3
A	3.3	3.3	1.5	2.5	1.8	1.5
P	6.6	5.1	4.2	2.6	2.1	2.2
FIN	4.2	1.4	0.3	1.6	1.4	2.0
S	5.7	3.0	2.7	1.2	2.2	1.5
UK	3.4	2.2	2.6	2.6	2.3	2.3
EUR	4.1	3.2	3.0	2.6	2.1	1.9
Standard deviation						
15 Member States	3.2	2.3	2.1	1.8	1.0	0.9
14 Member States (excl.EL)	1.7	1.1	1.5	0.9	0.5	0.6

* Spring 1998 economic forecasts.

Source: Commission services.

The favourable inflation performance observed in the Community as a whole during Stage Two has been shared by all Member States, although to varying degrees. Their performances at the start of the second stage also differed considerably. In this context, three groups of countries can usefully be distinguished.

4 The deflators of private consumption exhibit a higher degree of cross-country comparability than national consumer price indices. Their measurement is based on the national accounts methodology which has been harmonised across the Community in the framework of the European System of Accounts (edition 1979).

In a first group, comprising 11 Member States, the inflation rate in 1994 was close to or below the upper limit of the 2 to 3% range proposed by the 1993 Broad Economic Policy Guidelines as a step towards price stability. In the following years, these countries succeeded in either maintaining or further improving upon their already good initial inflation performances. As a result, in virtually all these countries inflation was close to or below 2% in 1997. To this group belong the seven Member States which have long participated in the exchange-rate mechanism (ERM) (Belgium, Denmark, Germany, France, Ireland, Luxembourg and the Netherlands) and Austria, whose currency remained fully stable against the DEM for more than a decade. These countries have also in common that they have enjoyed a long track record of rather low inflation.

This was not the case in the other three Member States completing the first group (Finland, Sweden and the United Kingdom). These countries experienced quite strong inflationary pressures during the late 1980s and early 1990s due to an overheating of the economy allied with excessive wage increases. They achieved, however, a marked convergence in terms of price stability towards the other sub-group during the first stage of EMU. This slowdown was mainly due to the very severe recessions and the moderate development of unit labour costs and occurred despite the cost pressures from the large depreciations of their currencies. Although price developments were somewhat erratic, these three countries managed to control inflation throughout the second stage. Indeed, especially in Finland and Sweden, inflation rates were very low over several years.

A second group of countries (Spain, Italy and Portugal) still suffered from relatively strong inflationary pressures just prior to the second stage, with inflation rates ranging between 5½ and 6½%. Remarkable progress has been made in reducing inflation in these three countries during the second stage. The disinflation process was initially rather slow and was hampered in 1995 by the combined impact of currency depreciations and indirect tax increases, which especially in Italy led to a temporary pick-up in inflation. However, thanks to a determined implementation of a comprehensive strategy aimed at tackling the root causes of structurally high price increases, inflation declined rapidly over the last two years. As a consequence, in all three countries inflation fell to 2.5% or below in 1997.

Finally, although the inflation rate declined substantially at the beginning of the 1990s, Greece still recorded a double-digit inflation rate at the start of the second stage. Since then, significant and steady progress has been made in reducing inflation, though Greece's inflation performance is not yet satisfactory.

The generalised and impressive reduction in inflation throughout the Community has been accompanied by remarkable progress in inflation convergence over the last couple of years. One indication of how inflation differentials have narrowed between Member States is provided by the standard deviation of individual inflation rates around the EC average. The standard deviation for inflation, measured by the private consumption deflator, declined from 3.2% in 1993 to 1.0% in 1997. If Greece is excluded, the standard deviation declined to 0.5% in 1997 compared to 1.7% in 1993, which means that the dispersion between the inflation rates of 14 of the Member States is very narrow.

3.4. Underlying factors and sustainability of inflation performance

The Treaty not only requires Member States to have achieved a high degree of price stability but also calls for a price performance that is sustainable (Protocol No 6). The requirement of sustainability aims at ensuring that the degree of price stability and inflation convergence achieved in previous years will be maintained during the third and final stage of EMU. This implies that the satisfactory inflation performance must essentially be due to the adequate behaviour of input costs and other factors influencing price developments in a structural manner rather than reflecting the influence of either cyclical conditions or temporary factors (such as a fall in indirect taxes and import prices).

The track record of inflation shows that price stability has prevailed in a majority of Member States for a rather prolonged period. The fact that a culture of price stability has increasingly gained ground and that the disinflation process withstood several adverse economic circumstances (such as German unification, a general cyclical overheating and exchange rate turbulence) suggests that the present low inflation and the high degree of price convergence rest on structural factors that are strong, well anchored and likely to influence inflation trends favourably in the medium term.

The satisfactory inflation performance observed in the Community during the second stage is also due, in part, to cyclical factors. Although recovery has been under way since the spring of 1996, output has continued to be below potential and unemployment has remained high. This situation has exerted a strong disincentive for firms to raise prices or to allow significant wage increases. However, a major part of the process of inflation convergence in the Community stems from fundamental changes in the attitude of all economic actors towards inflation.

3.4.1. Price stability as the primary objective of monetary policy

In the Community there is unanimous consensus on price stability being the primary objective of monetary policy. This consensus is enshrined in the Treaty and in the successive Broad Economic Policy Guidelines, which the Council has adopted unanimously since 1993. This common consent reflects both the recognition that inflation is ultimately a monetary phenomenon and the conviction that price stability is a condition for sustainable and employment-creating growth.

The task of the monetary authorities in pursuing a stability-oriented monetary policy has been facilitated by several institutional changes required by the Treaty for this purpose. The most crucial is the granting of independence to central banks (see Chapter 2). Other important institutional changes, which entered into force with the start of the second stage of EMU, include the prohibition of monetary financing of government deficits and the prohibition of privileged access of public authorities to financial institutions.

The above modifications have helped to strengthen the effectiveness, the transparency and the credibility of a stability-oriented monetary policy in the Member States. This in turn has contributed importantly to reducing inflation expectations (see also Chapter 6 on long-term interest rates) which play a key role in achieving and maintaining appropriate wage developments.

3.4.2. Disinflation process supported by adequate wage behaviour

Developments in unit labour costs, i.e. costs of labour per unit of output, take on a particular importance in the inflation process. They reflect trends in labour productivity and nominal compensation per head. The latter not only play a key role in the determination of input costs and thus of consumer prices, but also reflect private agents' inflation expectations. They therefore serve as an important indicator, amongst others, of the credibility of the anti-inflationary policy pursued by the monetary authorities and of the sustainability of the inflation performance.

As shown in Table 3.4 and Graph 3.3, significant wage moderation contributed strongly to the good inflation performance achieved during the second stage. In the Community as a whole, the rate of increase in unit labour costs decelerated rapidly from the beginning of the decade and the descent was actually faster than the drop in the rate of inflation. While the rate of increase of unit labour costs in the early 1990s was quite high in the Community (average annual growth rate of just below 5%), it was very subdued during the second stage (average annual growth rate of just above 1%). On the basis of currently available information, unit labour costs will continue to rise at a very moderate pace in the near future, thereby remaining consistent with favourable inflation trends in the Community.

Table 3.4

Labour costs

(percentage change, total economy)

	Nominal compensation per employee				Labour productivity growth				Nominal unit labour costs			
	1990 -93 [a]	1994 -97 [a]	1997	1998*	1990 -93 [a]	1994 -97 [a]	1997	1998*	1990 -93 [a]	1994 -97 [a]	1997	1998*
B	6.1	2.9	3.2	2.1	1.1	2.1	2.5	1.6	4.9	0.8	0.7	0.5
DK	3.6	3.6	4.0	4.3	2.2	1.9	0.7	1.5	1.4	1.7	3.2	2.7
D	6.4	2.9	1.8	2.0	2.4	2.9	3.7	2.7	3.8	0.0	-1.8	-0.6
EL	14.8	11.8	10.7	6.9	0.1	1.3	3.0	2.7	14.6	10.4	7.4	4.0
E	9.0	2.7	2.7	2.6	1.4	1.3	0.8	1.2	7.5	1.4	1.9	1.5
F	4.1	2.5	2.5	2.7	1.0	2.0	2.5	1.8	3.1	0.5	0.0	0.9
IRL	5.6	2.9	5.5	5.3	3.3	5.4	6.6	5.0	2.2	-2.4	-1.1	0.3
I	7.2	4.4	4.6	2.9	1.2	2.2	1.4	2.0	5.9	2.2	3.1	0.9
L	5.6	2.8	3.3	3.6	2.2	1.3	1.8	1.9	3.3	1.5	1.5	1.7
NL	3.9	2.4	2.7	3.3	1.1	1.7	1.1	1.6	2.8	0.6	1.6	1.7
A	5.6	2.4	1.6	2.2	1.6	2.3	2.7	2.3	3.9	0.0	-1.1	-0.1
P	14.8	6.5	4.3	3.9	2.1	2.3	1.8	2.7	12.4	4.1	2.5	1.2
FIN	4.4	3.0	1.3	3.4	2.0	3.8	3.8	2.4	2.4	-0.8	-2.4	1.0
S	6.6	4.5	3.8	2.7	1.8	2.9	2.9	2.0	4.7	1.6	0.8	0.7
UK	6.7	3.8	4.3	4.6	1.4	2.2	1.9	1.2	5.2	1.6	2.4	3.4
EUR	6.4	3.3	3.1	3.0	1.6	2.3	2.3	1.9	4.8	1.0	0.8	1.0

[a] average annual percentage change.
* Spring 1998 economic forecasts.

Source: Commission services.

Developments at the country level show a clear convergence between Member States toward a low rate of growth in unit labour costs. In the 11 Member States with HICP inflation below the reference value over the entire period for which a reference value can be calculated, unit labour costs decreased in Ireland (reflecting sizeable productivity gains) and Finland, remained broadly unchanged in Germany, and increased very moderately in the other countries during the second stage. Looking ahead, there seems to be little evidence of emerging cost pressures. In most of these countries, the rate of increase in unit labour costs is expected to be limited in 1998.

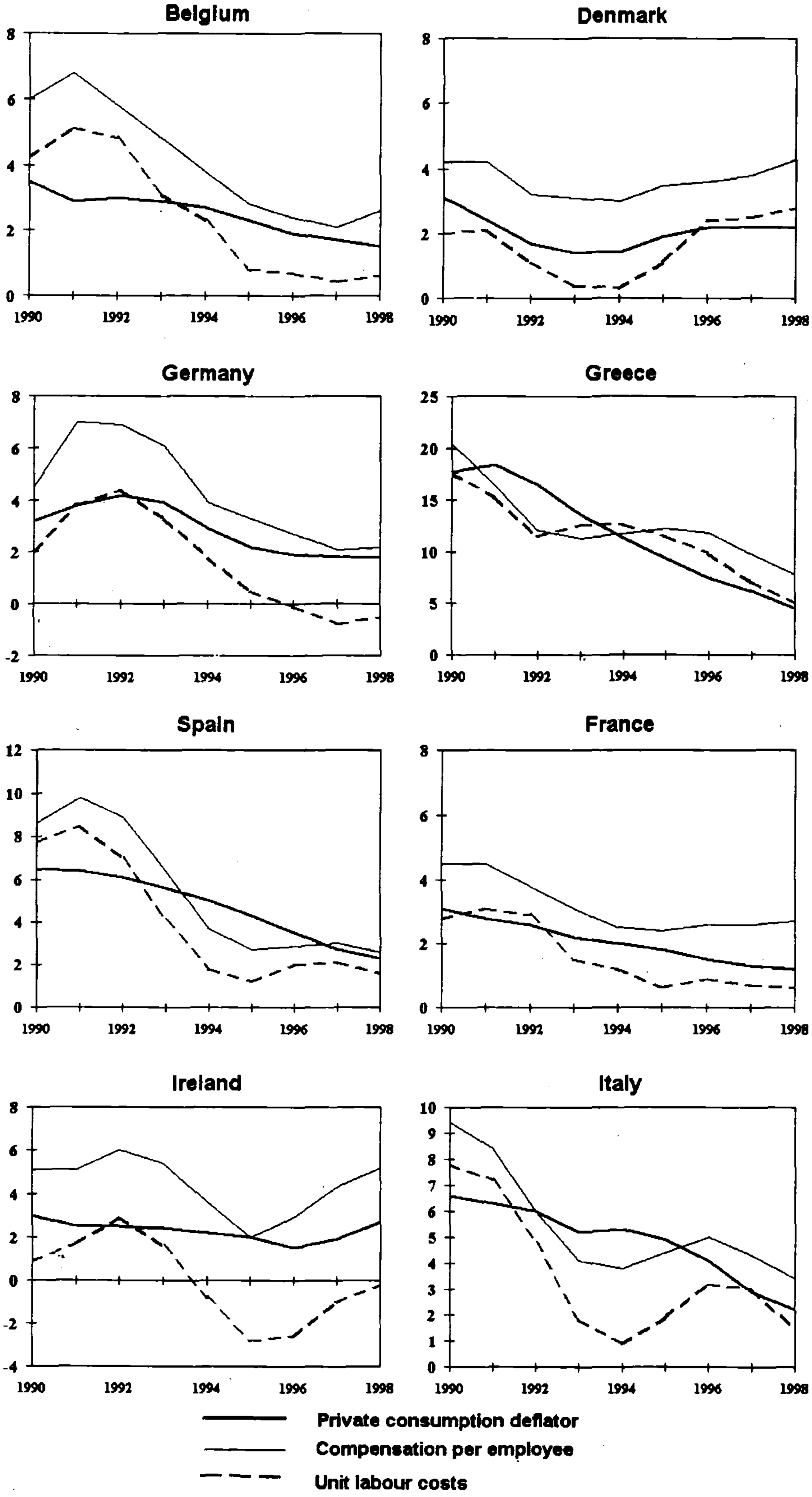
In the Member States where inflation fell below the reference value only more recently (Spain, Italy and Portugal), trends in unit labour costs during the second stage exhibited a marked break with the past pattern of high rates of increase. Following a dramatic deceleration in 1994-95, unit labour costs tended to accelerate subsequently in Spain and, especially, Italy, reflecting in part a partial catch-up on previous years' losses in employees' purchasing power. However, in both countries, moderate increases in unit labour costs are expected to prevail in the near future. A similar, though less erratic, pattern was discernible in Portugal. In contrast, in Greece, despite considerable progress in recent years, increases in unit labour costs have not yet decelerated to a range compatible with achieving and maintaining price stability.

Changes in unit labour costs are determined by labour productivity growth and by changes in nominal compensation per employee. The observed slow-down in unit labour costs may thus result from either an acceleration in labour productivity or a deceleration in nominal compensation per employee. Apart from the usual cyclical pattern, growth in labour productivity has remained fairly stable in the Community. With an average annual growth rate of just above 2%, labour productivity growth during the second stage was in line with the long-term trend observed in the Community since the first oil price shock. At the country level too, labour productivity increases did not show any significant shifts in trend in recent years. A cyclically induced rebound in productivity growth has been quite perceptible in nearly all the countries of the Community. In many countries (Belgium, Italy, the Netherlands, Austria, the United Kingdom), this rebound has only brought productivity back to its secular trend. The rise was above the trend in Germany and Sweden, and even more markedly in Finland and in Ireland. However, this cyclical effect now appears to have come to an end in the latter four countries.

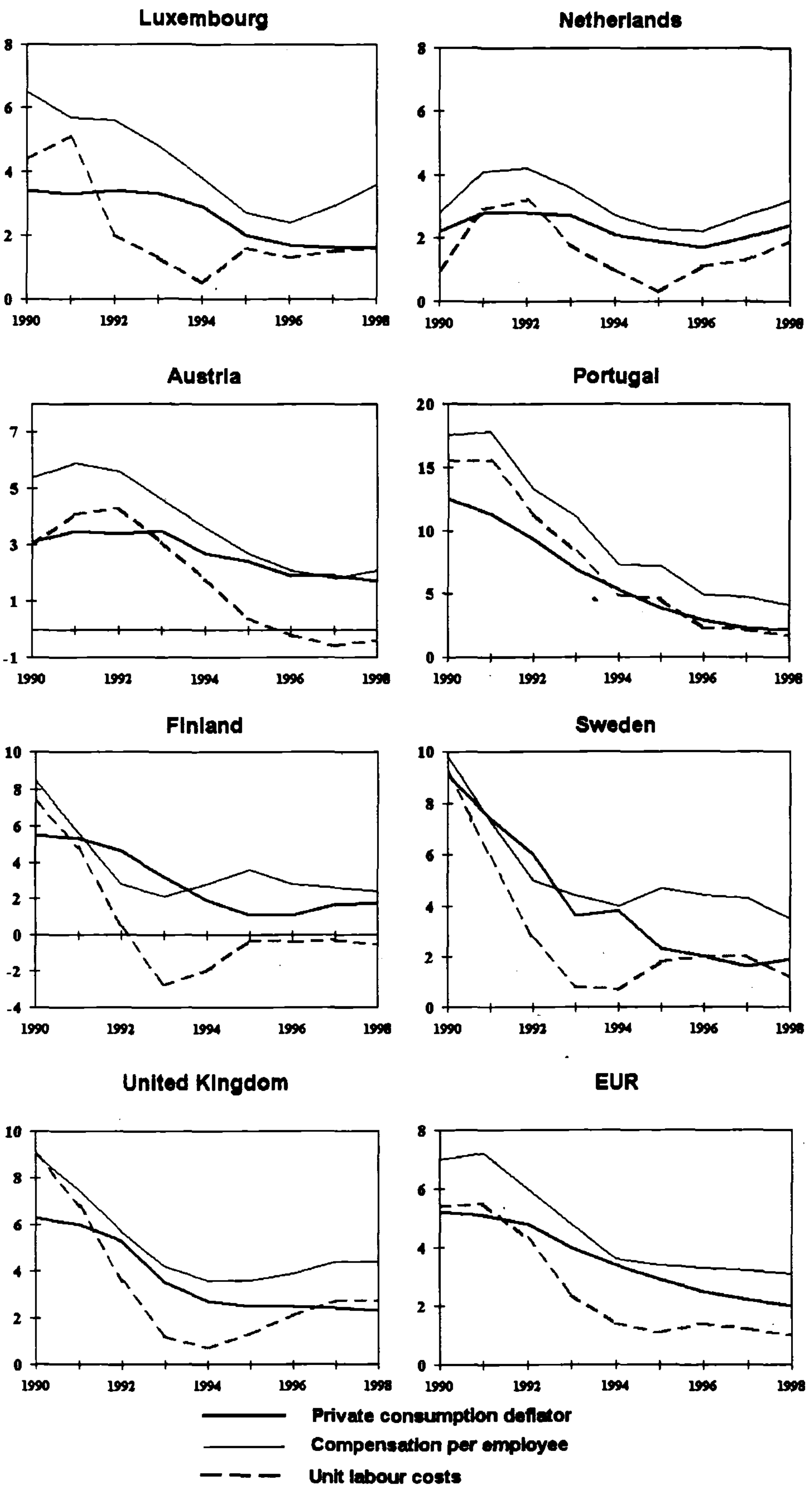
As a result, the slowdown in unit labour costs originated predominantly from moderate increases in nominal wages per head. After having risen by 6.4% per year at the Community level over the 1990-93 period, nominal compensation per employee increased at an annual average rate of 3.3% over the period 1994-97. This deceleration in wage growth over the 1990s was common to all Member States, though to varying degrees. The most spectacular progress has been registered in Spain, where nominal compensation per employee rose by less than 3% per year over the period 1994-97, i.e. below the Community average. In Italy and Portugal, the improvement has also been sizeable with the average annual increase in wages per head decelerating to 4.4% and 6.5% respectively during the period 1994-97 (against above 7% and close to 15% respectively in the period 1990-93).

Graph 3.3 Inflation and wage trends

(3-year moving average of annual percentage change)



Graph 3.3 continued



Source : Commission services

Several factors seem to explain the generally observed moderation in nominal wages. Firstly, the two sides of industry appear to have attached greater credibility to the resolve and ability of monetary authorities to achieve price stability. Hence, over the last few years, in all Member States inflation expectations underlying wage agreements have become increasingly consistent with the monetary authorities' announced inflation objectives. Secondly, this enhanced credibility has been accompanied by profound changes in wage-setting procedures with a view to ensuring continued appropriate wage developments. These institutional modifications include the removal of automatic wage indexation in Italy and the implementation in Spain, Ireland, the Netherlands and Finland of innovative multi-year wage agreements involving not only the Social Partners but also the government. Other countries have oriented their wage settlements towards safeguarding and improving external competitiveness (e.g. Belgium, Denmark and France). Thirdly, wage negotiations seem to have increasingly taken into account developments on the real side of the economy (overall productivity growth, labour market situation, profitability concerns). Finally, Member States have stepped up their efforts to improve the employability and adaptability of labour. These structural measures are essential to improve job opportunities but they will also help to avoid excessive upward pressure on wages when the recovery strengthens. In some Member States (e.g. Denmark, the Netherlands and the United Kingdom), these measures seem to have already had a tangible positive effect as the unemployment rate has come down significantly without any major acceleration in wage increases.

3.4.3. Appropriate domestic reaction to changes in import prices

Given the high degree of openness of the economies of the Member States, the evolution of import prices plays an important role in domestic price formation. Changes in import prices are the result from several different factors: changes in international prices and the value of the exchange rate, the geographical composition of imports, the price-setting behaviour of foreign suppliers and domestic demand conditions. In due course, changes in import prices are likely to feed through, at least partially, to final prices. The degree of this pass-through depends on the prevailing economic situation, the stance of macroeconomic policy and the structure of the economy. For the purpose of the assessment of a country's inflation performance and of its sustainability, it is important to examine whether external price pressures have led to domestically generated price increases.

In eight of the 14 Member States showing inflation rates below the reference value (namely Belgium, Denmark, Germany, France, Luxembourg, the Netherlands, Austria and Finland), increases in import prices have generally been low during the period 1994-96. This was due to both the very moderate rise in international commodity prices during most of this period and the strength of their currencies. Mainly as a result of the substantial appreciation of the US dollar against their currencies, these countries (with the exception of Luxembourg, Austria and Finland) experienced a noticeable acceleration in import price increases in 1997.

Table 3.5

Import prices

(percentage change in the deflator of imports of goods and services, in national currency)

	1993	1994	1995	1996	1997	1998*
B	-2.6	0.9	1.0	2.0	4.5	1.1
DK	-1.1	0.7	1.0	0.8	3.7	0.9
D	-1.4	0.5	0.6	0.7	3.0	1.2
EL	7.8	5.6	6.6	3.8	2.7	7.4
E	6.5	5.7	4.2	2.4	4.1	1.9
F	-2.5	1.7	1.3	1.2	2.1	0.8
IRL	4.4	2.8	4.2	-0.7	0.3	3.7
I	12.1	4.9	12.1	-1.9	-0.6	1.1
L	1.6	6.4	0.8	0.3	-0.1	2.4
NL	-2.3	0.1	0.9	0.7	3.1	1.8
A	0.7	0.8	1.0	1.2	0.7	1.0
P	4.8	4.8	3.4	0.3	1.1	1.5
FIN	8.7	-0.3	0.4	1.8	1.6	1.4
S	14.5	3.5	4.6	-4.9	2.0	0.7
UK	8.5	2.9	7.2	0.4	-6.5	-2.3
EUR	3.0	2.3	3.9	0.5	0.8	0.8

* Spring 1998 economic forecasts.

Source : Commission services.

In Ireland, import price increases were also generally moderate in 1994 and 1995. But, owing to the appreciation of the Irish punt, they were negative in 1996 and flat in 1997, thereby exerting a moderating impact on overall consumer price increases over the last two years.

In the five other Member States with inflation below the reference value, import prices rose quite substantially at the beginning of the second stage following a pronounced weakening of their currencies. For some of these countries (Spain, Italy and Portugal), this explains to some extent the rather slow progress with disinflation during these years. Import price increases were high in Spain and Italy in 1994 and 1995, in Portugal in 1994 and in Sweden and the United Kingdom in 1995. In all these countries, in contrast to previous episodes of sharp currency depreciation, only a small part of import price rises was passed on to consumer prices. The limited knock-on effect on domestic inflation was due partly to the weak growth environment prevailing in these countries but particularly to a non-accommodating stance of monetary policy. With the renewed strength of these countries' currencies, import price inflation was low or negative in 1996 and 1997 (with the exception of Spain in 1997), thereby exerting a restraining impact on domestic price pressure. This was particularly the case in the United Kingdom, where the marked appreciation of sterling led to a significant fall in import prices in 1997.

In Greece, import price inflation was high throughout the second stage but it decelerated and was less than consumer price inflation throughout the period. While initially rather slow, the pace of deceleration quickened in 1996 and 1997 under the influence of the "hard drachma" policy.

3.5. Sustainability of price performance reinforced by EMU

In the course of the second stage of EMU, all Member States, with the exception of Greece, have succeeded in achieving and/or maintaining low and convergent inflation rates. While cyclical factors such as the prolonged period of sluggish economic activity certainly contributed to easing price and cost pressures, a number of structural changes played a key role in the impressive performance on the inflation front. First and foremost, there is the acceptance of price stability as one of the major objectives of economic policy in general and the determined orientation of economic policies, especially monetary policy, towards that objective. This process has been underpinned by the trend towards granting independence to national central banks. Secondly, wage developments have strongly supported the disinflation process. The consistent deceleration, and subsequent maintenance at a low rate, of inflation, wages and unit labour costs suggest that wage settlements have internalised the target of low inflation, which in turn is testimony to the increased credibility of a stability-oriented policy framework. This process has also been underpinned by important institutional modifications to the wage formation process.

While these structural factors suggest that the current price performance is sustainable, it should be emphasised that EMU, through its implied institutional changes and new economic environment, is likely to safeguard and reinforce the results achieved in terms of price stability.

The Treaty guarantees the independence of the European Central Bank and bestows it with the clear objective to maintain price stability. The Treaty provisions on public finances, as complemented by the Stability and Growth Pact, will ensure the consistency of budgetary policy with a low inflation environment. As a result of this framework, the single currency regime will secure low and more predictable inflation. The enhanced credibility of the price stability objective will foster low and stable inflationary expectations and is thereby likely to strengthen wage and cost discipline. The incentives for wage discipline will also be improved since inappropriate wage increases will continue not to be accommodated by monetary, budgetary or exchange rate policies. An increase in wages faster than warranted by growth in productivity in a country (or region) would lead to a deterioration in competitiveness and investment profitability and therefore to reduced attractiveness as a production location. The country's (or region's) export performance would suffer, investment would be deterred and unemployment would increase. For these reasons, EMU is likely to result in a sustained wage behaviour consistent with job creation.

Furthermore, the exposure to imported inflation is likely to diminish in the third stage of EMU. Around 65% of total EC imports originate from EC countries. By definition, the implementation of a single currency will remove variations in intra-EC import prices due to exchange rate fluctuations between single currency participants, while the price stability that is expected to prevail in the Community should prevent any large increases in individual Member States' intra-EC import prices.

Extra-EC imports will still remain subject to fluctuations due to changes in international commodity prices and variations in the euro exchange rate against other currencies, especially the US dollar. However, with extra-EC imports representing only some 10% of Community GDP, these factors will have to undergo large gyrations in order to substantially affect Member States' domestic prices. Moreover, if a larger proportion of imports is, in the future, invoiced in euro, then inflation developments in the euro-area will be less likely to suffer from possible fluctuations in other currencies, especially the US dollar.

Annex: The harmonised index of consumer prices (HICP)

1. Reasons for the construction of the HICP[5]

The HICP has been set up in order to meet two requirements resulting from the EMU process. Firstly, the Treaty, especially Protocol No 6, stipulates that inflation should be measured by means (i) of the consumer price index, (ii) which is comparable among Member States, although taking into account differences in national definitions. Secondly, by definition, monetary policy will be conducted at the level of the EMU area. This requires indicators consistent amongst Member States, not only for comparison, but also in order to construct aggregate indicators at the EMU level. Among these indicators, a reliable and comparable consumer price index is clearly one of the most important.

2. Basic concepts underlying the construction of the HICPs

The requirements of the Treaty detailed above are being met through the implementation of HICPs which are as far as possible based on national CPIs.

Firstly, the new index measures changes in consumer prices. This implies that it covers the trend over time of actual prices of goods and services faced by consumers on the economic territory. The concept adopted for delimiting the coverage of the HICP can therefore be defined as "final monetary consumption expenditure of households". This includes all the monetary transactions made by households for goods and services directly satisfying consumer needs. Non-monetary transactions are transactions that do not involve the exchange of cash, assets or liabilities denominated in units of currency.

Secondly, the HICPs are comparable. The comparability was defined in the Council Regulation concerning the HICPs as follows: "HICPs shall be considered to be comparable if they reflect only differences in price changes or consumption patterns between countries." This means that HICPs are based on comparable concepts, methods, and practices in their definition and compilation. The HICPs currently provide the best statistical basis for comparisons of consumer price inflation in the Member States.

[5] The present annex is a short summary of the "Progress Report on Harmonization of Consumer Price Indices in the European Union", drafted by the Commission (Eurostat). The report deals in detail with all the issues related to the HICPs.

As far as possible, the Commission Regulation which implemented the detailed rules for constructing the HICPs are based on the best of current practices allowing for legal and institutional circumstances existing in Member States[6]. The general approach to the implementing regulations could be characterised by the term "minimum standards". "Minimum standards" in the sense that banning acknowledged bad practices has the effect of not only achieving convergence on good practices but also raising the general level of standards and, on the other hand, in the sense that the regulations generally specify outputs rather than inputs. They say what is required rather than how to achieve the requirement, the detail of which is left to Member States, sometimes in agreement with the Commission (Eurostat).

In view of the need to assess price performance over one year, Member States have been asked to provide retrospective data going back to January 1995.

All these provisions have been formally laid down in a series of Commission Regulations implementing Council Regulation (EC) No 2494/95 [7].

3. Major fields subject to harmonisation

At the outset, it was clear that the completion of the harmonisation process would last beyond the start of the EMU in January 1999. The intermediate objective was thus to focus on the key fields where harmonisation had to be achieved in order to ensure a level of comparability sufficient to meet the provisions of the Treaty. The following areas have been identified and their harmonisation requirements have been defined in Commission regulations:

- A common coverage and common classification (COICOP/HICP) of goods and services.
- Minimum standards for sampling: ensuring that samples of prices are properly representative.
- Minimum standards for the treatment of prices.
- Using comparable formulae for calculating price changes.
- Minimum standards for procedures of quality adjustment, i.e. making appropriate allowance for quality change of goods and services purchased.
- Timely incorporation of newly significant goods and services in the HICPs.
- Minimum standards for the quality of weights minimising disparities arising from different up-date frequencies.

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6 These regulations are elaborated by a Working Party including representatives of the National Statistical Offices and of the main users (central banks, EMI), under the leadership of the Commission (Eurostat).

7 Requirements of the Council Regulation have been specified by three Commission Regulations:
- Commission Regulation (EC) No 1749/96 on initial implementing measures for Council Regulation (EC) No 2494/95 concerning HICPs.
- Commission Regulation (EC) No 2214/96 concerning transmission and dissemination of sub-indices of the HICP.
- Commission Regulation (EC) No 2454/97 laying down detailed rules for the implementation of Council Regulation (EC) No 2494/95 as regards minimum standards for the quality of HICP weightings.

The final objective is to cover household final monetary consumption expenditure (HFMCE) as a whole. As it was unrealistic to attempt to solve all the technical problems before the decision on EMU participants, one intermediate goal was that all the HICPs should at least cover the same categories of goods and services, and that this coverage should be as large as possible. The weights assigned to each category of goods and services vary from country to country, reflecting the relative importance of consumers' expenditure on each good or service in each country. As Table 3.6 shows, the current HICP coverage in percent of the HFMCE is already high for most of the Member States. The table compares actual HICP coverage and that of the national CPI with HFMCE full coverage.

In addition to the extension of the initial HICP coverage to full HFMCE coverage, other methodological aspect will be the subject of harmonisation in the near future, i.e. the harmonisation of the geographic and population coverage of the HICPs.

Table 3.6

Comparison of coverage of harmonised and national consumer price indices

(coverage of HFMCE ; approximate weights per 1000 , annual 1996) [a]

	HICP initial coverage as of Jan.97	Expenditure covered by: HFMCE but excluded from CPI	CPI but excluded from HFMCE [b]
B	952	0	11
DK	903	82	114
D	953	2	114
EL	875	69	0
E	954	0	5
F	847	87	0
IRL	n.a.	n.a.	n.a.
I	973	0	48
L [c]	725	275	0
NL	886	84	173
A	960	132	86
P	943	0	77
FIN	930	0	0
S	896	0	165
UK	917	124	96

HFMCE: Household final monetary consumption expenditure.

a) The reference expenditure is household final monetary consumption expenditure which should be fully covered by the HICP from December 1999. This is set as weight of 1000. The weights are rough estimates which refer to the average price level of the year 1996.

b) Most commonly: imputed rents, mortgage interest, games of chance.

c) For Luxembourg the HICP and CPI are identical.

Source: Commission services , Eurostat.

4. The aggregate indices based on the HICPs

The HICPs are - and will be - used for the construction of various aggregate indices at the European level.

(i) The **European Index of Consumer Prices** (EICP) is calculated as a weighted average of the HICPs of the 15 Member States. The index is computed as an annual chain index allowing for changes in country weights each year. The weight of a Member State is its proportion of final consumption expenditure of households in the EU total. The values of final consumption in national currencies are converted into purchasing power standards (PPS) using the purchasing power parities of final consumption.

(ii) The **European Economic Area Index of Consumer Prices** (EEAICP) is calculated in the same way, with the inclusion of Iceland and Norway.

(iii) The forthcoming **Monetary Union Index of Consumer Prices** (MUICP) will be calculated as a weighted average of the HICPs of Member States participating in the single currency. The index will be computed as an annual chain index allowing for changes in country weights each year. The weight of a country will be its proportion of final consumption expenditure of households in the EMU total. The values of final consumption in national currencies will be converted using the conversion rates which will be announced at the time of the decision on which Member States will adopt the single currency, and in euros from January 1999. The Commission (Eurostat) will start to publish the MUICP for the first time in May 1998, just after the decision on the participating countries. The time series for the MUICP will be calculated back to January 1995.

5. Numerical comparison between HICPs and CPIs

As detailed above, HICPs diverge from national CPIs as a result of differences in concepts, methods, definitions and practices. The fact that the differences in the results obtained using HICPs and using CPIs are not of the same sign and magnitude across countries highlights the fact that the methodology underlying national CPIs differs across Member States.

In most Member States, differences between the two indices are not important. Table 3.7 shows that, for 1997, the numerical discrepancy is in the range of ±0.1 percentage point for eight Member States and in the range of ±0.3 percentage point for another four countries. Only in Sweden and the United Kingdom does the discrepancy amount to about 1 percentage point (but with a different sign). This results from major differences in coverage (the inclusion of mortgage rates in the CPIs for both countries) and in methodology for the United Kingdom.

Table 3.7

Difference between HICPs and CPIs in 1997
(percentage change)

	HICP	CPI	Difference HICP-CPI
B	1.5	1.6	-0.1
DK	1.9	2.2	-0.3
D	1.5	1.8	-0.3
EL	5.4	5.5	-0.1
E	1.9	2.0	-0.1
F	1.3	1.2	0.1
IRL	1.2	1.5	-0.3
I	1.9	2.0	-0.1
L	1.4	1.4	0.0
NL	1.9	2.3	-0.4
A	1.2	1.3	-0.1
P	1.9	2.2	-0.3
FIN	1.2	1.2	0.0
S	1.8	1.0	0.8
UK	1.8	3.1	-1.3
EUR	1.7	2.0	-0.3

Source: Commission services , Eurostat.

4. GOVERNMENT BUDGETARY POSITION

4.1. Excessive deficit procedure

According to the second indent of Article 109j(1), fulfilment by a Member State of the criterion on the sustainability of the government financial position *"...will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104c(6)"*. Furthermore, Protocol No 6 on the convergence criteria states in Article 2 that:

"The criterion on the government budgetary position referred to in the second indent of Article 109j(1) of this Treaty shall mean that at the time of the examination the Member State is not the subject of a Council decision under Article 104c(6) of this Treaty that an excessive deficit exists".

The convergence assessment in the budgetary area is thus directly linked with the excessive deficit procedure of Article 104c of the Treaty. The main features of this procedure during the second stage of EMU are described in the box on the "Excessive deficit procedure". Failure by a Member State to fulfil the requirements under either or both of the criteria on the government deficit ratio and the government debt ratio could lead, following the steps of the procedure, to a decision by the Council on the existence of an excessive deficit. When a Member State has, in the view of the Council, corrected the excessive deficit, the Council, on a recommendation from the Commission, abrogates its earlier decision.

The excessive deficit procedure has been implemented by the Commission and the Council each year since the relevant provisions of Article 104c and of the associated Protocol No 5 came into effect at the beginning of the second stage of EMU in January 1994. Each year the various steps of the procedure have been applied following the March reporting of budgetary data by Member States, as specified in Council Regulation (EC) No 3605/93.

Box: Excessive deficit procedure

The excessive deficit procedure set out in Article 104c of the Treaty and the associated Protocol No 5 determines the steps to be followed to reach a decision by the Council that an excessive deficit exists.

The Commission is required (in paragraph 2 of Article 104c) to monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors. In particular, compliance with budgetary discipline is to be examined by the Commission on the basis of the following two criteria:

"*(a)* *whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value* (specified in the Protocol as 3%), *unless:*

- *either the ratio has declined substantially and continuously and reached a level that comes close to the reference value;*
- *or, alternatively, the excess of the reference value is only exceptional and temporary and the ratio remains close to the reference value;*

(b) *whether the ratio of government debt to gross domestic product exceeds a reference value* (specified in the Protocol as 60%), *unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.*"

The Commission is required to prepare a report if a Member State does not fulfil the requirements under one or both of these criteria. The report shall also take into account whether the government deficit exceeds government investment expenditure and all other relevant factors, including the medium-term economic and budgetary position of the Member State (paragraph 3).

Subsequent steps in the procedure include the formulation by the Monetary Committee of an opinion on the report of the Commission (paragraph 4); the addressing of an opinion to the Council by the Commission, if it considers that an excessive deficit exists (paragraph 5); and then a decision by the Council after an overall assessment whether an excessive deficit exists (paragraph 6). Finally, the Council makes non-public recommendations to the Member State for which the existence of an excessive deficit has been decided with a view to bringing that situation to an end within a given period (paragraph 7). The Council may subsequently make its recommendations public, where it establishes that there has been no effective action in response to its recommendations within the period laid down (paragraph 8). When, in the view of the Council, the excessive deficit in the Member State concerned has been corrected, the Council abrogates its decision (paragraph 12).

The provisions of Article 104c in paragraphs 9 and 11 (which can lead to sanctions) are not applicable during the second stage of EMU. Furthermore, in the second stage Member States shall endeavour to avoid excessive government deficits (Article 109e(4)), the full force of Article 104c(1) that "*Member States shall avoid excessive government deficits*" only applying from the beginning of the third stage.

Considerable efforts have been made during the second stage of EMU by all the parties involved to improve the quality and comparability of data on Member States' budgetary positions. In particular, Eurostat, after consultation of national statistical offices, has issued a series of rulings on the appropriate treatment of certain transactions within the general government accounts in order to ensure a common and harmonised interpretation of the ESA-1979 accounting rules for the compilation of the deficit and debt figures. This has led to the establishment of comparable time series for budgetary data in all Member States and the analysis given in this report is based on these figures. The close examination by Eurostat of the figures reported by the Member States has allowed the ruling out of cases where the accounting treatment was not in accordance with the ESA-1979 rules. The statistical revisions introduced by the Member States to comply with the ESA-1979 rules and with Eurostat's decisions led in a number of cases to non-negligible retroactive modifications of previously published figures, which entailed both upward and downward revisions of the deficit and debt data. The Annex on "Budgetary surveillance and comparability of figures" gives more information about these developments.

In the first application of the excessive deficit procedure in 1994 the Council decided[1] in accordance with Article 104c(6) on the existence of an excessive deficit in 10 of the then 12 Member States. Only Ireland and Luxembourg were not the subject of such a decision. For these two countries, the Commission had not initiated the procedure. In Ireland the government deficit was below the reference value of 3% of GDP and the government debt ratio, while above the reference value of 60% of GDP, had been declining significantly. In Luxembourg the government balance was in surplus and the debt ratio was far below the reference value. All the other 10 Member States did not satisfy one or both of the criteria for government deficit and debt.

In 1995 the procedure was applied for the first time to the three new Member States (Austria, Finland and Sweden) and the Council decided[2] that an excessive deficit existed in each of them. At the same time the Council decided[3] in accordance with Article 104c(12) to abrogate the decision on Germany: the government deficit in Germany had fallen below the reference value in 1994 and was expected then to remain below in 1995, and the government debt ratio remained below the reference value.

1 Council decisions of 26 September 1994.

2 Council decisions of 10 July 1995.

3 Council decision of 10 July 1995.

In the application of the procedure in 1996 the Council adopted a new decision[4] on the existence of an excessive deficit in Germany: as it had turned out, the government deficit in Germany rose above the reference value in 1995 and was expected to remain above in 1996. The German debt ratio, even though increasing sharply, remained below the 60% of GDP reference value in 1995. The Council also decided[5] to abrogate the decision on Denmark: the government deficit in Denmark fell well below the reference value in 1995 and was expected to remain at a low level in 1996, and the government debt ratio, while still above the reference value, declined significantly in 1994 and 1995.

In the application of the procedure in 1997 the Council decided[6] to abrogate the decisions on the Netherlands and Finland. In the Netherlands the government deficit fell below the reference value in 1996 and was expected to decline further in 1997, and the government debt ratio, while still above the reference value, had peaked in 1993 and declined in 1994 and 1996. In Finland the government deficit was estimated at the time[7] to have fallen below the reference value in 1996 and was expected to decline further in 1997, and the government debt ratio remained below the reference value.

Thus, following the decisions of 1997 and earlier years, five Member States (Denmark, Ireland, Luxembourg, the Netherlands and Finland) are not the subject of a decision on the existence of an excessive deficit. Decisions on the existence of an excessive deficit still apply to the other 10 Member States.

Data on government deficits and debt and nominal GDP were reported by Member States to the Commission[8] by the beginning of March 1998 in accordance with the requirements of Council Regulation (EC) No 3605/93. Eurostat has confirmed that these data are in conformity with the ESA-1979 rules and with the decisions it has issued.

4 Council Decision of 27 June 1996 (96/421/EC); OJ L 172, 11.7.1996, p. 26.

5 Council Decision of 27 June 1996 (96/420/EC); OJ L 172, 11.7.1996, p. 25.

6 Council decisions of 30 June 1997 (97/416/EC and 97/417/EC); OJ L 177, 5.7.1997, p. 23 and p. 24.

7 In the September 1997 reporting from Finland the estimate for the government deficit in 1996 was revised upwards to 3.1% of GDP (from 2.6% in the March 1997 reporting). The revised 1996 outturn still represented a significant decline from the deficit of 5% of GDP recorded in 1995 and a further reduction to well below 2% of GDP was expected in 1997. The Commission did not reopen the procedure.

8 Article 4 of Protocol No 5 on the excessive deficit procedure specifies that the statistical data to be used for the procedure are provided by the Commission.

The 1998 application of the excessive deficit procedure is being carried out concurrently with this convergence assessment. The following sections of this chapter examine budgetary developments in the Member States during the second stage, in particular results in 1997 and expected developments in 1998, and also look at different aspects of the sustainability of public finances. Detailed evidence is then presented for each of the Member States which are at present the subject of an excessive deficit decision and have achieved correction of their budgetary imbalances.

In the light of this examination and of the budgetary adjustment achieved, the Commission is adopting, at the same time as this report, recommendations for the Council to abrogate the decisions on the existence of an excessive deficit in a further nine Member States (Belgium, Germany, Spain, France, Italy, Austria, Portugal, Sweden and the United Kingdom). If these recommendations are acted upon by the Council, then 14 Member States (all except Greece) will not be the subject of an excessive deficit decision and are to be considered as fulfilling the criterion on the government budgetary position.

The budgetary correction already achieved in Greece is not considered by the Commission to be sufficient for it to recommend abrogation this year of the excessive deficit decision relating to Greece. In the framework of this year's application of the excessive deficit procedure, the Commission will adopt in May a recommendation for a new Council recommendation to Greece in accordance with Article 104c(7) with a view to bringing the excessive deficit situation to an end.

4.2. Overview of the budgetary situation in the Member States

The convergence criterion concerning the government budgetary position imposed by the Treaty has undeniably set off a genuine budgetary adjustment process in the Member States. The determination with which most governments have undertaken budgetary adjustment policies since the start of the second stage of EMU and the magnitude of these adjustments have been quite remarkable. Even though the adjustment process has been difficult and gathered pace mainly towards the end of the period, it represents a genuine break with past budgetary behaviour and constitutes a major step towards budgetary discipline among Member States. The scale of the adjustment has been particularly important in those Member States which at the start of the second stage of EMU experienced the most serious public finance imbalances.

Even though a small part of the improvement in Member State government deficits can be ascribed to the recovery in the economic situation since the recession of the early 1990s or to measures having only a temporarily beneficial impact on their budgetary position, most of the improvement has resulted from the budgetary adjustment policies introduced. Successful budgetary retrenchments are those that reduce the deficit mainly by cutting current primary expenditure, while non-lasting adjustments tend to rely more on tax increases or cuts in capital spending. The composition of the adjustments which took place in most Member States involved important reductions in primary current government expenditure. Thus, the composition of these adjustments indicates that they were generally soundly based and therefore likely to be maintained in the future.

The budgetary adjustment achieved so far will have to be pursued further in future years. The leeway provided by higher economic growth and further falling debt service costs in the coming years should not lead to a relaxation of adjustment efforts. On the contrary, these favourable conditions present a unique opportunity to further correct existing budgetary imbalances. The budgetary targets set by the Member States in their convergence programmes indicate that Member States are committed to reducing their government deficit and debt ratios further in coming years.

This commitment was strengthened with the adoption of the Stability and Growth Pact at the Amsterdam European Council in June 1997[9]. Under the pact, Member States will have to respect the medium-term budgetary objective of positions *"close to balance or in surplus"*. By continuing their adjustment efforts in the coming years, Member States will put their public finances in a more favourable position to face the budgetary consequences of potential adverse economic developments.

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9 The Stability and Growth Pact consists of:
- Resolution of the European Council on the Stability and Growth Pact of 17 June 1997 (97/C 236/01); OJ C 236, 2.8.1997, p.1;
- Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies; OJ L 209, 2.8.1997, p.1;
- Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure; OJ L 209, 2.8.1997, p.6.

4.2.1. Government deficit

Respect of the deficit criterion is quite clear in cases where the government deficit ratio does not exceed the reference value of 3% of GDP in both the "actual" year (1997 in the present examination) and the "planned" year (1998). The deficit criterion may also be satisfied in cases where the deficit ratio exceeds the reference value but in accordance with Article 104c(2)(a):

"- *either the ratio has declined substantially and continuously and reached a level that comes close to the reference value;*
- *or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value".*

In earlier applications of the excessive deficit procedure both "actual" and "planned" deficits were below the reference value in relevant years for all those Member States which have either never been the subject of an excessive deficit decision or have had the decisions concerning them abrogated.

Respect of the deficit criterion, once it has been achieved, should be sustained in the subsequent years. Indeed, it would not be sufficient for budgetary adjustment efforts to concentrate solely on respect of this criterion in a single year, perhaps followed by a relaxation of budgetary policies and a renewed widening of budgetary imbalances. It is for this reason that the excessive deficit procedure examines "actual" and "planned" deficits. The present report therefore looks at both the budgetary results achieved in 1997 and those in prospect for 1998, as forecast by the Commission services. As the excessive deficit procedure also makes reference to the magnitude and pace of the improvement in the budgetary situation of the Member States, such features of the budgetary adjustment processes which have taken place in most Member States are also examined in this report.

In 1997 three Member States (Denmark, Ireland and Luxembourg) had a surplus on their government accounts, four Member States (the Netherlands, Finland, Sweden and the United Kingdom) had a government deficit of less than 2.0% of GDP and a further seven Member States (Belgium, Germany, Spain, France, Italy, Austria and Portugal) had a deficit greater than 2.0% of GDP but no more than 3.0% of GDP[10]. Greece had a deficit of 4.0% of GDP in 1997. Thus 14 of the Member States had a government balance in 1997 which was better than or equal to the reference value for the deficit of 3% of GDP (see Table 4.1).

Table 4.1

Government surplus / deficit
(General government net lending (+) / net borrowing (-), as % of GDP)

	1993	1994	1995	1996	1997	1998*
B	-7.1	-4.9	-3.9	-3.2	-2.1	-1.7
DK	-2.8	-2.8	-2.4	-0.7	0.7	1.1
D	-3.2	-2.4	-3.3	-3.4	-2.7	-2.5
EL	-13.8	-10.0	-10.3	-7.5	-4.0	-2.2
E	-6.9	-6.3	-7.3	-4.6	-2.6	-2.2
F	-5.8	-5.8	-4.9	-4.1	-3.0	-2.9
IRL	-2.7	-1.7	-2.2	-0.4	0.9	1.1
I	-9.5	-9.2	-7.7	-6.7	-2.7	-2.5
L	1.7	2.8	1.9	2.5	1.7	1.0
NL	-3.2	-3.8	-4.0	-2.3	-1.4	-1.6
A	-4.2	-5.0	-5.2	-4.0	-2.5	-2.3
P	-6.1	-6.0	-5.7	-3.2	-2.5	-2.2
FIN	-8.0	-6.4	-4.7	-3.3	-0.9	0.3
S	-12.2	-10.3	-6.9	-3.5	-0.8	0.5
UK	-7.9	-6.8	-5.5	-4.8	-1.9	-0.6
EUR	-6.1	-5.4	-5.0	-4.2	-2.4	-1.9

* Spring 1998 economic forecasts.

Source: Commission services.

Member States have also reported to the Commission their planned deficits for 1998. These data have been taken into account by the Commission services in their forecasts for 1998 (also shown in Table 4.1). In several cases Member States have reported for 1998 the deficit targets first adopted in their draft budget in Autumn 1997. Differences between the data for 1998 reported by the Member States and the forecasts used here may be explained by the incorporation of more recent information by the Commission services, especially concerning the 1997 deficit outturns and recent growth developments.

Government deficits in 1998 are expected to decline further in all Member States still in deficit, except the Netherlands. Sweden and Finland are expected to move into surplus in 1998. For the three Member States already in surplus in 1997, a widening of the surplus is expected in Denmark and Ireland while some narrowing of the surplus is likely for Luxembourg. None of the 15 Member States is expected to have a government deficit in excess of the reference value of 3% of GDP in 1998.

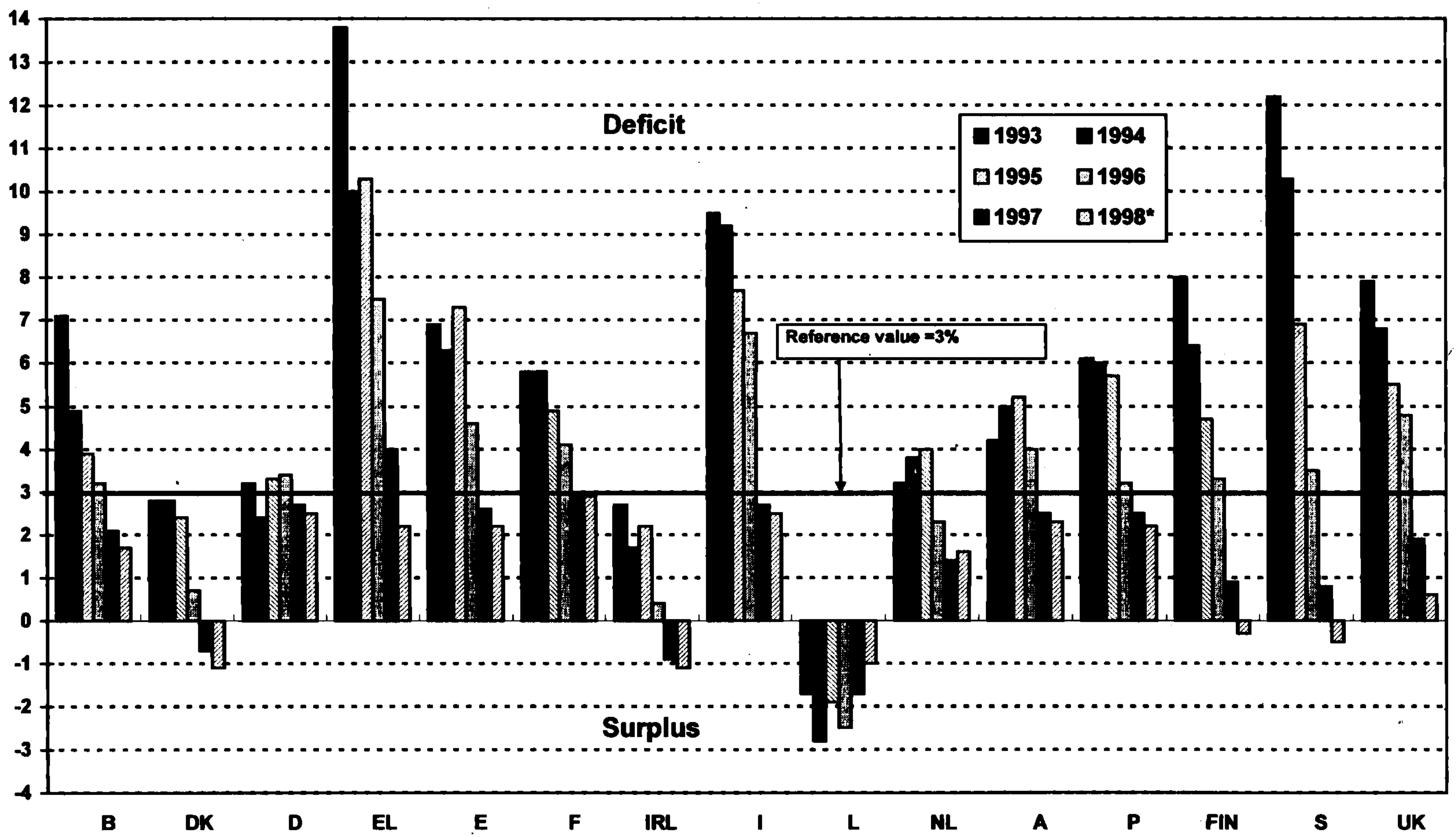
10 It may be noted that Article 1 of Protocol No 5 on the excessive deficit procedure defines the reference value for the ratio of the government deficit to GDP as 3%, without specifying a figure after the decimal point. The above analysis uses data providing one figure after the decimal point.

Most Member States have achieved substantial improvements in their budgetary positions since the beginning of the second stage of EMU. The starting positions differed markedly among Member States: whereas government deficits were swollen in most countries in 1993 by the effects of the recession and often also by the legacy of inappropriate budgetary policies in earlier years, other countries had already carried out a budgetary retrenchment during the preceding years and therefore started from a more favourable position. Clearly the scale of the adjustment aimed for and achieved since 1993 has depended to a considerable extent on the seriousness of the budgetary imbalances existing at the time of entry into the second stage of EMU.

The government deficit for the total of Member States declined from a peak of 6.1% of GDP in 1993 to 2.4% in 1997 and a further decline to 1.9% of GDP is expected in 1998. Among the individual Member States very large reductions in the deficit took place between 1993 and 1997 in Sweden (by 11.4 percentage points of GDP), Greece (9.8 percentage points), Finland (7.1 percentage points) and Italy (6.8 percentage points). Substantial reductions took place in the United Kingdom (6.0 percentage points), Belgium (5.0 percentage points), Spain (4.3 percentage points, or 4.7 percentage points from the peak deficit in 1995), Portugal (3.6 percentage points) and France (2.8 percentage points). Reductions were also achieved over this same period in the Netherlands (1.8 percentage points, or 2.6 percentage points from the peak deficit in 1995), Austria (1.7 percentage points, or 2.7 percentage points from the peak deficit also in 1995), and Germany (0.5 percentage points, or 0.7 percentage points from the peak deficit in 1996). In Denmark, which is now estimated[11] to have had a deficit below the reference value in 1993, there was an improvement in the government balance of 3.5 percentage points by 1997, and in Ireland, which also had a deficit already below the reference value in 1993, the improvement in the government balance was 3.6 percentage points. Luxembourg remained in surplus throughout the period.

11 Earlier estimates available when the excessive deficit procedure was implemented in 1994 to 1996 showed the government deficit in Denmark exceeding the reference value in 1993 and 1994. Since then, the data have been revised to comply with the ESA-1979 accounting rules and Eurostat's decisions concerning these rules.

Graph 4.1 **Government deficit**
(as % of GDP)



* Spring 1998 economic forecasts
Source : Commission services

4.2.2. Government debt

Respect of the debt criterion is clear in cases where the debt ratio does not exceed the reference value of 60% of GDP. The debt criterion may also be satisfied in cases where the debt ratio exceeds the reference value but it is judged in accordance with Article 104c(2)(b) that *"...the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace"*.

The government debt criterion should be assessed not only by examining the path of the government debt ratio but also by analysing its underlying dynamics. Once continued deficit reductions and economic growth have become the main driving forces of the decline in the debt ratio, countries with high debt ratios should be able to achieve larger reductions in their debt ratio over several years than countries with a debt ratio close to the 60% of GDP threshold. Indeed, the reduction in the debt ratio - based on identical deficit ratios and nominal GDP growth rates - is more pronounced when the initial level of the debt ratio is high than when the ratio is close to the 60% of GDP reference value. For countries where the debt ratio has only just started to decline, there should be clear prospects for further reductions in the debt ratio due to the continuing reduction of the government deficit and to economic growth.

General government gross debt ratios are shown in Table 4.2. At the end of 1997, the debt ratio was below the reference value of 60% of GDP in four Member States (France, Luxembourg, Finland and the United Kingdom). The debt ratio was in the range of 60% to 70% of GDP in Denmark, Germany, Spain, Ireland, Austria and Portugal and in the range of 70% to 80% of GDP in the Netherlands and Sweden. The debt ratio in Greece was below 110% of GDP and in Belgium and Italy it was above 120% of GDP.

Table 4.2

Government debt

(General government consolidated gross debt, as % of GDP)

	1993	1994	1995	1996	1997	1998*
B	135.2	133.5	131.3	126.9	122.2	118.1
DK [a]	81.6	78.1	73.3	70.6	65.1	59.5
D	48.0	50.2	58.0	60.4	61.3	61.2
EL	111.6	109.3	110.1	111.6	108.7	107.7
E	60.0	62.6	65.5	70.1	68.8	67.4
F	45.3	48.5	52.7	55.7	58.0	58.1
IRL	96.3	89.1	82.3	72.7	66.3	59.5
I	119.1	124.9	124.2	124.0	121.6	118.1
L	6.1	5.7	5.9	6.6	6.7	7.1
NL	81.2	77.9	79.1	77.2	72.1	70.0
A	62.7	65.4	69.2	69.5	66.1	64.7
P	63.1	63.8	65.9	65.0	62.0	60.0
FIN	58.0	59.6	58.1	57.6	55.8	53.6
S	75.8	79.0	77.6	76.7	76.6	74.1
UK	48.5	50.5	53.9	54.7	53.4	52.3
EUR	65.9	68.0	71.0	73.0	72.1	70.5

[a] Government deposits with the central bank, government holdings of non-governmental bonds and public enterprises related debt amounted to some 13 percent of GDP in 1997.

* Spring 1998 economic forecasts.

Source: Commission services.

The budgetary consolidation efforts pursued by Member States in recent years have led first to a slowing and then in most cases to a reversal of the upward trends in debt ratios generally evident since the first oil crisis in the early 1970s. For the Community as a whole the debt ratio declined in 1997 for the first time since 1988 and 1989 (which were years of very rapid economic growth). The level of the debt ratio for the Community as a whole amounted to 72.1% of GDP in 1997 and as such was much higher than during previous decades.

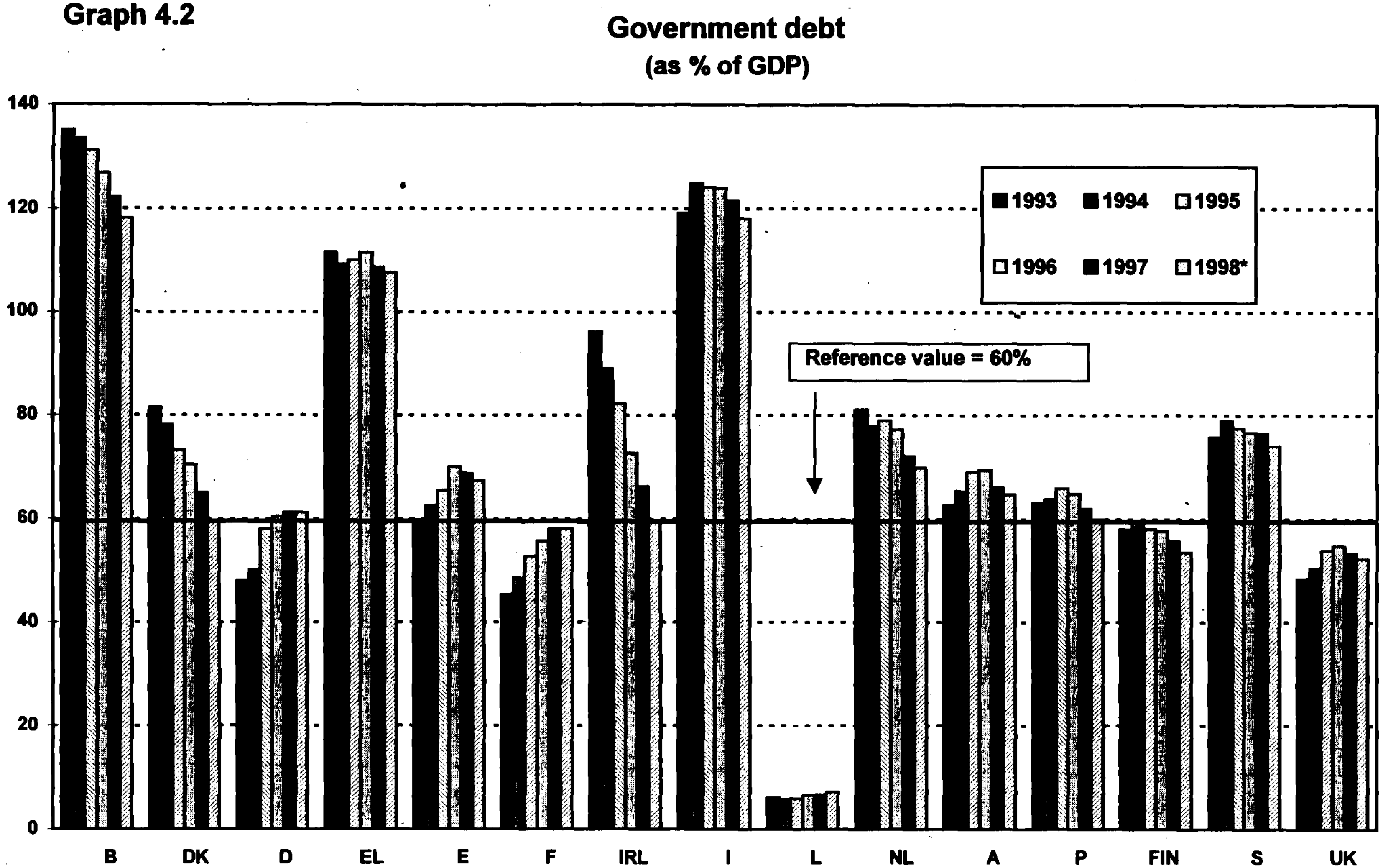
Among those Member States with debt ratios higher than the reference value, the debt ratio declined in 1997 in all of them except Germany. Among Member States with debt ratios below the reference value, the debt ratio also declined in 1997 in Finland and the United Kingdom but it rose in France, while it remained at a very low level in Luxembourg.

Forecasts by the Commission services for 1998 (also given in Table 4.2.) show that the debt ratio is expected to decline in all Member States with a debt ratio above the reference value, as well as in Finland and the United Kingdom and in the Community as a whole. In Denmark, Ireland and Portugal this decline is likely to take the debt ratio to or below the 60% of GDP reference value in 1998.

In Ireland the debt ratio has been on a downward trend since 1988, but it rose temporarily in 1993; between 1993 and 1997 the debt ratio has been reduced very rapidly by 30.0 percentage points of GDP. The debt ratio peaked in 1993 in Belgium, Denmark and the Netherlands; since then the debt ratio has declined by 13.0 percentage points in Belgium, by 16.5 percentage points in Denmark and by 9.1 percentage points in the Netherlands. In Italy and Sweden the debt ratio peaked in 1994 and has since declined by 3.3 and 2.4 percentage points respectively. In Portugal the reduction in the debt ratio from the peak reached in 1995 is 3.9 percentage points. In Greece, Spain and Austria the debt ratio reached its peak in 1996 and has so far declined for only one year. In Germany the debt ratio has continued to rise throughout the second stage, although at a slower pace in 1997; the debt ratio was below the reference value until it rose slightly above the 60% of GDP threshold in 1996.

The above analysis shows that developments concerning government debt particularly in Belgium, Germany, Spain, Italy, Austria and Sweden require further scrutiny. The government debt ratio in Belgium is still at a very high level, even though it fell continuously during each year of the second stage and the overall reduction was important. The debt ratio in Germany continued to increase, although at a decelerating pace, until 1997. The German debt ratio has been swollen by the inclusion of unification-related liabilities amounting to around 10% of GDP. Without the inclusion of these liabilities, the German debt ratio would have remained well below the reference value and even when they are included, the debt ratio remains close to the 60% of GDP threshold. In Italy, the debt ratio has been falling during the past three years but the overall decline was small and the debt ratio is still at a very high level. However, the pace of debt reduction is expected to accelerate in Italy in the coming years in view of the further fall in debt service costs, the upturn in economic growth and continuing high primary surpluses. Since its peak in 1994, the debt ratio in Sweden has fallen only slightly. However, in view of the expected surpluses in 1998 and subsequent years as well as improved economic growth, the prospects are for a continued reduction in the debt ratio in the coming years. In Spain and Austria, the debt ratio has declined during one year so far. However, in both countries the debt ratio remains not far above the 60% of GDP reference value and, given the favourable growth expectations and further reductions in the government deficit, is projected to continue on a downward path in the coming years. The cases of these Member States are examined in more detail in Section 4.4.

Graph 4.2



* Spring 1998 economic forecasts
Source : Commission services

4.2.3. Government investment expenditure

In its monitoring of budgetary developments for the excessive deficit procedure the Commission, as well as examining compliance with the government deficit and debt criteria, has also to take into account whether the government deficit exceeds government investment expenditure (Article 104c(3)). Investment is defined in Article 2 of Protocol No 5 to mean gross fixed capital formation.

Table 4.3

Government investment expenditure
(General government gross fixed capital formation, as % of GDP)

	1993	1994	1995	1996	1997
B	1.5	1.6	1.4	1.2	1.4
DK	1.9	1.9	1.9	2.1*	1.8*
D	2.5	2.4*	2.2	2.0	1.8
EL	3.1	3.0	3.2	3.1	3.3
E	4.0	3.9	3.7	3.0	2.9*
F	3.3	3.2	3.1	2.7	2.8
IRL	2.2	2.3*	2.2*	2.2*	2.2*
I	2.6	2.3	2.2	2.3	2.3
L	5.4*	4.4*	4.7*	4.7*	4.9*
NL	2.7	2.7	2.7	2.7*	2.7*
A	3.2	3.2	3.0	2.8	2.6*
P	4.0	3.6	3.7	4.0*	4.3*
FIN	2.8	2.8	2.6	2.7	2.7*
S	1.1	3.1	2.9	2.1	2.5*
UK	1.9	1.8	1.8	1.3	1.0
EUR	2.7	2.6	2.5	2.2	2.1

* Denotes that government investment expenditure is greater than or equal to the government deficit.

Source: Commission services.

Table 4.3 shows government investment expenditure as a percent of GDP in the Member States in the years 1993 to 1997. Data for years in which government investment expenditure was greater than or equal to the government deficit are shown with an asterisk (*).

There has been some tendency in recent years for government investment expenditure to be reduced relative to GDP. Some of this reduction is due to sales of capital assets (recorded as negative investment expenditure) and to a shift towards the private financing and operation of public infrastructure investments. For the Community as a whole the government investment share fell since 1993 by 0.6 percentage points to 2.1% of GDP in 1997. However, with the successful curtailing of deficits, nine Member States (Denmark, Spain, Ireland, Luxembourg, the Netherlands, Austria, Portugal, Finland and Sweden) had government investment expenditure in 1997 greater than or equal to the government deficit (or were in surplus). Ireland and Luxembourg have been in this position throughout the period since 1994, and Denmark, the Netherlands and Portugal since 1996.

Portugal in 1996 is the only example of a Member State with a government deficit higher than 3.0% of GDP but with investment expenditure greater than the deficit. In all the other cases mentioned above the government deficit was less than 3.0% of GDP.

4.3. Sustainability of the government financial position

"Sustainability" is mentioned in Article 109j(1) of the Treaty, which specifies that the Commission has to examine whether Member States have achieved *"a high degree of sustainable convergence"* and that the convergence criterion for the public finances relates to *"the sustainability of the government financial position"*. No specific definition of "sustainability" is given in the Treaty, but Article 109j(1) specifies further that budgetary sustainability will be apparent when a Member State is not in a position of excessive deficit. Therefore, if a Member State meets the budgetary convergence criteria and is not the subject of a decision on the existence of an excessive deficit, the Treaty assumes as a matter of principle that its public finances are sustainable. Moreover, Article 104c(3) of the Treaty specifies that for the examination of the government budgetary position *"... all other relevant factors, including the medium-term economic and budgetary position of the Member State"* should be taken into account.

In assessing convergence achievements and readiness for participation in the single currency, it is of utmost importance that sound government budgetary positions shall be achieved durably and that Member States shall be in a position to ensure on a continuing basis that they *"avoid excessive government deficits"* in the third stage of EMU.

When assessing the sustainability of the public finances, the following issues must be addressed:

- The state of the public finances is influenced by the economic cycle: during recessions, the cycle exerts a negative influence on the government budget but this influence is reversed and even becomes positive during phases of economy recovery. To be sustainable, the improvement in Member States' budgetary positions should result mainly from budgetary adjustment measures and should thus be of a structural nature instead of resulting predominantly from the recovery in cyclical conditions. The influence of the cycle on budgetary positions in the Member States is explored in Section 4.3.1.

- There is concern that there may have been over-reliance on measures to reduce the deficit which are of a "one-off" nature, only reducing the deficit in a single year and not of a structural nature with lasting impact. It is essential, when one-off measures have been resorted to, that they should be replaced by measures of a more lasting nature in subsequent years. This subject is considered further in Section 4.3.2.

- There is increasing support for the view that the success of budgetary consolidation efforts is linked to their size and to the composition of the adjustment measures taken, with measures reducing current expenditure appearing to give more successful results than revenue increases or cuts in capital spending, the latter corresponding to government investment and capital transfers. Section 4.3.3 looks at the size and composition of the Member States' budgetary adjustments achieved so far.

- For 1998 and beyond, an indication of where Member States are aiming to take their public finances is given by the medium-term objectives set out in their convergence programmes. These are looked at in Section 4.3.4.

- Finally, the sustainability of public finances can also be assessed by examining the factors which determine the underlying dynamics of the path of the government debt ratio. These are: the primary balance which corresponds to the government budget balance excluding interest payments, the contribution of debt service costs and nominal GDP growth or so-called "snowball effect", and other factors which contribute to changes in the stock of government debt. Section 4.3.5 examines these elements in more detail.

4.3.1. Influence of the cycle

The state of the public finances is influenced by the cyclical position of the economy: during recessions, the cycle exerts a negative influence on the government budget and widens the deficit by depressing revenues and pushing up social expenditure. This influence is reversed and even becomes positive during phases of economic expansion. During recessions, the actual government deficit is larger than the deficit corrected for the influence of the cycle, while the reverse is true during expansions.

During most of this decade, the cycle has had an adverse impact on Member States' government deficits. During the recession of the early 1990s, the influence of the cycle on Member States' government budgets became negative. Since then, actual government deficits have been larger than the underlying cyclically adjusted deficits in most Member States. Indeed, calculations based on the Commission services' cyclical adjustment method[12] show that the actual deficit for the Community as a whole has remained larger than the cyclically adjusted deficit from 1993 onwards and is expected to remain so even in 1998 (see Table 4.4).

When the economy recovers from a recession, the negative impact of the cycle on the government budget gradually diminishes and these changing cyclical conditions therefore contribute to an improvement in the actual deficit. To be sustainable, however, the improvement of the deficit should not be predominantly the result of a recovery in the cycle but should mainly derive from budgetary adjustment measures of a structural nature.

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12 See Commission of the European Communities (1995), "Technical note: the Commission services' method for the cyclical adjustment of government budget balances", *European Economy*, No 60, November. The cyclically adjusted deficit figures published by international organisations such as the IMF and the OECD are generally lower than those calculated by the Commission services and present a more favourable picture.

Table 4.4

Influence of the cycle on government surplus / deficit

(General government net lending (+) / net borrowing (-), as % of GDP)

	1993			1994			1995			1996			1997			1998 *		
	Actual balance	Cyclical component	Cyclically adjusted balance	Actual balance	Cyclical component	Cyclically adjusted balance	Actual balance	Cyclical component	Cyclically adjusted balance	Actual balance	Cyclical component	Cyclically adjusted balance	Actual balance	Cyclical component	Cyclically adjusted balance	Actual balance	Cyclical component	Cyclically adjusted balance
B	-7.1	-1.0	-6.1	-4.9	-0.6	-4.3	-3.9	-0.6	-3.3	-3.2	-1.0	-2.2	-2.1	-0.6	-1.5	-1.7	-0.4	-1.3
DK	-2.8	-1.9	-0.9	-2.8	-0.6	-2.2	-2.4	-0.3	-2.1	-0.7	-0.2	-0.5	0.7	0.0	0.7	1.1	0.1	1.0
D	-3.2	0.0	-3.2	-2.4	0.2	-2.6	-3.3	0.0	-3.3	-3.4	-0.5	-2.9	-2.7	-0.6	-2.1	-2.5	-0.5	-2.0
EL	-13.8	-0.8	-13.0	-10.0	-0.9	-9.1	-10.3	-1.1	-9.2	-7.5	-0.9	-6.6	-4.0	-0.5	-3.5	-2.2	-0.1	-2.1
E	-6.9	-0.9	-6.0	-6.3	-1.2	-5.1	-7.3	-1.1	-6.2	-4.6	-1.3	-3.3	-2.6	-0.9	-1.7	-2.2	-0.5	-1.7
F	-5.8	-1.0	-4.8	-5.8	-0.6	-5.2	-4.9	-0.6	-4.3	-4.1	-0.8	-3.3	-3.0	-0.7	-2.3	-2.9	-0.3	-2.6
IRL	-2.7	-2.7	0.0	-1.7	-2.3	0.6	-2.2	-0.4	-1.8	-0.4	0.0	-0.4	0.9	1.0	-0.1	1.1	1.2	-0.1
I	-9.5	-1.0	-8.5	-9.2	-0.7	-8.5	-7.7	-0.1	-7.6	-6.7	-0.6	-6.1	-2.7	-0.7	-2.0	-2.5	-0.4	-2.1
L	1.7	:	:	2.8	:	:	1.9	:	:	2.5	0.0	2.5	1.7	-0.1	1.8	1.0	-0.1	1.1
NL	-3.2	-0.6	-2.6	-3.8	-0.4	-3.4	-4.0	-0.8	-3.2	-2.3	-0.6	-1.7	-1.4	-0.3	-1.1	-1.6	0.1	-1.7
A	-4.2	0.0	-4.2	-5.0	0.0	-5.0	-5.2	-0.1	-5.1	-4.0	-0.6	-3.4	-2.5	-0.5	-2.0	-2.3	-0.3	-2.0
P	-6.1	0.0	-6.1	-6.0	-0.9	-5.1	-5.7	-1.3	-4.4	-3.2	-1.0	-2.2	-2.5	-0.6	-1.9	-2.2	-0.2	-2.0
FIN	-8.0	-5.9	-2.1	-6.4	-4.2	-2.2	-4.7	-2.3	-2.4	-3.3	-1.7	-1.6	-0.9	0.3	-1.2	0.3	1.1	-0.8
S	-12.2	-4.1	-8.1	-10.3	-2.5	-7.8	-6.9	-0.5	-6.4	-3.5	-0.8	-2.7	-0.8	-0.8	0.0	0.5	-0.1	0.6
UK	-7.9	-2.0	-5.9	-6.8	-0.9	-5.9	-5.5	-0.4	-5.1	-4.8	-0.3	-4.5	-1.9	0.3	-2.2	-0.6	0.1	-0.7
EUR	-6.1	-1.0	-5.1	-5.4	-0.6	-4.8	-5.0	-0.4	-4.6	-4.2	-0.6	-3.6	-2.4	-0.5	-1.9	-1.9	-0.2	-1.7

* Spring 1998 economic forecasts

Source : Commission services

With the recovery in 1994 and 1995, cyclical conditions improved slightly in most Member States and more than half of the deficit reduction in the Community as a whole during this period originated from improving cyclical conditions. Cyclical conditions worsened again, however, during the growth pause between mid-1995 and mid-1996 and held back the reduction in government deficits which took place in almost all Member States. The actual deficit for the Community as a whole was reduced by 0.8 percentage points of GDP in 1996, whereas the improvement in the cyclically adjusted deficit was even larger and amounted to 1.0 percentage point.

With actual growth returning above its trend growth rate in 1997, cyclical conditions improved again and helped to reduce the government deficit in most Member States. The actual deficit for the Community as a whole improved by 1.8 percentage points of GDP in 1997, of which 0.1 percentage points were due to improved cyclical conditions and 1.7 percentage points to the reduction in the cyclically adjusted deficit. As actual deficits in 1997 were equal to or below the 3% of GDP threshold in all Member States except Greece, cyclically adjusted deficits were situated even lower in those countries where the cycle continued to exert a negative influence on the government deficit. The cyclically adjusted deficits in Ireland, Finland and the United Kingdom - Member States where the cycle had a positive influence on the government budget in 1997 due to vigorous economic growth - were situated above the actual budget positions but also in these countries they remained well below the 3% of GDP threshold, while in Denmark both balances were in surplus.

For most Member States, the largest part of the progress in reducing budget deficits which has been achieved over the period 1993-97 results from discretionary tightening while only a minor part can be ascribed to the cyclical upturn since 1993. Only in Ireland can the improvement in the government deficit be principally attributed to beneficial cyclical developments, while in Denmark and Finland the improvement in cyclical conditions also contributed to a large extent to the reduction in the government deficit.

Cyclically adjusted deficits are expected to stabilise or to decline slightly in most Member States in 1998 and adjustment efforts are thus not being relaxed. As economic growth is forecast to remain vigorous in 1998, cyclical conditions are expected to contribute to the further improvement in actual deficits.

4.3.2. One-off measures

In several Member States the governments have included among their adjustment measures the adoption of one-off measures with only a temporarily beneficial impact on the budgetary situation. In some cases, because of the unusual or complex nature of the transactions involved, it was necessary for Eurostat to give a ruling on whether such transactions should be accounted for as reducing the deficit (see Annex).

One-off measures only temporarily reduce the government deficit, by concentrating revenue in one year or a limited number of years only, postponing expenditure or asymmetrically recording the receipts and expenditure aspects of a budgetary operation; one-off measures thus do not generally correct underlying public finance imbalances. As they only have a temporary effect on the budget, these operations need to be replaced by measures of a more durable nature with lasting impact. When undertaken at the start of the consolidation process, however, such measures may contribute to a rapid reduction of the deficit and thereby help to reverse expectations of a further deterioration of the government's budgetary position, while during economic slowdowns they may restrain the worsening of the government deficit and thereby prevent it from getting out of hand. In general, it is common practice for government budgets to include several such measures and the magnitude of each of these measures usually remains small.

One-off operations on the revenue side include the collection in one year of receipts from the sale of buildings and intangible assets, such as for example the sale of mobile phone licences in Belgium and Austria, or receipts from temporary fiscal measures, such as the euro-tax package in Italy. On the expenditure side, they include the postponement of government investment spending or delays in payments. The exceptional payments made by *TeleDanmark* in Denmark, *France Télécom* in France, the *Postsparkasse* in Austria and the *Banco Nacional Ultramarino* in Portugal to the government are examples of measures which have a temporary positive effect on the budget at the cost of future expenditure. In return for these exceptional receipts, the governments in these Member States took over future pension payments to the employees of these enterprises. Through these operations, receipts were recorded in the government accounts in one particular year only while additional pension payments will have to be made in future years.

Even though one-off measures have made some contribution to the deficit reductions achieved since the start of the second stage of EMU and several of them were concentrated in 1997, the scale of these measures can be regarded as small relative to the overall adjustment effort. Both the Commission's forecasts for 1998 and the medium-term budgetary projections provided by the Member States in their convergence programmes indicate that governments are replacing these temporary measures by measures of a more durable nature. These budgetary projections confirm that the ongoing trend of deficit and debt reduction is planned to be continued in future years. In the detailed presentation for each Member State in Section 4.4, reference is made to the larger one-off transactions as well as to their importance relative to the total adjustment achieved.

4.3.3. Size and composition of budgetary adjustment

There is ample evidence that both the size and composition of budgetary adjustments are important in determining whether they will be successful in having a durable impact on the government's budgetary position and thus in shifting the government debt ratio onto a declining path. Large and persistent adjustment efforts tend to be more successful, and deficit reductions which take place through cuts in current primary expenditure rather than tax increases are less likely to be reversed in the future. Budgetary adjustments strongly based on cuts in current primary expenditure are often more difficult to implement and their adoption is therefore a clear sign of the government's commitment to budgetary discipline and of its determination to maintain these efforts in the future.

The scale of budgetary consolidation achieved can best be assessed by looking at the improvement in the cyclically adjusted primary balance, which corresponds to the government balance excluding interest payments and adjusted for the influence of the cycle. Unlike the overall unadjusted balance which includes interest payments on the government debt and is subject to the influence of the cycle, the cyclically adjusted primary balance is more directly controlled by the budgetary authorities. During the second stage, five Member States - Greece, Spain, Italy, Sweden and the United Kingdom - have implemented a major budgetary adjustment and achieved an improvement in their cyclically adjusted primary balance of more than 3 percentage points of trend GDP (see Table 4.5). In most other Member States, the size of the retrenchment was situated between 1.5 and 3 percentage points. Some budgetary loosening took place in Denmark and Ireland, while the Netherlands only implemented a relatively minor retrenchment, but large budgetary adjustments had already been carried out in these countries during preceding years. The size of the consolidation thus depended on the initial conditions at the start of Stage Two of EMU: countries with high public finance imbalances were obliged to implement a sharp retrenchment to meet the Treaty's budgetary criteria while less adjustment was required in countries which had already carried out a budgetary adjustment during previous years and which therefore started from a more favourable budgetary position.

Table 4.5

Composition of budgetary consolidation between 1993 and 1997
(Cyclically adjusted, as % of trend GDP)

	Change in overall balance	of which : Change in interest payments	Change in primary balance	of which : Change in revenue	Change in primary expenditure	of which : Change in current primary expenditure	Change in capital expenditure
	(1)=(3)-(2)	(2)	(3)=(4)-(5)	(4)	(5)=(6)+(7)	(6)	(7)
B	4.6	-2.6	2.0	1.2	-0.8	-0.6	-0.2
DK	1.5	-1.8	-0.3	-0.5	-0.2	0.2	-0.4
D	1.1	0.4	1.5	-1.3	-3.0	-1.6	-1.4
EL	9.2	-2.9	6.3	3.2	-3.0	0.6	-3.6
E	4.3	-0.7	3.6	-1.6	-5.2	-3.5	-1.7
F	2.4	0.3	2.7	1.4	-1.3	-0.5	-0.8
IRL	-0.1	-1.8	-1.9	-2.1	-0.2	-0.7	0.5
I	6.4	-2.6	3.8	0.5	-3.3	-1.7	-1.6
L	:	:	:	:	:	:	:
NL	1.6	-1.0	0.6	-4.2	-4.7	-4.2	-0.5
A	2.3	-0.3	2.0	0.0	-2.1	-1.3	-0.8
P	4.3	-1.9	2.4	4.6	2.2	2.8	-0.6
FIN	0.6	1.3	1.9	0.1	-1.8	-1.6	-0.2
S	7.7	0.3	8.0	2.4	-5.5	-2.9	-2.6
UK	3.4	0.8	4.2	2.3	-1.8	-0.4	-1.4
EUR	3.2	-0.4	2.8	0.0	-2.8	-1.5	-1.3

Note: The primary balance does not include interest payments. It is obtained by deducting primary expenditure from revenue. Primary expenditure can be decomposed further into current primary expenditure and capital expenditure. Due to the rounding of figures, the components may not exactly add to totals.

Source: Commission services.

Several Member States relied on revenue increases to achieve correction of their budgetary imbalances but only in Belgium, Greece, France and the United Kingdom did the increase in revenue outweigh cuts in primary expenditure. In Italy, Finland and Sweden, there was also an increase in the ratio of revenue to GDP but it was smaller than the cut in primary expenditure, while the increase in revenue in Portugal more than offset the rise in primary expenditure. There was a decline in the revenue share in Denmark, Germany, Spain, Ireland and the Netherlands.

Cuts in current primary expenditure made a significant contribution to the deficit reduction in most Member States. However, several Member States also relied on cuts in capital expenditure to bring down their deficits. In Denmark, Greece, France and the United Kingdom, reductions in capital spending were the major source of adjustment on the primary expenditure side and they were also important in Germany, Italy and Sweden.

Reduced interest payments more than outweighed improvements in the primary balance in Belgium and the Netherlands and more than offset the small deterioration of the primary balance in Denmark. Interest payments increased during the second stage in Germany, due to the take-over of unification-related debts by the government, as well as in France, Finland, Sweden and the United Kingdom. The increased interest payments in Finland and Sweden resulted from the sharp rise in government debt, which was partly due to the support to the banking sector during the severe 1991-93 recession.

The budgetary adjustments which took place in most Member States involved important reductions in current primary government expenditure. Only in a few Member States did the retrenchment occur essentially via revenue increases. There were important cuts in capital spending in several Member States but only in a few Member States were they the major source of adjustment on the expenditure side. Thus, the composition of these adjustments suggests that they were generally soundly based and therefore likely to be sustained in the future.

4.3.4. Medium-term prospects

Since 1993 Member States have been presenting at Community level convergence programmes, setting out their medium-term strategies for achieving and maintaining respect of the convergence criteria. The submission of such programmes was not compulsory but took place at the own initiative of Member States. These programmes were assessed by the Commission services and discussed in the Council. Most of the programmes have had a particular focus on the public finances, given the adjustment needed in this area. Updated programmes have been presented on an annual basis by some Member States, while new or revised programmes were also submitted to take account of the latest economic and budgetary developments and of newly introduced measures, or following the election of new governments.

Table 4.6

Convergence programme projections for government surplus/deficit

(General government net lending (+) / net borrowing (-), as % of GDP)

	Date submitted	1997	1998	1999	2000	2001
B	1/97	-2.9	-2.3	-1.7	-1.4	
DK [a]	6/97	0.7	0.7	0.9	1.1	
D [b]	1/97	-2.9	-2½	-2	-1½	
EL	7/97	-4.2	-2.4	-2.1		
E	4/97	-3.0	-2.5	-2.0	-1.6	
F	1/97	-3.0	-2.8	-2.3	-1.8	-1.4
IRL	12/97	0.4	0.3	0.7		
I	6/97	-3.0	-2.8	-2.4	-1.8	
NL	12/96	-2.2	-2¼			
A	10/97	-2.7	-2.5	-2.2	-1.9	
P	3/97	-2.9	-2.5	-2.0	-1.5	
FIN	9/97	-1.3	-0.1	0.3	1.0	1.9
S	9/97	-1.9	0.6	0.5	1.5	
UK [c]	9/97	-1.6	-0.3	-0.1/0.4	0.5/1.5	0.9/2.4

[a] Government surplus of 2.8% of GDP projected for 2005.
[b] Revised estimates submitted by the German authorities in February 1997.
[c] Financial years.

Source: National convergence programmes.

Table 4.6 shows for the most recently submitted versions of convergence programmes the objectives for the government budget balance projected for future years (in most cases up to the year 2000 or beyond). These programmes were submitted during the period from December 1996 to December 1997; the month of submission of each programme is shown in the table. Only Luxembourg has never submitted a convergence programme, its strong performance over many years in relation to convergence indicators making this unnecessary. The French convergence programme still dates from before the change in government in June 1997.

The programmes generally aim for a continuing improvement in budgetary positions in 1998 and future years based on underlying projections of vigorous economic growth and further falls in interest costs. By the year 2000, deficits less than 2% of GDP are aimed for by all the Member States that give projections that far. Indeed, by 1999 already five Member States (Denmark, Ireland, Finland, Sweden and the United Kingdom) expect their government accounts to be in surplus or balance.

Corresponding to the planned further improvement in budget balances, government debt ratios are projected to continue declining, or to start declining where they have not already done so, in all Member States during the years covered by their programmes.

While not all the measures necessary for achieving the objectives of these programmes have been introduced and in several countries more adjustment efforts will be necessary in the budgets for 1999 and later years, there is a clear commitment in all Member States to pursue policies for budgetary consolidation in the coming years. These commitments will be reinforced once the Stability and Growth Pact enters into force. Under this pact and in the framework of the stability and convergence programmes, Member States will have to pursue budgets which are "*close to balance or in surplus*" over the medium term.

4.3.5. Sustainable debt trends

The widespread progress in reducing budget deficits has allowed government debt ratios to come down in almost all Member States in 1997. The driving force behind the debt reduction for most Member States came from the combined contribution of GDP growth and deficit reductions and only in a few Member States – mainly Austria and Portugal – can the debt reduction in 1997 be attributed to a large extent to "stock-flow adjustment" measures.

The so-called "stock-flow adjustment" regroups factors, other than the government deficit, which contribute to the variation in the stock of government gross debt: included are changes in the net holdings of financial assets, changes in the value of debt denominated in foreign currency and other statistical adjustments. Whereas in earlier years these factors contributed to increasing the government debt ratio in most Member States, governments in recent years have taken measures to limit their level of government debt via a more careful management of their financial assets. Indeed, over recent years governments cut their extension of loans and accelerated the reimbursement of outstanding loans. They also reduced their liquid working balances on bank accounts and increased operations which allow for the consolidation of claims and liabilities within the government sector. In addition, important privatisation operations were launched in most Member States. Following the ESA-1979 accounting rules and Eurostat's decisions, the proceeds of these privatisation operations could not be booked as revenue influencing the government deficit but could only be used to redeem the outstanding government debt. These sales of government-owned public enterprises often also contributed to increasing the efficiency of the economic system and induced a durable reduction of government transfers to these enterprises.

Whereas over the period 1990-93, the "stock-flow adjustment" factors added more than 3 percentage points on average each year to the government debt ratio, their annual average effect over the period 1994-97 has become negligible or even negative in most Member States, except for Germany (where the large unification-related debt assumptions were regrouped in this category), Greece and Luxembourg (see Table 4.7).

Table 4.7

Factors, other than the deficit, adding to the debt stock
(Stock-flow adjustment, as % of GDP)

	1990-93 annual average	1994-97 annual average
B	1.6	-1.7
DK	5.2	-1.5
D	2.4	2.2
EL	10.2	3.0
E	2.8	0.8
F	0.6	0.4
IRL	2.0	-0.5
I	2.0	0.9
L	2.4	2.7
NL	0.2	-1.5
A	1.4	-0.5
P	2.1	-0.3
FIN	8.3	-0.9
S	5.1	-1.7
UK	0.3	-0.7
EUR a)	3.1	0.0

a) Unweighted average.

Source: Commission services.

The primary surplus which Member States have to maintain in order to put their debt ratio on a downward path increases with the level of their outstanding debt and with the speed at which the debt ratio must come down. Primary surpluses were sufficiently large in 1997 for the debt ratio to come down in most Member States, the stock-flow adjustment not being taken into account (see Table 4.8). Especially Belgium, Denmark, Greece and Italy achieved large primary surpluses while in Denmark, Greece and Ireland the primary surplus was much larger than that needed to stabilise the debt ratio. In Germany and France the primary surplus was not sufficiently large in 1997 to put the debt ratio on a declining path; the debt ratio remained below the 60% of GDP threshold in France.

Table 4.8

Sustainability of debt trends

	Government debt ratio in 1997 (as % of GDP)	Change in debt ratio 1996-97 (as % of GDP)	Actual primary balance in 1997 (as % of GDP) (1)	Debt stabilising primary balance in 1997 (as % of GDP) (2)	Debt stability gap a) in 1997 (as % of GDP) (3)=(2)-(1)	Number of years needed to bring the debt ratio below 60% of GDP b)	Year when the debt ratio falls below 60% of GDP b)
B	122.2	-4.7	5.8	2.7	-3.1	14	2011
DK	65.1	-5.5	6.5	1.9	-4.6	1	1998
D	61.3	0.8	1.1	2.1	1.0	4	2001
EL	108.7	-2.9	5.6	-1.0	-6.6	10	2007
E	68.8	-1.3	1.9	0.7	-1.2	6	2003
F	58.0	2.4	0.6	1.8	1.2	Debt<60%	Debt<60%
IRL	66.3	-6.4	5.2	-2.4	-7.6	1	1998
I	121.6	-2.4	6.8	4.5	-2.3	19	2016
L	6.7	0.1	2.1	-0.1	-2.2	Debt<60%	Debt<60%
NL	72.1	-5.0	3.9	1.3	-2.6	5	2002
A	66.1	-3.4	1.6	1.5	-0.1	7	2004
P	62.0	-3.0	1.9	0.8	-1.1	1	1998
FIN	55.8	-1.8	4.5	1.6	-2.9	Debt<60%	Debt<60%
S	76.6	-0.1	5.4	4.2	-1.2	4	2001
UK	53.4	-1.3	1.6	0.3	-1.3	Debt<60%	Debt<60%
EUR	72.1	-0.9	2.6	1.3	-1.3	7	2004

a) A negative sign means that the actual primary balance is sufficiently large to bring down the debt ratio in 1997. The stock-flow adjustment is not taken into account for these calculations.

b) The calculations have been made as follows : Spring 1998 economic forecasts for the debt ratio until 1999 and projections thereafter, fixing interest rates on government debt at a common level of 6%, inflation rates at 2%, stock-flow adjustments at zero and keeping real GDP trend growth rates and primary balances constant at the levels forecast for each Member State in 1999.

Source: Commission services.

Based on the Commission services forecasts for the debt ratio until 1999 and on mechanical projections thereafter - fixing interest rates on the government debt at a common level of 6%, inflation rates at 2%, the stock-flow adjustment at zero and keeping real GDP trend growth rates and primary balances constant at their levels forecast for 1999 - the debt trajectory for each Member State can be calculated and the year when the debt ratio is projected to fall below the 60% of GDP reference value can be determined.

It would take seven years or less to bring the debt ratio below the 60% of GDP threshold for those Member States which currently have a debt ratio in the 60% to 80% of GDP range, (see Table 4.8). For the highly-indebted Member States with a debt ratio over 100% of GDP, reducing the debt ratio to acceptable levels will obviously take much longer. The speed at which the debt ratio will decline in these countries depends on future growth performance and debt service costs – in several Member States the latter are coming down rapidly – as well as on expenditures and revenues being kept under control. However, the level of surplus on the primary balance already achieved in Belgium, Greece and Italy should ensure a steadily continuing reduction in the debt ratio. Under these conditions, the debt ratio in these countries could fall below the 60% of GDP threshold within less than 20 years (see Table 4.8). If Ireland's debt ratio falls below the reference value in 1998, as is forecast by the Commission services, it would have taken Ireland only 11 years to bring down its debt ratio from a peak of around 115% of GDP in 1987 to less than 60% in 1998. The main factors which contributed to this rapid reduction in Ireland's debt ratio were the major budgetary retrenchment which it implemented at the end of last decade and which has not been reversed since then as well as its high real GDP growth rates over the last few years.

4.4. Member States now considered ready for abrogation of excessive deficit decisions

From the information presented in the previous sections of this chapter it can be seen that the budgetary positions of the five Member States not at present the subject of an excessive deficit decision (Denmark, Ireland, Luxembourg, the Netherlands and Finland) have improved further or remained satisfactory in 1997 and are likely to do so again in 1998. There is no reason for the Commission to reopen the excessive deficit procedure for any of these five countries.

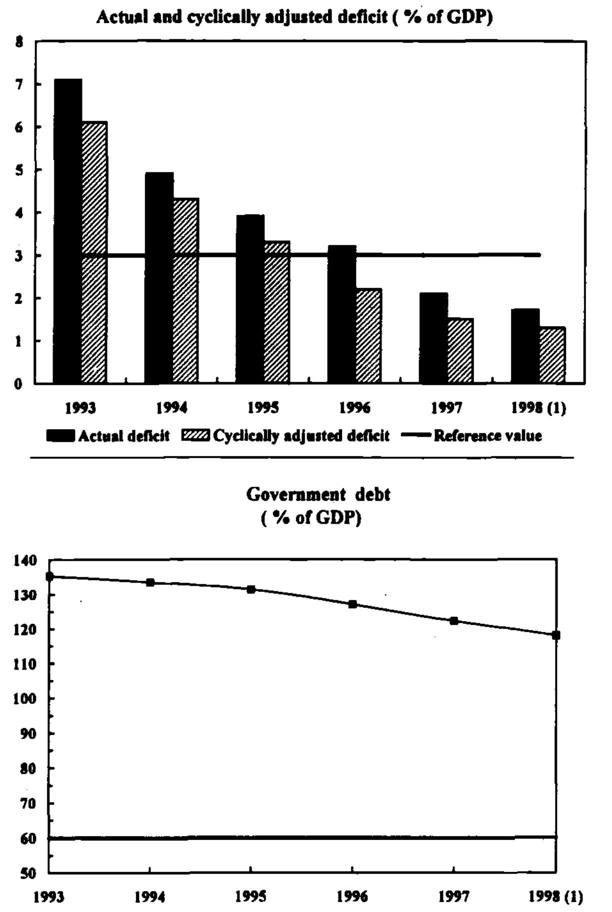
Greece has made substantial progress in reducing the large imbalances in its public finances since the early 1990s. It has reduced the government deficit from almost 14% of GDP in 1993 to 4.0% in 1997 and is expected to reach 2.2% in 1998; the high government debt ratio which had been on a strongly rising trend has been stabilised and a first reduction took place in 1997 when the debt ratio fell by 2.9 percentage points to 108.7% of GDP. However, the budgetary correction already achieved is not considered by the Commission to be sufficient for it to recommend abrogation this year of the excessive deficit decision relating to Greece.

For Belgium, Germany, Spain, France, Italy, Austria, Portugal, Sweden and the United Kingdom, which at present still are the subject of an excessive deficit decision, the Commission considers that the excessive deficit has been corrected. The Commission is therefore recommending to the Council the abrogation of the decision on the existence of an excessive deficit for these Member States. The budgetary correction achieved in each of these countries is examined in detail below.

4.4.1. Belgium

The budgetary position of Belgium was not satisfactory at the start of Stage Two. Due to adverse economic conditions and despite significant adjustment measures, the government deficit amounted to 7.1% of GDP in 1993 and the government debt ratio reached 135.2% of GDP.

Graph 4.3 Belgium : government deficit and debt



(1) Spring 1998 economic forecasts
Source: Commission services

Since 1993 and in the framework of two convergence programmes, the Belgian authorities have carried out a substantial consolidation effort in order to correct the budgetary imbalances and to prepare the country to participate in the third stage of EMU. Significant adjustment measures have been adopted since 1993, bringing down the government deficit to 2.1% of GDP in 1997. There was a continuous fall in the deficit in the intermediate years. This substantial reduction in the government deficit was due to the combined effect of high primary surpluses and of lower interest payments.

A multi-annual plan of measures was included in the 1993 budget and set a double norm of keeping primary expenditure unchanged in real terms and of stabilising revenue as a percent of GDP. New saving measures were adopted in November 1993 within the framework of the global plan for employment, competitiveness and social security. These measures included new taxes but also expenditure measures concerning the social security system, in particular the limitation of real annual growth in health care spending to 1.5%. In general, however, the budgetary consolidation effort over the years 1993-96, which was the period covered by the first convergence programme, mainly relied on raising revenues.

Further tightening measures were adopted in the 1997 budget and, combined with more favourable economic developments, brought about a reduction of the government deficit from 3.2% of GDP in 1996 to 2.1% in 1997. These measures included revenue increases but also substantial cuts in primary expenditure of the federal government and the social security system. The measures adopted in the 1997 budget are expected to yield further results in the coming years. In particular, the effects of the measures on pensions and family allowances are expected to build up over the medium term. This package of measures was aimed at increasing the primary surplus of the federal government and the social security sector combined from 5.1% of GDP in 1996 to 5.3% in 1997. As cyclical conditions continued to exert an adverse impact on the government budget, the cyclically adjusted deficit remained below the actual deficit and fell further to a low level (see Graph 4.3).

For 1998, the Commission services forecast the deficit to fall further to 1.7% of GDP. The second convergence programme, which was submitted in January 1997 and covered the period 1997-2000, projected a further reduction in the government deficit to 1.4% of GDP by the year 2000. The convergence programme retained the intermediate target of maintaining a primary surplus on the combined accounts of the federal government and social security sector of 5.3% of GDP over the projection period. Interest payments as a percent of GDP are expected to continue to fall in the coming years as a result of the effect of the current low level of interest rates combined with the further decline in the government debt ratio.

The government debt ratio fell by 13.0 percentage points from 135.2% of GDP in 1993 to 122.2% in 1997 (see Table 4.9). This outcome complied with the government's target for reducing the debt ratio by at least 10 percentage points of GDP over this period. This decline in the debt ratio is the result of a sustained policy of budgetary consolidation, which kept the primary surplus above 5% of GDP during the second stage. In the period 1996-97, financial operations aimed at reducing the government debt ratio amounted to over 4% of GDP and consisted of: first, proceeds of gold sales by the central bank ; second, increased holdings of government debt within the government sector and, third, privatisation receipts .

Over the period from 1997 to 2000, covered by the January 1997 convergence programme, the Belgian government aims for a further reduction in the government debt ratio; the decline is foreseen to lie between 6 to 10 percentage points of GDP, depending on the prevailing economic conditions. The Belgian government has recently re-confirmed its commitment, which had already been given in the 1997 convergence programme, to maintain the primary surplus of the general government at a high level of some 6% of GDP over the medium term. In addition, the Belgian government over past years has succeeded in reducing the exposure of the debt to interest and exchange rate variations and to lengthen the average maturity of the debt.

Since 1993 the government deficit in Belgium has declined substantially and continuously and in 1997 it reached a level below the 3% of GDP reference value. A further decline in the deficit is expected in 1998. The government debt ratio is still at a very high level but it has been declining every year since 1993. Provided the primary surplus remains at a high level and in view of the expected favourable growth conditions, the government debt ratio is expected to decline further in 1998 and future years. In view of these developments, the Commission considers that the excessive deficit situation has been corrected and that an excessive deficit no longer exists in Belgium. The Commission is therefore recommending to the Council the abrogation of the decision on the existence of an excessive deficit for Belgium.

Table 4.9 Belgium: government debt dynamics

(as % of GDP)

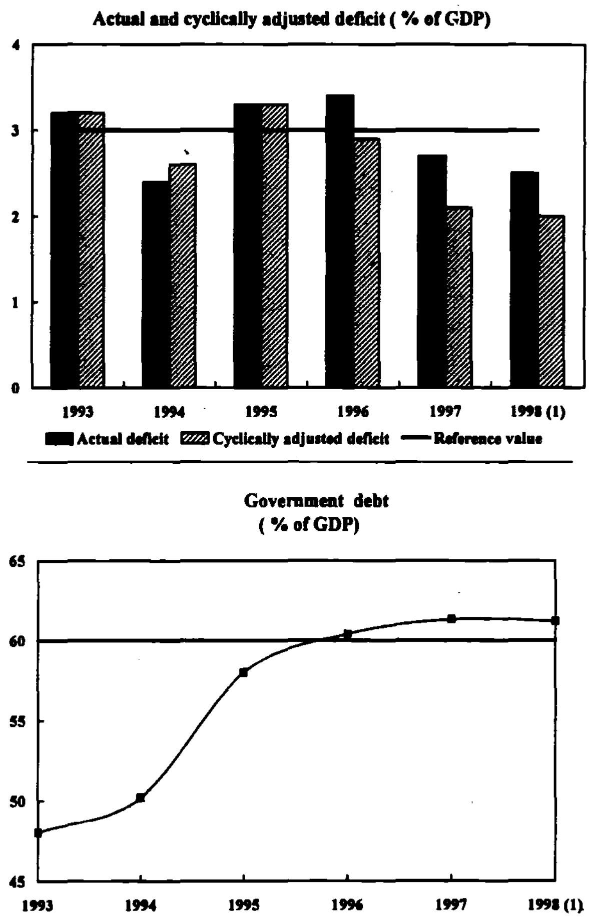
	1993	1994	1995	1996	1997	1998*
Change in debt ratio:	6.2	-1.7	-2.2	-4.3	-4.7	-4.2
- Contribution of primary balance	-3.6	-5.1	-5.1	-5.3	-5.8	-6.0
- Interest and nominal GDP growth contribution	7.4	3.9	4.1	4.6	2.7	2.7
- Stock-flow adjustment	2.3	-0.4	-1.3	-3.6	-1.5	-0.9
Government debt ratio	135.2	133.5	131.3	126.9	122.2	118.1

* Spring 1998 economic forecasts.
Source : Commission services.

4.4.2. Germany

Compared to most other Member States, Germany had a relatively favourable budgetary position at the start of Stage Two. In spite of the recession, the government deficit was only 3.2% of GDP in 1993 and budgetary performance turned out even better than expected in 1994 when the deficit dropped to 2.4% of GDP. A deterioration occurred, however, in both 1995 and 1996 with budgetary outcomes - a deficit of 3.3% of GDP in 1995 and of 3.4% in 1996 - overshooting the government's initial projections.

Graph 4.4 Germany : government deficit and debt



(1) Spring 1998 economic forecasts
Source: Commission services

Tax revenues were repeatedly overestimated in the course of 1995 and 1996, as nominal GDP growth turned out lower than expected in both years. Moreover, the frequent changes in several German tax regulations over the previous years made it more difficult to estimate tax revenue. There was an unforeseen deterioration in the social security balance in 1995, while in 1996 it was almost exclusively the increase in the federal government deficit which caused the overall general government finances to deteriorate further.

The budgetary deterioration was halted in 1997 when the deficit was brought down to 2.7% of GDP. Budgetary spending remained well under control in 1997: spending on social security, government sector employment and administrative costs practically stabilised and there were further cuts in transfers to enterprises and government investment. A budget freeze – reinforcing the control of the Finance Minister over large expenditure items – was introduced by mid-year and was tightened further at the end of the year. The sharp rise in unemployment in 1997 seemed to affect the deficit somewhat less than expected, as part of the increased unemployment resulted from a shift out of government-funded employment schemes in the new Länder. Interest payments by the special funds managing the unification-related debts - such as the *German Unity Fund* or the *Debt Redemption Fund* - also turned out lower than expected. There continued to be important unforeseen shortfalls on the revenue side, part of which, however, were due to higher-than-expected use of tax allowances by individuals and enterprises.

Cyclical conditions made a negative contribution to the government deficit during most of the period under examination. However, the marked deterioration in the 1995 deficit can only to a limited extent be attributed to worsening economic conditions (see Graph 4.4). The decrease in the government deficit between 1996 and 1997, on the other hand, was brought about by a discretionary budget tightening, as the contribution of the cycle to the budget remained virtually unchanged.

In order to bring the national accounting system in line with the ESA-1979 rules, a statistical reclassification of public hospitals outside the government sector was introduced in 1997, which entailed a downward revision of the government deficit by around 0.1 percentage points of GDP in both 1996 and 1997 and by even more in previous years.

The deficit is forecast by the Commission services to fall further to 2.5% of GDP in 1998. Transfers to enterprises and government investment are expected to remain under control, while spending on transfers to households and government consumption could pick up slightly. The VAT standard rate will be increased from 15% to 16% in April 1998, the proceeds of which will be used to cover shortfalls in the social security pension system. The effect of the reduction in the solidarity tax from 7.5% to 5.5% is expected to remain small. The cyclically adjusted deficit will continue to lie below the actual deficit in 1998.

The revised German convergence programme submitted in January 1997 projected a further gradual reduction of the government deficit over the period 1998-2000, with the deficit reaching 1½% of GDP by the year 2000. The government's budgetary strategy, as outlined in the programme, is to reduce the expenditure, tax and social security contribution ratios while simultaneously diminishing the government deficit. The aim is to reduce the expenditure ratio by the year 2000 to its pre-unification level of 46% of GDP. This should be achieved by limiting the growth rate of nominal general government expenditure to 2 percentage points below the projected annual nominal GDP growth rate.

The government debt ratio increased by more than 13 percentage points over the period 1993-97 – from 48.0% of GDP in 1993 to 61.3% of GDP in 1997. A major part of this debt increase is due to the take-over by the government of the debt of the German railways in 1994 - amounting to 2.0% of GDP - and to the assumption of the unification-related debts from the *Treuhandanstalt* and the eastern housing companies in 1995 amounting to 6.6% of GDP.

The government debt ratio rose just above the 60% of GDP reference value for the first time in 1996 and continued to increase, at a decelerating pace, in 1997. The primary surplus was not sufficiently large in 1997 for the debt ratio to be put on a downward path, even though privatisation receipts and other operations more than offset the debt-increasing effect of further debt take-overs from East German agencies – amounting to 0.3% of GDP – and the build-up of financial assets by the social security funds (see Table 4.10).

The increase of the debt ratio is expected to be reversed in 1998: the debt ratio is forecast by the Commission services to be reduced by 0.1 percentage points to 61.2% of GDP in 1998. The convergence programme submitted in January 1997 projected the government debt ratio to decline marginally but to still be slightly above the 60% of GDP threshold by the year 2000.

The exceptional event of German unification in 1990 continues to have profound effects not only on the German economy but also on the government budgetary position. Transfers of financial resources from the old to the new Länder continue to impose a heavy burden on the government budget: net transfers amounted to around 4% of GDP per year over the period 1991-97. Interest payments on the unification-related debts also had a significant negative effect on the government deficit - amounting to around 0.6% of GDP in 1997 - and, in turn, led to a higher government debt ratio than would otherwise have been the case. These budgetary costs of unification explain the government deficits which occurred during recent years. In addition, without inclusion of unification related liabilities, the German debt ratio would have remained well below the 60% of GDP reference value.

Despite the continuing heavy burden on the budget resulting from the exceptional circumstances of German unification, the government deficit in Germany was reduced in 1997 below the reference value. A further decline in the deficit is expected in 1998. The government debt ratio has been rising during the second stage and surpassed the 60% of GDP reference value in 1996. The debt ratio continued to rise in 1997 but at a decelerating pace and exceeded the 60% of GDP reference value only by a small amount. The debt ratio is forecast to decline in 1998 and is expected to return below the reference value soon. In view of these developments, the Commission considers that the excessive deficit situation has been corrected and that an excessive deficit no longer exists in Germany. The Commission is therefore recommending to the Council the abrogation of the decision on the existence of an excessive deficit for Germany.

Table 4.10 Germany: government debt dynamics
(as % of GDP)

	1993	1994	1995	1996	1997	1998*
Change in debt ratio:	3.9	2.2	7.8	2.4	0.8	-0.1
- Contribution of primary balance	-0.1	-1.0	-0.5	-0.3	-1.1	-1.2
- Interest and nominal GDP growth contribution	2.1	1.0	1.9	2.3	2.1	1.5
- Stock-flow adjustment	1.9	2.2	6.4	0.4	-0.1	-0.4
Government debt ratio	48.0	50.2	58.0	60.4	61.3	61.2

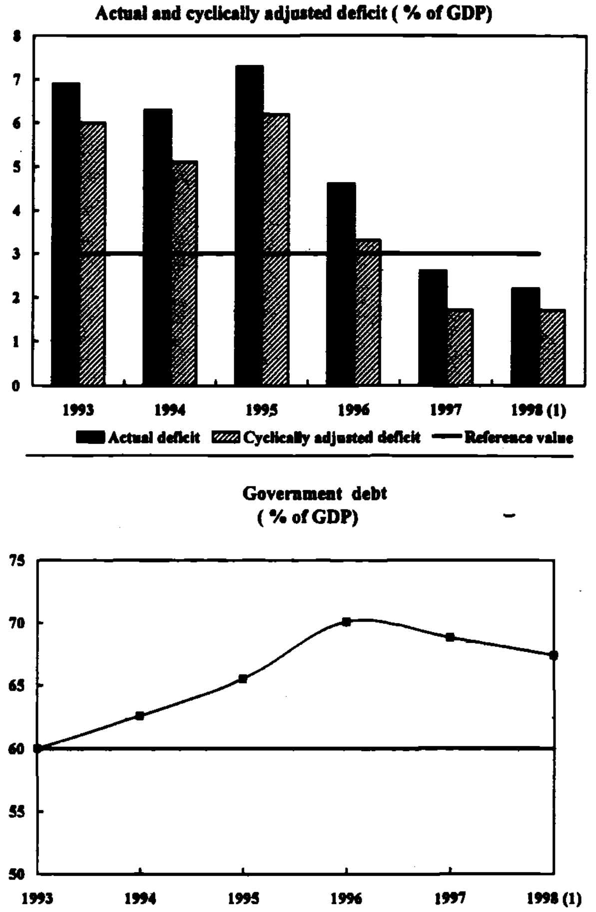
* Spring 1998 economic forecasts.
Source : Commission services.

4.4.3. Spain

The budgetary position of Spain was not satisfactory at the beginning of Stage Two. Due to the recession, the government deficit amounted to 6.9% of GDP in 1993. The deficit was cut to 6.3% of GDP in 1994 but widened again to 7.3% in 1995. Part of this increase was due to the disclosure in 1996 of a number of unregistered operations for 1995. A substantial budgetary adjustment took place in 1996 and 1997. The strongest deficit reduction occurred in 1996, bringing down the deficit to 4.6% of GDP. Budgetary adjustment continued in 1997, when the deficit was reduced to 2.6% of GDP.

The budgetary adjustment was brought about by a tightening of expenditure. The strong reduction in budgetary imbalances was in no way due to the cyclical component in 1996 and was only to a minor extent supported by the favourable development of cyclical conditions in 1997 (see Graph 4.5).

Graph 4.5 Spain : government deficit and debt



(1) Spring 1998 economic forecasts
Source: Commission services

In 1996, current government expenditure rose less than nominal GDP, due to a fall in interest payments and in current transfers to enterprises and to low growth in government consumption. Both government investment and capital transfers were cut sharply. Moreover, in 1996 revenue increased faster than nominal GDP, mainly due to higher revenues from social security contributions and a rise in excise taxes. The primary balance turned into a small surplus in 1996.

In 1997, the deficit reduction was mainly due to discretionary measures to contain expenditure, based on a freeze in civil servants' wages and on restraints in the purchases of goods and services and of capital expenditure. A significant fall in interest rates largely offset the impact on interest payments of the debt increase in 1996. Strong tax revenues, linked to strong growth, also contributed to the reduction in the deficit in 1997.

In 1998, the government deficit is forecast by the Commission services to reach 2.2% of GDP. This reduction is due to limited growth in social expenditure, in interest payments and in government consumption. Total revenue is due to grow in line with nominal GDP, partly due to an additional increase in indirect taxes, mainly excise duties. Government investment is expected to rise more rapidly than nominal GDP.

The Spanish convergence programme of April 1997 aims for the government deficit to fall further to 1.6% of GDP by the year 2000, in a context of sustained economic growth. The government is committed to reduce the expenditure-to-GDP ratio by 1.8 percentage points of GDP to 41.9% by the year 2000, while the revenue-to-GDP ratio would decrease only slightly. The reduction in government expenditure is concentrated on current expenditure - as a result of major efforts to curb government consumption but also due to the decline in debt costs -, while government investment should rise faster than nominal GDP. The reduction in the government deficit is to be shared by all levels of general government. In this context, an agreement inspired by the Stability and Growth Pact has been reached between the central government and the Autonomous Communities, setting ceilings to the budget deficits of the regional governments.

The government debt ratio increased by 10.1 percentage points from 60.0% of GDP in 1993 to 70.1% in 1996. In 1996, most of the increase in the government debt ratio was due to stock-flow adjustments (see Table 4.11). These were the result of: first, the issue of debt by the Treasury for an amount higher than strictly necessary because of portfolio reasons and in order to take advantage of the low interest rates prevailing at the end of 1996, and second, the need to fund the uncovered expenditure liabilities detected mid-1996.

In 1997, the previous upward trend in the government debt ratio was halted and the debt ratio fell by 1.3 percentage points to 68.8% of GDP. This improvement is explained by the further increase in the primary surplus and by the negative stock-flow adjustment, resulting mainly from privatisation proceeds. The reduction in the debt ratio is expected to continue in 1998, mainly owing to a further improvement in the primary surplus and strong economic growth. The reduction in the government deficit is projected in the convergence programme to lead to a steady decline in the debt ratio to approximately 65% of GDP by the year 2000.

The government deficit in Spain has declined substantially since 1995 and in 1997 it reached a level below the reference value. A further decline in the deficit is expected for 1998. The government debt ratio had been rising until 1996 and declined for the first time in 1997. However, in a context of expected strong economic growth and low interest rates, the government debt ratio is expected to remain on a downward path in the coming years. In view of these developments, the Commission considers that the excessive deficit situation has been corrected and that an excessive deficit no longer exists in Spain. The Commission is therefore recommending to the Council the abrogation of the decision on the existence of an excessive deficit for Spain.

Table 4.11 Spain: government debt dynamics

(as % of GDP)

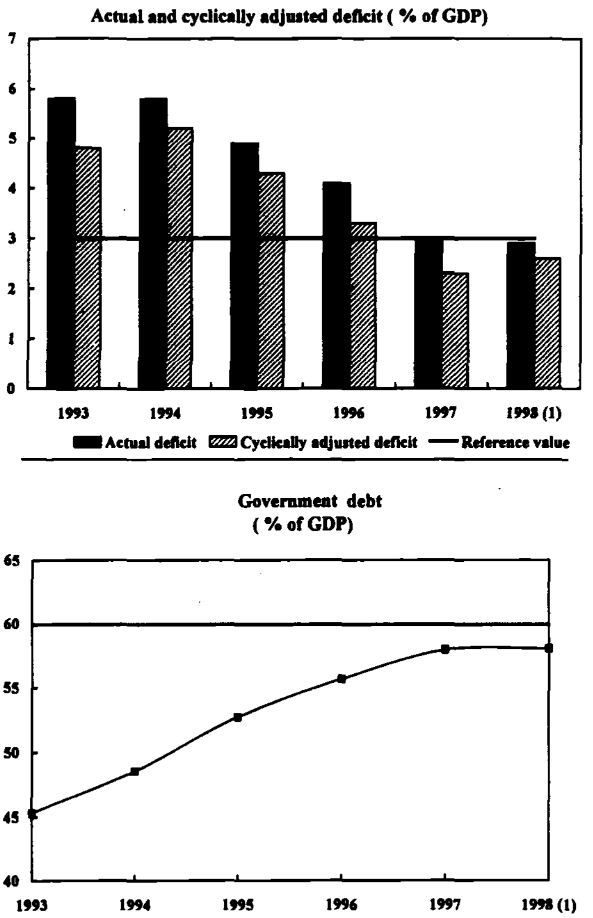
	1993	1994	1995	1996	1997	1998*
Change in debt ratio:	12.0	2.6	2.9	4.6	-1.3	-1.4
- Contribution of primary balance	1.7	1.5	1.8	-0.5	-1.9	-2.1
- Interest and nominal GDP growth contribution	3.7	1.3	1.1	1.7	0.7	0.3
- Stock-flow adjustment	6.6	-0.2	0.0	3.4	-0.1	0.4
Government debt ratio	60.0	62.6	65.5	70.1	68.8	67.4

* Spring 1998 economic forecasts.
Source : Commission services.

4.4.4. France

The budgetary position of France was unfavourable at the beginning of Stage Two. Mainly as a result of the recession, the government deficit reached a peak of 5.8% of GDP in 1993. In 1994 the government deficit remained at the same level as in the previous year, partly due to the cancellation of the debt of former colonies which increased the deficit by 0.3% of GDP. Clear progress in budgetary consolidation was made in 1995 and 1996, with the government deficit falling to 4.9% of GDP in 1995 and to 4.1% in 1996, in line with the government's objectives. The government deficit declined further in 1997 to 3.0% of GDP.

Graph 4.6 France : government deficit and debt



(1) Spring 1998 economic forecasts
Source: Commission services

The reduction in the deficit during the second stage has been largely due to discretionary measures; cyclical factors contributed little to the budgetary adjustment (see Graph 4.6). In 1994 the positive effect of the economic recovery on the deficit was offset by the impact of the measures taken to stimulate activity, in particular the reduction of income taxes and the fourfold increase in school expenses payments. However, since 1995 the reduction in the cyclically adjusted deficit has been significant. Adjustment was achieved through expenditure tightening as well as tax increases. The discretionary measures and reforms adopted since 1995 laid the foundations for gradual and lasting budgetary consolidation in subsequent years. First, the government put the emphasis on controlling government expenditure as a means of reducing the deficit and with a view to reversing the upward trend in the ratio of government expenditure to GDP; a series of measures were taken to control central government expenditure together with local government spending. Second, the government undertook a far-reaching reform of the social security system in 1996 in order to bring the social accounts back to balance on a durable basis. Measures to curb spending were complemented by tax increases in order to achieve the deficit targets. To lessen the tax burden on the economy, a reform of the personal income tax system has been initiated and the health insurance contributions of employees have been progressively reduced by shifting the financing of health care to a tax on a broader range of income.

The deficit reduction in 1997 stemmed in part from the tight control of state expenditures and measures to consolidate the social accounts. In the course of the year 1997, following the presentation of the audit of the public finances which had revealed a marked slippage in the state budget deficit, the government adopted additional adjustment measures amounting to 0.4% of GDP. These corrective measures together with expenditure containment resulted in a lower than targeted state budget deficit. Furthermore, the tight spending norm set by Parliament for health care spending growth was respected in 1997. In addition, almost half of the deficit reduction between 1996 and 1997 was due to the one-off payment by *France Télécom* to a central government fund, amounting to 0.5% of GDP.

Since 1996 some statistical changes were introduced mainly in order to bring the French accounting system in line with the ESA-1979 rules. These changes contributed to reducing the deficit by between 0.2% and 0.5% of GDP per year. They consist of changes in the booking of certain items such as *coupons courus* and linear bonds and the correct treatment of public hospital spending and subsidies to the aeronautical industry.

The government deficit is forecast by the Commission services to decline marginally to 2.9% of GDP in 1998. This implies that the one-off *France Télécom* transfer is being replaced by more durable measures in 1998. The state budget and the social security financing law for 1998 give a clear indication of the government's commitment to budgetary consolidation. The 1998 budget holds expenditure constant in real terms and includes new tax measures amounting to 0.15% of GDP. As regards the social security system, Parliament has limited the increase in health care spending to 2.2% in 1998 and the government has taken additional adjustment measures amounting to 0.2% of GDP. Furthermore the government plans to bring the social accounts back to balance in 1999 by proceeding with the implementation of the reform of the health care system introduced in 1996.

During the second stage the government debt ratio has grown at a sustained, although decelerating, pace but it has remained below the 60% of GDP reference value; it rose from 45.3% of GDP in 1993 to 58.0% in 1997 (see Table 4.12).

Since 1994 the government deficit in France has declined substantially and in 1997 it reached a level equal to the reference value. A further small decline in the deficit is expected in 1998. The government debt ratio has been rising but it remains below the 60% of GDP reference value. In view of these developments, the Commission considers that the excessive deficit situation has been corrected and that an excessive deficit no longer exists in France. The Commission is therefore recommending to the Council the abrogation of the decision on the existence of an excessive deficit for France.

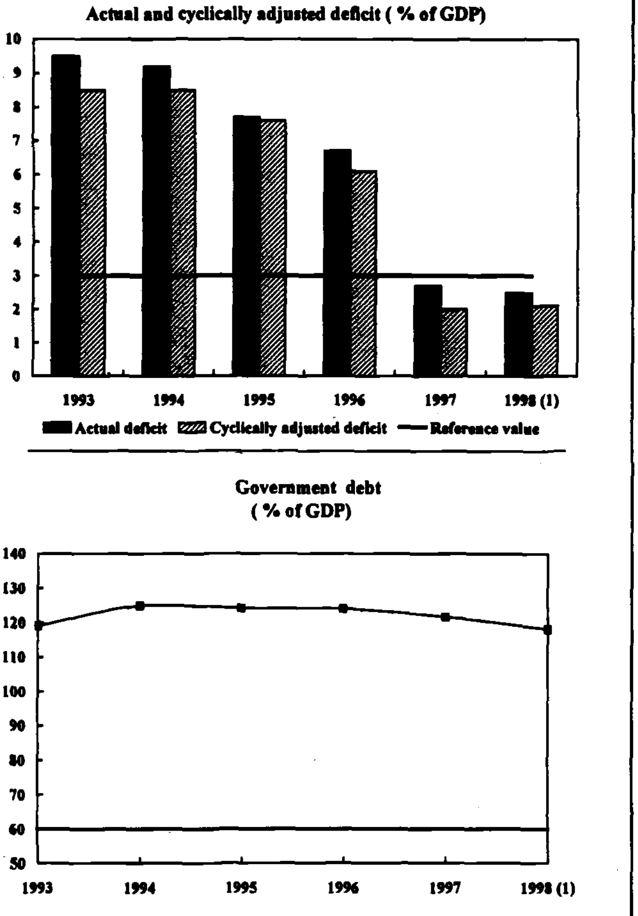
Table 4.12 France: government debt dynamics
(as % of GDP)

	1993	1994	1995	1996	1997	1998*
Change in debt ratio:	5.5	3.2	4.2	2.9	2.4	0.0
- Contribution of primary balance	2.4	2.2	1.1	0.3	-0.6	-0.7
- Interest and nominal GDP growth contribution	3.0	1.7	2.1	2.4	1.8	1.1
- Stock-flow adjustment	0.2	-0.7	1.0	0.2	1.2	-0.4
Government debt ratio	45.3	48.5	52.7	55.7	58.0	58.1

* Spring 1998 economic forecasts.
Source : Commission services.

4.4.5. Italy

Graph 4.7 Italy : government deficit and debt



(1) Spring 1998 economic forecasts
Source: Commission services

Italy entered Stage Two of EMU with an unsatisfactory budgetary position. Due to the recession and despite stern retrenchment measures, the deficit amounted to 9.5% of GDP in 1993. The surge in interest rates that accompanied the exit of the lira from the ERM in September 1992 pushed government interest payments to an unprecedented high level. The consolidation effort was relaxed in 1994 as the measures behind the sharp increase in taxation introduced in 1993 were not extended to 1994 and revenues relative to GDP fell. However, better growth conditions allowed the deficit to be reduced slightly to 9.2% of GDP in 1994.

In 1995, budgetary consolidation resumed, also assisted by vigorous economic growth, and the deficit fell to 7.7% of GDP. This decline was entirely obtained through cuts in non-interest expenditure. During the same year a far-reaching pension reform was approved, which transformed the general pension system from an earnings-based into a contribution-based scheme. The new system, however, applies fully only to new entrants into the labour market, so that its full impact will only be felt in the long term. The reduction in government debt service costs and the increase in revenues, recovering part of the decline previously recorded, played a major role in further reducing the deficit to 6.7% of GDP in 1996.

The largest budgetary consolidation effort, however, was made in 1997 when the deficit was reduced by no less than 4.0 percentage points of GDP to 2.7% of GDP. The government introduced measures to reduce tax allowances, increased social security contributions and cut current and capital transfers to enterprises. Some temporary measures – amounting to 1.1% of GDP – were also introduced. These temporary measures, such as for example the euro-tax, were mostly concentrated on the revenue side. A crucial role in accomplishing the budgetary objectives for the year was played by the strict limits which were set by the Parliament on the cash budget. This prevented budget appropriations from being transformed into liquidity available to government agencies. As a result, many government agencies ran down their outstanding liquidity reserves, which had accumulated during past years. However, the size of the unspent appropriations – the *residui passivi* – grew significantly. As these *residui passivi* can be carried over to the following budget, there is a risk that they might lead to increased expenditure in the future. As long as the Parliament continues to impose severe limits on the cash budget, this risk is limited. The Budget Law for 1998 specifies that the cash constraints which were imposed in 1997 are to be maintained for the following three years. Recent decisions already brought down the outstanding stock of *residui passivi* by 2 percentage points of GDP. In addition, the government intends to gradually phase out the outstanding stock of *residui passivi* and is currently preparing new legislation to limit the proportion of *residui passivi* that can be carried over to the following year.

Throughout the second stage, economic activity has remained below trend and the cyclically adjusted deficit was therefore consistently below the actual deficit (see Graph 4.7). As cyclical conditions continued to exert a negative influence on the government budget, the cyclically adjusted deficit in 1997 was lower than the actual deficit. The contribution of the cycle to the budgetary improvement remained modest. The reduction in the deficit ratio from 9.5% of GDP in 1993 to 2.7% in 1997 was almost entirely due to expenditure reduction. The single largest contribution to the deficit reduction was given by lower interest payments. Government consumption declined significantly while production subsidies, capital transfers to enterprises and government investment were also reduced. On the other hand, social security expenditure remained pratically unchanged and total revenues increased only slightly. As a consequence of these developments, the primary balance has been in surplus throughout the whole period and rose from 2.6% of GDP in 1993 to 6.8% of GDP in 1997.

In 1997 some statistical revisions were introduced in order to ensure the compatibility of the national accounting system with the ESA-1979 rules. These changes consisted mainly of revisions in the recording of interest payments on postal bonds and the recognition of the debt of the railways as government debt. The effect of these changes on the deficit figures for previous years ranged from increasing the deficit by 0.1 percentage points of GDP to a decrease by 0.4 percentage points of GDP.

The government deficit in 1998 is forecast by the Commission services to decline to 2.5% of GDP. Discretionary measures amounting to 1.2% of GDP have been approved for 1998, in line with the indications of the June 1997 convergence programme. The VAT rate structure has been changed, cuts in transfers to public service agencies decided and adjustments to the pension system introduced. These measures, mostly of a permanent nature, replace the one-off elements of the 1997 budget. A further considerable fall in interest payments should also take place. Two important structural reforms will be implemented in 1998: the reform of the taxation system and the reform of the state budget. Although their impact on the accounts is estimated to be neutral in 1998, the budgetary consequences in the medium term are potentially significant, as should be the favourable implications for resource allocation and the efficiency of the entire economic system. The convergence programme projects the government deficit to be reduced further to 1.8% of GDP by the year 2000. Since the adoption of the convergence programme the Italian government has announced the commitment to a further decline in the deficit towards 1% of GDP in 2001.

The government debt ratio, which was already at a very high level, continued to increase to a peak of 124.9% of GDP in 1994. Since then the debt ratio has been falling, driven by the high primary surpluses of recent years. However, the decline in the debt ratio remained small due to high debt service costs and, in most years, unfavourable growth conditions. The debt ratio started to decline in 1995, the only year with high nominal growth during this period. (see Table 4.13). The debt ratio continued to fall in 1996 when the primary surplus reached 4.1% of GDP and the stock-flow adjustment contributed to its decline. As the primary surplus reached a high level of 6.8% of GDP in 1997, the debt ratio fell further to 121.6% of GDP. In that year, the primary surplus was sufficiently large to more than offset the snowball effect. The Commission services forecast the debt ratio to fall faster to 118.1% of GDP in 1998 as the primary surplus will be kept at a high level, debt service costs are declining and economic growth is expected to recover. The June 1997 convergence programme for Italy projected the decline in the debt ratio to accelerate further in coming years. The Italian government recently announced that it intends to bring down the debt ratio by some 3 percentage points of GDP per year and that the debt ratio should be reduced below 100% of GDP by the year 2003 and renewed its commitment to maintain the primary surplus at an appropriately high level.

In the past four years, developments in government debt have also been influenced by the privatisation of state-owned enterprises. The Treasury realised privatisation receipts amounting to 0.4% of GDP in 1994, 0.5% in both 1995 and 1996 and 0.7% in 1997. In the years 1999-2001 privatisation receipts are expected to continue to lie within the range of 0.5-0.75% of GDP per year.

A far-reaching budgetary consolidation has been accomplished in Italy since 1993, in generally difficult economic conditions. The adjustment has been based on a substantial reduction in government expenditure and has led to large and rising primary surpluses. The slowing of inflation has stabilised the currency and allowed for a marked reduction in interest rates. As a result of the decline in interest rates which has occurred so far, the reduction in government debt service costs is likely to progress further in coming years. These developments, together with the increase in the average maturity of the government debt pursued in recent years, justifies the expectation that government interest payments as a percentage of GDP will not climb back to the figures observed in the recent past. Three important structural reforms were decided during the second stage of EMU: the reform of the pension system in 1995 and the reforms of the taxation system and state budget in 1997. Several important privatisation operations were also completed in the period.

Since 1993 there has been a very large and continuous reduction in the government deficit in Italy and in 1997 the deficit reached a level below the 3% of GDP reference value. A further decline in the deficit is expected in 1998. The government debt ratio is still at a very high level but it has been declining every year since 1994. The primary surplus has increased sharply in recent years and has been sufficiently large since 1995 to sustain the continuing reduction in the debt ratio. In view of expected further reductions in debt service costs, improving economic growth and provided that the primary surplus stays at a high level, the pace of the decline in the government debt ratio will accelerate in 1998 and in future years. In view of these developments, the Commission considers that the excessive deficit situation has been corrected and that an excessive deficit no longer exists in Italy. The Commission is therefore recommending to the Council the abrogation of the decision on the existence of an excessive deficit for Italy.

Table 4.13 Italy: government debt dynamics
(as % of GDP)

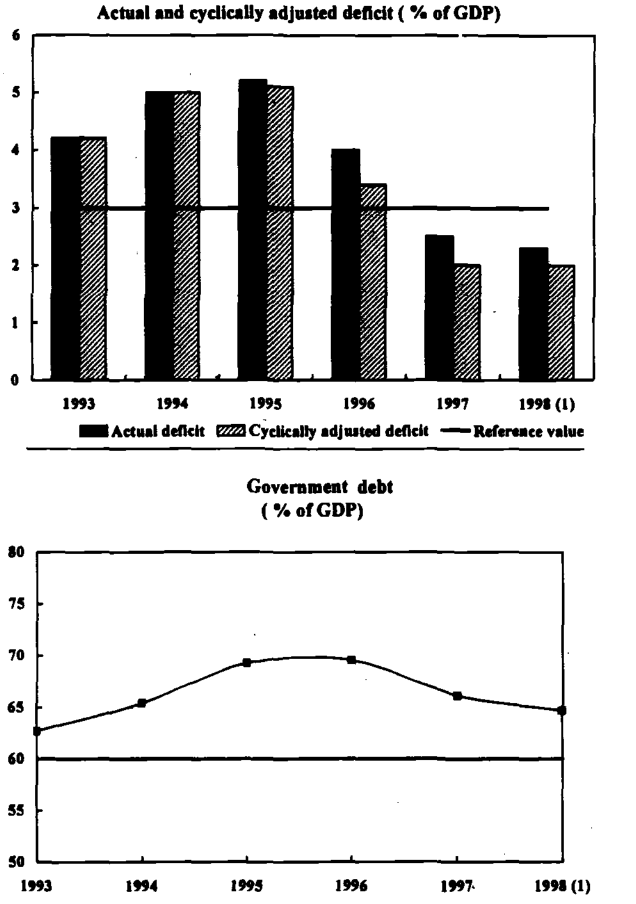
	1993	1994	1995	1996	1997	1998*
Change in debt ratio:	10.4	5.8	-0.7	-0.2	-2.4	-3.5
- Contribution of primary balance	-2.6	-1.8	-3.7	-4.1	-6.8	-5.5
- Interest and nominal GDP growth contribution	8.8	4.6	1.9	4.1	4.5	2.6
- Stock-flow adjustment	4.2	3.1	1.0	-0.2	-0.1	-0.6
Government debt ratio	119.1	124.9	124.2	124.0	121.6	118.1

* Spring 1998 economic forecasts.
Source : Commission services.

4.4.6. Austria

Austria's budgetary situation sharply deteriorated in the years preceding its membership of the European Union: between 1992 and 1994, the government deficit rose by 3.0 percentage points of GDP to 5% of GDP in 1994. This budgetary slippage was triggered by the 1993 growth slowdown and was exacerbated further by the 1994 income tax reform. When Austria joined the Union in 1995, the government deficit continued to increase slightly and reached a peak of 5.2% of GDP.

Graph 4.8 Austria : government deficit and debt



(1) Spring 1998 economic forecasts
Source : Commission services

To correct the budgetary situation, the Austrian government undertook a major consolidation effort in both the years 1996 and 1997, bringing down the government deficit to 2.5% of GDP in 1997. This budgetary retrenchment was initiated in spite of a weakening of the underlying economic conditions in 1996. However, in 1997 there was a recovery in economic growth. Given the worsening in the cyclical conditions at the beginning of the adjustment period, the improvement in the cyclically adjusted government deficit was larger than the reduction in the actual deficit (see Graph 4.8).

The measures included in the Austrian government's 1996-97 federal budget savings package - which was the framework within which the government implemented its consolidation policy - consisted, on the expenditure side, of a stricter control of unemployment benefits, a tightening and streamlining of social transfers, a reduction in the number of government sector employees and control of the government wage bill. Measures on the revenue side included the suspension of exemptions on wage and corporate taxes as well as small increases in withholding tax rates, in motor vehicle and tobacco tax rates and the introduction of a tax on electricity and gas.

The 1997 budget also included one-off measures. The sale of government buildings and of the third mobile phone licence each yielded around 0.1% of GDP. The *Postsparkasse* made a one-off payment to the government of around 0.15% of GDP, in return for which the government took over all future pension payments to employees of this public enterprise. Moreover, the improvement in the budgetary balances of the Länder in 1997 appeared to some extent to be attributable to a switch in the system for housing support from grants to loans, thereby excluding these transfers from the general government deficit. The measures envisaged in the government's 1998 federal budget as well as in its 1999 draft budget indicate, however, that the Austrian government is replacing the 1997 one-off measures by measures of a structural nature.

The Commission services forecast the government deficit in 1998 to decrease further to 2.3% of GDP. The targets set in the October 1997 updated convergence programme show small further reductions in the government deficit of 0.2 to 0.3 percentage points of GDP per year over the projection period. The programme projects that a deficit of just below 2% of GDP will be reached by the year 2000.

Due to the budgetary deterioration at the beginning of this decade, Austria's government debt ratio breached the 60% of GDP threshold in 1993 and steadily increased in the following years until it reached almost 70% of GDP in 1996. Even though the primary balance was brought into surplus in 1996 and 1997, and was only just sufficient in 1997 to put the debt ratio on a downward path (see Table 4.14). However, "stock-flow adjustment" measures amounting to around 3% of GDP also contributed to bring down the debt ratio for the first time to 66.1% of GDP in 1997. These measures included the privatisation of several government-owned enterprises as well as the reclassification outside the government sector of municipal utility agencies and of the road-financing agency *Asfinag*. Measures of the same nature are also expected to make a further contribution to the reduction in the debt ratio in 1998.

The October 1997 updated convergence programme projects the debt ratio to fall continuously to slightly below 65% of GDP by the year 2000. The programme expects economic growth and continued deficit reductions to be the main contributors to the decline in the debt ratio from 1999 onwards.

The government deficit in Austria has been reduced since 1995 and in 1997 it fell below the reference value. A further decline in the deficit is expected in 1998. The government debt ratio continued to rise until 1996 but was reduced in 1997 for the first time. Given the expected upturn in economic growth in the coming years, the budgetary situation is expected to continue to improve steadily, with the debt ratio falling gradually. In view of these developments, the Commission considers that the excessive deficit situation has been corrected and that an excessive deficit no longer exists in Austria. The Commission is therefore recommending to the Council the abrogation of the decision on the existence of an excessive deficit for Austria.

Table 4.14 Austria: government debt dynamics
(as % of GDP)

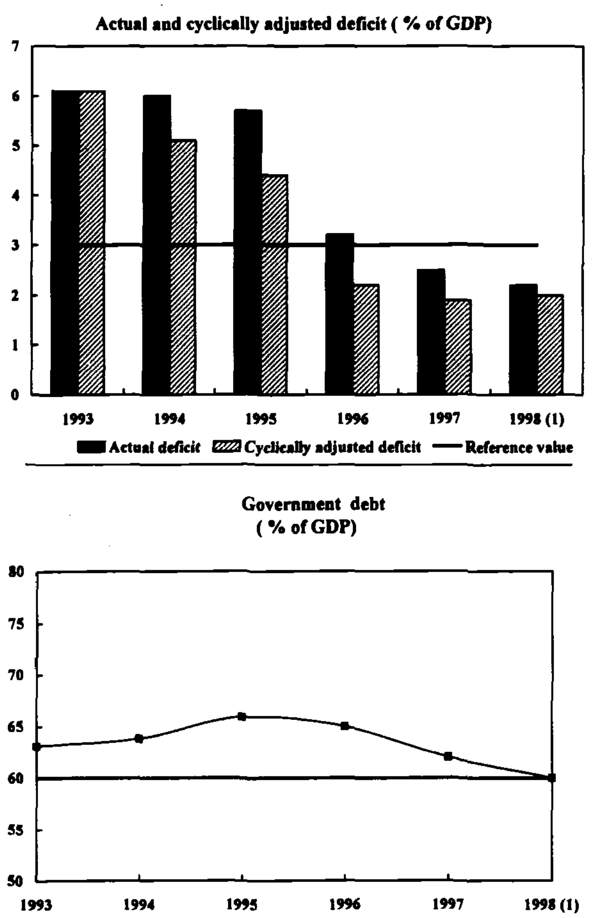
	1993	1994	1995	1996	1997	1998*
Change in debt ratio:	4.6	2.7	3.8	0.3	-3.4	-1.4
- Contribution of primary balance	-0.1	0.9	0.8	-0.4	-1.6	-1.7
- Interest and nominal GDP growth contribution	2.5	0.9	1.7	1.9	1.5	1.2
- Stock-flow adjustment	2.3	1.0	1.3	-1.2	-3.2	-1.0
Government debt ratio	62.7	65.4	69.2	69.5	66.1	64.7

* Spring 1998 economic forecasts.
Source : Commission services.

4.4.7. Portugal

Following the recession in 1993 and the slow recovery of the economy up to 1995, Portugal's government deficit reached 6.1% of GDP in 1993 and declined only slightly to 5.7% of GDP in 1995. The government deficit was brought down to 3.2% of GDP in 1996, due to the gradually improving economic conditions and the consolidation measures adopted since 1994.

Graph 4.9 Portugal : government deficit and debt



(1) Spring 1998 economic forecasts
Source: Commission services

Growth in government expenditure slowed down in 1996 and spending on government investment, the public wage bill and subsidies to enterprises remained restrained. Interest payments fell sharply in 1996, due to falling interest rates and improved debt management. The most important contribution to the marked reduction of the government deficit came, however, from a noticeable improvement in the efficiency of the collection of taxes. Measures were taken since 1994 to increase sanctions against tax evasion, to close tax loopholes, to step up the recovery of tax arrears and to implement a general overhaul of the tax administration.

A discretionary tightening already took place in 1994 and 1995 but there was only a small reduction in the actual deficit due to the worsening economic conditions during these years (see Graph 4.9). The substantial reduction in the government deficit which took place in 1996 was mainly brought about by an additional budgetary retrenchment, even though improving cyclical conditions also contributed to this result. Since 1996 government investment expenditure has been larger than the government deficit.

In 1997, the government deficit fell more than initially expected to 2.5% of GDP. The further improvement in the 1997 deficit resulted mainly from economic growth and relied less on further structural consolidation. The measures included in the 1997 budget were similar to those implemented over the past years: better debt management to bring down interest payments, control of current primary expenditure and further increases in tax receipts and social security contributions due to improved tax collection methods. The measures to speed up the recuperation of tax arrears which had been adopted during the previous year generated further significant increases in tax revenue in 1997 and government investment expenditure remained below the budgeted targets. Health expenditures, however, turned out higher than expected.

In 1997, the pension fund of the *Banco Nacional Ultramarino* made a one-off payment to the government of 0.3% of GDP, in return for which the government took over future pension payments to employees of this publicly-owned bank.

For 1998, the deficit is forecast by the Commission services to fall further to 2.2% of GDP. Tax revenues and social security contributions are expected to remain buoyant, due to the improved efficiency of the tax administration and the social security system, while interest payments are expected to be reduced further and government investment will remain restrained. The cyclically adjusted deficit is expected to remain broadly unchanged in 1998 and budgetary adjustment efforts are thus being maintained. The cyclically adjusted deficit will remain below the actual deficit.

The Portuguese convergence programme of March 1997 projects a further gradual reduction of the government deficit to 1.5% of GDP by the year 2000, in a context of continuously buoyant economic growth. Two thirds of the projected deficit reduction would come from further reductions in interest payments, while the rest would be generated by the limitation of current primary expenditure. The programme sets an explicit limit for current primary expenditure and aims for a re-orientation of government expenditure towards increased spending on social security, education and investment.

Following its sharp increase to 63.1% of GDP in 1993, the government debt ratio continued to drift upwards in 1994 and 1995, before starting to decline in 1996, when it fell for the first time to 65.0% of GDP. The debt ratio fell further by 3.0 percentage points to 62.0% of GDP in 1997, due to the combined impact of the lower government deficit, higher GDP growth and the use of substantial privatisation receipts to redeem government debt (see Table 4.15).

Part of the receipts from the privatisation of public enterprises in the telecommunications and electricity sector carried out in 1997 was used to redeem government debt for an amount of almost 4% of GDP in the same year. These debt-reducing measures were partially offset, however, by a net accumulation of financial assets by the social security sector and an increase in the national currency value of dollar-denominated outstanding debt, together amounting to around 2% of GDP. As a result, the stock-flow adjustment amounted to -1.9% of GDP in 1997.

For 1998, the Commission services forecast the government debt to fall further to 60.0% of GDP. The Portuguese government plans to realise around 2% of GDP of privatisation receipts in 1998, a large part of which will be used to further redeem the government debt.

The government deficit in Portugal has been reduced substantially and continuously since 1993 and in 1997 it fell below the reference value. In view of the sustained buoyancy of economic growth and the further decline in interest payments, the government deficit is expected to continue to decrease further in 1998. The government debt ratio has been declining since 1995 and exceeded the 60% of GDP reference value by only a small amount in 1997. The government debt ratio is expected to equal 60.0% of GDP in 1998 and then to fall below the reference value. In view of these developments, the Commission considers that the excessive deficit situation has been corrected and that an excessive deficit no longer exists in Portugal. The Commission is therefore recommending to the Council the abrogation of the decision on the existence of an excessive deficit for Portugal.

Table 4.15 Portugal: government debt dynamics
(as % of GDP)

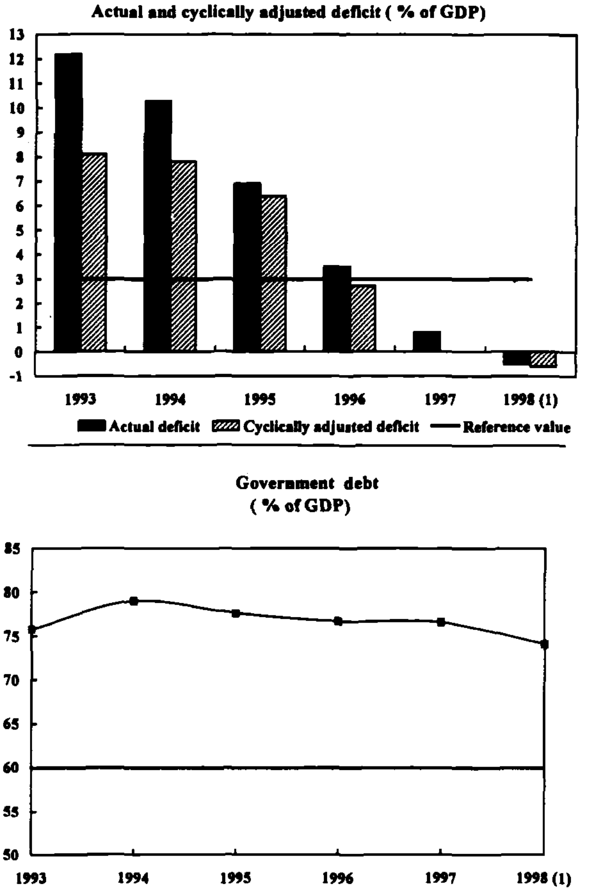
	1993	1994	1995	1996	1997	1998*
Change in debt ratio:	3.0	0.7	2.1	-0.9	-3.0	-2.0
- Contribution of primary balance	-0.1	-0.2	-0.6	-1.6	-1.9	-1.6
- Interest and nominal GDP growth contribution	2.8	1.2	1.5	1.0	0.8	-0.3
- Stock-flow adjustment	0.3	-0.3	1.1	-0.4	-1.9	-0.2
Government debt ratio	63.1	63.8	65.9	65.0	62.0	60.0

* Spring 1998 economic forecasts.
Source : Commission services.

4.4.8. Sweden

Due to the severe recession, Sweden suffered a dramatic deterioration in its budgetary situation in the early 1990s. By 1993, the government deficit had reached a peak at 12.2% of GDP. Since 1993, however, a very large and sustained adjustment has taken place. The deficit fell by around 2 percentage points to 10.3% of GDP in 1994. The improvement accelerated sharply in the next two years, 1995 and 1996, over the course of which the deficit fell by 6.8 percentage points of GDP. From 1996 the pace of deficit reduction eased but nevertheless a significant adjustment amounting to 2.7% of GDP occurred in 1997, which brought the deficit down to 0.8% of GDP.

Graph 4.10 Sweden : government deficit and debt



(1) Spring 1998 economic forecasts
Source : Commission services

The reduction in the deficit over the period 1993-1997 was due in large measure to the consolidation programme undertaken by the Swedish government which involved widespread measures on revenue and expenditure. In total, measures amounting to 7.5% of GDP were planned in the years 1994-1998 and the deficit was to be eliminated by 1998. The measures were reinforced in 1996 when it appeared that the targets might not be met, bringing the total value of proposed measures to 8% of GDP.

Over the period 1993-1996 revenues increased significantly. Apart from revenue buoyancy as the economy recovered from recession, there were increases in personal taxation, social security contributions and corporate taxes. Expenditures were cut sharply as the costs of the bank rescue measures which were implemented in the early 1990s were phased out and due to changes in social welfare provisions and cuts in government sector employment. Owing to higher than expected unemployment, however, transfers to households fell less than expected.

Deficit reduction continued in 1997 at a slower but still significant pace. However, revenue in relation to GDP stabilised as the effect of temporary and timing influences diminished while the expenditure ratio was reduced further. In response to higher than expected unemployment and given that the consolidation programme's targets were being exceeded, the government introduced measures to alleviate unemployment while still aiming for a balanced budget in 1998.

Cyclical conditions were favourable as strong growth enabled the actual deficit to fall faster than the cyclically adjusted deficit up to 1995 (see Graph 4.10). In 1996, however, as the impact of the measures in the consolidation programme gathered pace the cyclically adjusted deficit fell sharply. Discretionary measures continued to be the main factor in reducing the deficit in 1997. As economic activity remained below its trend level and continued to have a negative influence on the government budget, the cyclically adjusted balance remained below the actual deficit.

The Commission services forecast the deficit to turn into surplus in 1998. However, this includes the one-off sale of pension fund real estate, with a positive influence on the government balance of0.9 percentage points of GDP.

In 1997, the government announced new targets for the government deficit after 1998 and these were included in the September 1997 review of the convergence programme. The government will aim for a budgetary surplus of 2% of GDP over the business cycle. In addition to a balanced budget in 1998, a surplus of 0.5% and 1.5% of GDP would be aimed for in 1999 and 2000. Over the period to 2000 revenues would continue to decline relative to GDP and the entire burden of adjustment would fall on expenditures which are expected to continue to decline relative to GDP.

The government debt ratio continued to rise in the early years of the consolidation programme to reach a peak of 79.0% of GDP in 1994. Although it declined in each of the next three years, by 1997 the debt ratio had fallen only slightly by 2.4 percentage points to 76.6% of GDP. The primary deficit contributed strongly to the increase in the debt ratio in 1993 and 1994 but as the programme of consolidation measures came into effect there was a strong reversal in the primary balance which by 1997 was in surplus to the extent of 5.4% of GDP (see Table 4.16). The achievement of a small surplus in 1998 and rising surpluses in 1999 and 2000 would ensure a continued fall in the debt ratio.

Since 1993 there has been a very large and continuous reduction in the government deficit in Sweden. By 1997 the deficit was well below the 3% of GDP reference value and prospects are for a surplus in 1998. Despite the continuous decline in the deficit, the government debt ratio continued to rise to a peak in 1994 and since then the debt ratio has declined only slightly. The prospects are for a further continued reduction in the government debt ratio in coming years. In view of these developments, the Commission considers that the excessive deficit situation has been corrected and that an excessive deficit no longer exists in Sweden. The Commission is therefore recommending to the Council the abrogation of the decision on the existence of an excessive deficit for Sweden.

Table 4.16 Sweden: government debt dynamics
(as % of GDP)

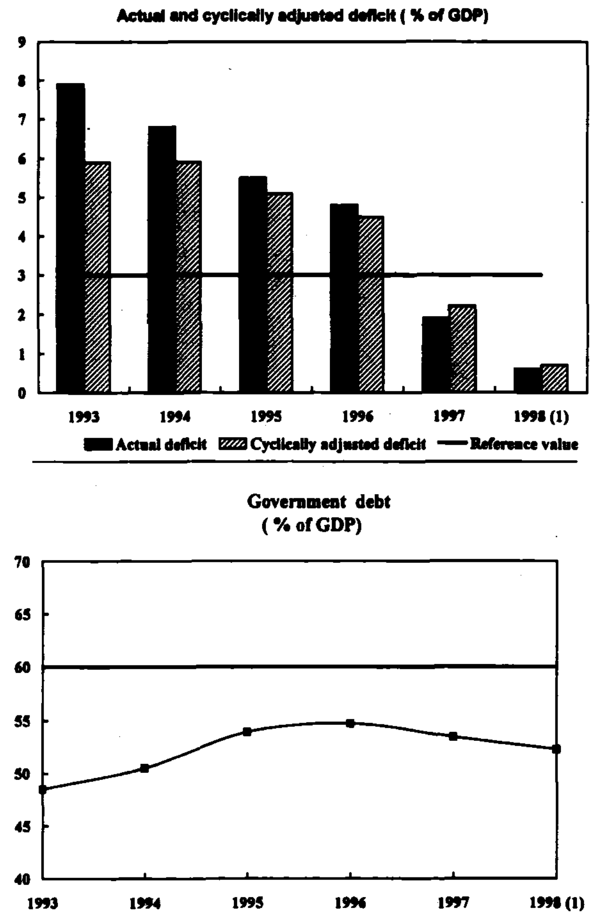
	1993	1994	1995	1996	1997	1998*
Change in debt ratio:	8.9	3.2	-1.4	-0.9	-0.1	-2.5
- Contribution of primary balance	6.1	3.5	0.5	-3.7	-5.4	-6.8
- Interest and nominal GDP growth contribution	6.0	2.5	0.7	5.3	4.2	2.9
- Stock-flow adjustment	-3.1	-2.8	-2.6	-2.5	1.1	1.4
Government debt ratio	75.8	79.0	77.6	76.7	76.6	74.1

* Spring 1998 economic forecasts.
Source : Commission services.

4.4.9. United Kingdom

Following the recession of the previous years, the government deficit peaked in 1993 at just under 8% of GDP, and since then the government deficit has been substantially reduced to 1.9% of GDP in 1997. The pace of consolidation has not been uniform; the deficit was still around 5% of GDP in 1996 and its fall in 1997 amounted to almost 3 percentage points of GDP.

Graph 4.11 United Kingdom : government deficit and debt



(1) Spring 1998 economic forecasts
Source: Commission services

The reduction in the deficit by 6 percentage points of GDP since 1993 was accompanied by a recovery in economic activity. However, most of the reduction in the deficit is attributable to discretionary measures (see Graph 4.11). The government acknowledged in 1993 that measures were required to bring the public finances back to health and successive budgets tightened budgetary policy.

In particular, in 1993 and 1994, substantial tax rises were announced, including regular increases in tobacco and fuel duties at a faster rate than inflation and a reduction of tax relief on mortgage interest payments. These were re-inforced by cuts in government expenditure.

The fall in the deficit in 1997 accounted for almost half of the budgetary adjustment observed since 1993. The decline resulted, in part, from strong economic growth in 1997, which was well above trend, but most of it, over 2 percentage points of GDP, resulted from budgetary adjustment measures. The budget of November 1996 raised taxation and constrained expenditure growth to below that of nominal GDP. The budget of mid-1997 implemented additional tax rises, including a rise in road fuel and tobacco duties above that previously announced.

Continued restraint of expenditure and the full-year effects of announced tax rises are expected to result in a further reduction in the deficit in 1998. The Commission services forecast the deficit to fall to 0.6% of GDP in 1998. Since the economy is operating near to its potential and forecast economic growth in 1998 is close to trend, the cyclically adjusted deficit is similar to the actual deficit. In 1998, the reduction in the deficit is expected to be fully achieved by discretionary adjustment measures.

The September 1997 convergence programme for the United Kingdom envisaged continued budgetary consolidation in the medium term and the budget is expected to be in balance by the turn of the century and then to move into surplus due to further control of expenditure growth and rises in excise duties.

The deficits in 1997 and 1998 are reduced by a one-off 'windfall' tax on the profits of recently privatised utilities, amounting to 0.6% of GDP in total. The revenues from this are to be spent on helping the long-term unemployed obtain work. But the bulk will not be spent until after 1998 so the deficit is aided in the short term by these measures. In the medium term this positive effect will unwind as revenues are spent.

The decline in the deficit since 1993 did not prevent a rise in the government debt ratio, which peaked at 54.7% of GDP in 1996. However, in 1997 the debt ratio fell to 53.4% of GDP when the primary balance moved into surplus and more than offset the contribution of interest charges and GDP growth (see Table 4.17). The debt ratio is expected to fall further in 1998. In the medium term, the path of the deficit in the September 1997 convergence programme results in a debt ratio that falls to around 45% of GDP or less by the end of the programme.

Since 1993 the government deficit in the United Kingdom has declined substantially and continuously and in 1997 it reached a level well below the reference value. A further decline in the deficit is expected in 1998. The government debt ratio rose in the years to 1996 but remained significantly below the 60% reference level. In 1997 the debt ratio fell slightly and it is expected to fall further in 1998. In view of these developments, the Commission considers that the excessive deficit situation has been corrected and that an excessive deficit no longer exists in the United Kingdom. The Commission is therefore recommending to the Council the abrogation of the decision on the existence of an excessive deficit for the United Kingdom.

Table 4.17 United Kingdom: government debt dynamics
(as % of GDP)

	1993	1994	1995	1996	1997	1998*
Change in debt ratio:	6.7	2.0	3.5	0.8	-1.3	-1.2
- Contribution of primary balance	5.0	3.6	2.0	1.1	-1.6	-2.8
- Interest and nominal GDP growth contribution	0.8	0.5	0.9	1.0	0.3	1.3
- Stock-flow adjustment	0.9	-2.1	0.5	-1.3	0.0	0.4
Government debt ratio	48.5	50.5	53.9	54.7	53.4	52.3

* Spring 1998 economic forecasts.
Source : Commission services.

Annex : Budgetary surveillance and comparability of figures

Budgetary surveillance at Community level requires comparable, transparent and homogenous figures from Member States to be fully efficient. Such figures are important to allow for equal treatment between Member States. The Maastricht Treaty has formalised the Commission surveillance of budgetary situations of the Member States in the framework of the excessive deficit procedure[13]. A protocol annexed to the Treaty provides the common definitions of government deficits and debt to be used in the monitoring[14]. These provisions are supplemented by a secondary legislation[15] which lays down the precise definitions and organises the provision of budgetary data to the Commission.

1. Budgetary surveillance refers to the European System of Economic Accounts (ESA)

Figures presented by governments in their budget laws follow national practices where accounting procedures, methods of compilation of data, as well as the coverage of budgets usually differ among Member States.

Therefore, to ensure comparability and usage of figures suitable for economic analysis, it has been decided to use economic accounts as the accounting framework for budgetary surveillance. More specifically, the reference is the European System of Economic Accounts (ESA)[16]. The philosophy of an economic accounting system like the ESA is to record events in a meaningful and suitable way for economic analysis, forecasting and policy making.

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13 Article 104c of the Treaty.

14 Protocol No 5 on the excessive deficit procedure annexed to the Treaty.

15 Council Regulation (EC) No 3605/93 of 22 November 1993 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community (OJ L 332, 31.12.93).

16 The ESA economic accounts system currently in operation is the European System of Integrated Economic Accounts second edition (ESA-1979). A new system (ESA-1995) will become operational in 1999 and will be applied to the excessive deficit procedure in March 2000.

The budget deficit concept retained in economic accounting is net borrowing of the general government sector. Net borrowing refers to the excess of all current and capital expenditure over the corresponding receipts and excludes all financial transactions[17]. Net borrowing must not be confused with the borrowing requirement often used as reference in budget laws, as the borrowing requirement normally includes some financial transactions and usually only covers the central government. The general government sector covers central government, local authorities and social security funds. The general government definition is not on an institutional basis but on a functional basis. Thus, only units of which the principal function is the production of non-market services or the redistribution of resources are included. Accordingly, publicly owned units dealing with commercial operations such as public enterprises are excluded.

The system presently in use (ESA-1979) only records economic flows. Since no stocks are recorded, there are no balance sheets in the system and thus no measurement of government debt. Hence, a definition of government debt had to be agreed upon. This was laid down in the Protocol on the excessive deficit procedure and specified in Council Regulation (EC) No 3605/93. The concept retained is general government gross debt at nominal value, consolidated for government liabilities held within the sub-sectors of general government. The requirements taken into account by the legislators when they decided on the debt concept were that the definition needed to be transparent, simple and quickly operational.

2. Operational procedures to ensure methodological comparability of ESA figures

Before the Maastricht Treaty, budgetary data following economic account definitions were produced mainly for the purpose of economic analysis. The figures, viewed as a complement to national budget law figures and targets, were considered useful for comparative evaluations, macroeconomic forecasting and medium-term projections. Nevertheless, the importance of economic account figures for budgetary policy purposes was limited in most Member States.

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17 A financial transaction is the sale and purchase of financial assets, such as gold, currency, deposits, loans, equity and bonds. Financial transactions must not be confused with capital transactions which cover capital formation (investment) and capital transfers (such as investment grants and capital taxes). Capital transactions influence net borrowing.

However, with the Maastricht Treaty provisions, the importance of budget figures based on economic accounts has increased substantially. National authorities not only have an increased interest to take them into consideration as early as possible in their domestic budgetary policy setting, but also Member States have to supply them to the European Commission twice a year[18].

The obligation by Member States to report ESA based budgetary figures twice a year in a timely way has put more focus on the technical aspects of the production of data. In this respect, it has been necessary to review closely the statistical quality of the figures reported to the Commission and their methodological compatibility with the accounting rules of the ESA system. This task has been performed by the Statistical Office of the European Communities (Eurostat).

Overall, the ESA system gives adequate methodological rules on the statistical treatment to be followed. Nevertheless, the need has arisen for Eurostat to complement or to make more explicit some ESA accounting rules.

Such guidance has been called for when the question arose whether a specific statistical treatment applied by a Member State was compatible with the ESA-1979 system, when there was ambiguity about the interpretation of an existing ESA-1979 rule, or when the ESA-1979 system currently in use needed further clarification given that it was initially written in the early 1970s. In these cases, the issue has been examined with Member States' national account experts and Eurostat has ultimately decided after a thorough examination of all the elements.

3. Clarification of accounting treatments has been completed

Member States and Eurostat have clarified accounting treatments and made sure that the ESA framework is correctly applied. A large number of methodological issues have been resolved and special attention has been given to areas where differing interpretations of the required accounting treatment could have had a significant quantitative impact on the size of budgetary variables. When deciding upon the most appropriate treatment in cases where the ESA-1979 accounting rules need to be made more precise, guidance has been obtained from the new ESA-1995 system and from looking at the broad rationale of economic accounts.

18 Before 1 March and 1 September, in accordance with Article 4(1) of Regulation (EC) No 3605/93.

The main accounting topics subjected to clarification can be regrouped in three broad issues: the classification of units inside or outside the general government sector, the inclusion or not in the deficit of specific types of transactions, and the time of recording of certain transactions. Each one is presented below with the most noteworthy examples.

- <u>The classification of units inside or outside the general government sector</u>
  In economic accounts, the classification of units in the institutional sectors is made on the basis of the economic function of the unit. This is the reason why the general government sector only includes units which principally produce non-market services. When a unit performs both non-market and market activities, the classification of the unit inside or outside the general government sector is decided on the basis of the dominant share in its resources between non-market and market sources. As the composition of resources may change over time, sectoral reclassifications may be necessary. Public hospitals have been reclassified into the corporate sector in *Germany* in 1997, as the main part of their resources comes from the sale of services. Similarly in *Austria* a restructuring of a public agency in charge of financing and maintaining certain roads (Asfinag) has led to its reclassification into the corporate sector and consequently to the reclassification of its debt outside general government.

  Questions were also raised concerning the classification inside or outside general government of certain pension funds in *Finland* which mostly operate on a pay-as-you-go basis but also rely to a minor extent on capital funding. The alternative was between a classification in the social security sub-sector of general government or in the insurance sector. As these pension funds were found to pay benefits without reference to individual exposure to risk, which means that these pension schemes have collective characteristics, their classification in the general government sector has been confirmed.

- <u>The inclusion or not in the deficit of specific types of transactions</u>
  Many questions have arisen about the inclusion in the deficit or exclusion from it of certain types of government transactions. The net borrowing concept retained by the Treaty excludes all financial transactions, but the financial or non-financial character of a set of complex transactions is not always clear-cut.

This is the case when the government receives proceeds from the sale by a public holding company of one of its subsidiaries (indirect privatisation). The receipt for the government could be interpreted as a financial transaction in shares and other equities or viewed as a payment of dividends which reduces the deficit. Eurostat has decided that proceeds from an indirect privatisation must be treated similarly to proceeds from direct privatisations, i.e. as financial receipts which do not influence the deficit. This rule of general application has notably been applied to the indirect privatisations of CGER in *Belgium* and Repsol in *Spain*.

A similar question was raised concerning the accounting treatment of central bank payments to the State which originate from the exceptional sale of gold and foreign exchange currencies, from the revaluation of foreign exchange reserves, and from capital gains realised by central banks on the exchange market. This issue came up in connection with the sale of monetary gold in *Belgium* and the *Netherlands*, and with plans to revalue gold and foreign exchange reserves in *Germany*. It has been ruled that payments from central banks to the State involving these assets do not influence the deficit calculation. This decision has also been applied in *Italy* to a payment made by the Ufficio Italiano dei Cambi (UIC) to the government following the sale of its monetary gold to the Banca d'Italia.

The same type of issue was raised in *France* when the government received in 1997 an exceptional payment from France Télécom in exchange for taking over the pension obligations on employees with a civil servant status. Future pension obligations on a pay-as-you-go basis are not recognised as financial liabilities in the ESA-1979 system and consequently no financial transaction can be recorded. Therefore it has been ruled that such transactions have a non-financial character and reduce the deficit. Similar types of operations were carried through in *Denmark* in 1995 and in *Portugal* and *Austria* in 1997.

In *Italy*, the 1997 budget contains a package of new taxes ("Eurotax") including an income tax surcharge. Authorities have evoked the possibility of a partial refund of this surcharge in future years. In economic terms, a link between a surcharge and a refund could be seen as a forced saving scheme. However, such broad political intentions cannot be recognised in accounting terms. There were therefore no grounds to record the surcharge receipts in a way other than a tax.

Another borderline case which needed clarification concerns the treatment of assumption or cancellation by government of public corporation debt. In fact, such operations have multiplied recently as many public enterprises have been restructured, often in relation to their privatisation. In the ESA-1979 system at present in force, there are no guidelines on how assumption of debt must be treated. Therefore it has been decided that the provisions of the new ESA-1995 system must be used. Although the general rule in ESA-1995 is that the counterpart of debt assumed or cancelled must be recorded as a transfer payment which influences the deficit, ESA-1995 allows for exceptions whereby the assumption/cancellation of debt does not influence the deficit. This is the case when a public corporation is liquidated or is subject to an on-going process of privatisation to be achieved in a short-term perspective. These ESA-1995 exceptions have been applied to *Germany* in the case of the assumption by the German government in 1995 of the debt of the Treuhandanstalt. They have also been applied to other operations of assumption/cancellation of debt by government, for example in *Ireland* (for Irish Steel), *Portugal* (for the petrochemical company CNP), and the *United Kingdom* (for British Coal).

- The time of recording of certain transactions
  It is sometimes difficult to decide on the time of recording of certain transactions, and therefore on the year of registration into the deficit. Such a problem arose in *Ireland* in 1995 in relation to a High Court decision that established a liability towards women which had accumulated since 1985. It was decided that a transfer must be recorded at the time the claim/liability is established with certainty and the exact amounts are known. The Irish transaction was therefore recorded in the year 1995. The same criteria have been applied in *Italy* to rulings by the Constitutional Court allowing to cumulate two pensions and have led to the recording of the amount of the recognised pension rights in the year 1995.

Another area which is related to the question of time of recording is the treatment of interest on specific financial instruments, including some which did not exist at the time the ESA-1979 system was completed. In the absence of precise enough guidelines, Eurostat has taken a series of decisions on how and when to record capitalised interest, interest on zero-coupon bonds, deep-discounted bonds, index-linked bonds, and linear bonds. Depending on the statistical treatment previously used in different Member States, the impact on the deficit from these decisions has varied. The impact of the decisions on government interest expenditure has been especially noticeable in *Denmark*, *Italy*, *Portugal* and *Sweden*, and most countries have been affected.

The time dimension is particularly complex in economic accounting terms in cases of large public infrastructure programmes developed with the help of the private sector. There has been a need for accounting guidelines to record such operations which are usually conducted over several years and often involve sophisticated financing schemes, like concession rights and handing over to the State of the infrastructure without simultaneous corresponding payment. The accounting decisions concern programmes in many Member States, like the construction of the bridge between *Sweden* and *Denmark*, the bridge built over the Tagus river in *Portugal*, the private finance initiatives (PFI) in *the United Kingdom* or the pre-financing of roads in *Germany* and *Spain*.

4. Conclusion

All major issues where differences in accounting treatments existed and hampered the comparability of figures have been reviewed and settled. The way has therefore been paved for Member States to report data with adequate comparability characteristics which thus allow for a proper evaluation by the Commission of the budgetary positions of the Member States.

The long tradition of national economic accounting in most Member States has permitted a smooth implementation of the technical requirements of the excessive deficit procedure since the start of the second stage of EMU, as initial differences in the interpretation and in the use of economic accounts among Member States were limited and identifiable. A dynamic process has taken place whereby the technical provisions of the excessive deficit procedure have provided a strong incentive for Member States to set their respective practices of monitoring budgetary developments and of deciding budgetary priorities into a common framework.

5. EXCHANGE RATES

5.1. Treaty provisions and application of the criterion

The third indent of Article 109j(1) of the Treaty refers to the exchange rate criterion as:

"the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State;"

Article 3 of Protocol No 6 specifies that:

"The criterion on participation in the exchange-rate mechanism of the European Monetary System referred to in the third indent of Article 109j(1) of this Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period."

Developments within the exchange-rate mechanism (ERM) subsequent to the ratification of the Treaty on European Union have made the application of the criterion more difficult. In this context, the decision in August 1993 to widen the obligatory marginal intervention thresholds or fluctuation margins around ERM central rates to a uniform 15% is particularly significant. When this decision was made, the widening of the bands was meant to be temporary. Extensive and systematic use of the wider margins was not foreseen. The intention in widening the margins was not to facilitate greater exchange rate variability but rather to counter speculation against ERM currencies. However, the absence of a formal commitment to observe the original ±2.25% margins and the presumption that the wider margins could be exploited, at least temporarily, must be taken into account when assessing fulfilment of the criterion.

For the purposes of assessing fulfilment of the criterion for each Member State currency, it is necessary to construct an operational framework which is considered to meet the technical requirements of the criterion and which reflects the underlying spirit of the Treaty. This framework should verify participation in the ERM for at least the last two years and assess exchange rate behaviour. The framework used in this report may be outlined as follows

- A verification of participation in the ERM during the two-year period before the examination. The two-year period to be considered extends from March 1996 to February 1998.

- The behaviour of a currency within the ERM is examined with respect to a chosen reference currency or benchmark[1]. The benchmark is the median currency within the ERM grid. In short, the median currency is that which has an equal number of currencies above and below it within the grid at the official ECU fixing on any given day. The use of the median currency is preferred to the alternatives (e.g. the strongest/weakest ERM currency, the ECU, the DEM) as it establishes as the benchmark the currency at the "centre" of the ERM. The median currency is conventionally used in realignments as the basis for the calculation of the new parity grid. It also allows every ERM currency to be assessed relative to a representative currency within the mechanism. In this way, it ensures neutrality in the examination by assessing the behaviour of each currency in the context of the overall functioning of the mechanism. The rationale for choosing the median-currency approach is explained in more detail in the box, while the alternatives are analysed in the Annex to this chapter.

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1 Several alternative options, each with advantages and drawbacks, could be used and some of these are discussed in the Annex.

- The exchange rate variability of a currency is measured on the basis of a ±2.25% fluctuation range around its central rate against the median currency. This range, while corresponding to the original narrow fluctuation margins of the ERM, allows for deviations greater than 2.25% against the exchange rates of the other ERM currencies[2]. The original narrow margins of the ERM were tighter in that they applied simultaneously against all currencies in the mechanism and not just against one reference currency. However, the significance of the greater exchange rate variability permitted by the median approach should be considered in the context of the widening of the fluctuation margins to ±15%. The important feature of the median currency approach is that it assesses favourably those ERM currencies which are clustered (i.e. within a range of ±2.25%) around the centre of the mechanism. A currency is deemed to have enjoyed exchange rate stability in periods when it has traded within ±2.25% of its central rate against the median currency[3]. This does not imply, however, that a larger deviation is automatically considered as indicative of severe tensions for a currency within the ERM. In assessing whether a larger deviation corresponds to severe tensions, a range of elements is taken into account. These include (i) duration and amplitude of the deviation; (ii) the nature and extent of any policy response, with particular reference to foreign exchange intervention and/or changes in short-term interest rates[4]; and (iii) whether the pressure has been towards appreciation or depreciation of the currency. Indeed, it seems appropriate to draw a distinction between tensions in respecting the upper and lower fluctuation margins which correspond, respectively, to relative strength and weakness of a currency. Given the implied linkage between severe tensions and devaluation in the wording of the Treaty, it seems reasonable to exclude movements above the 2.25% range against the median currency as a possible cause for non-fulfilment of the criterion.

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2 See box.

3 In the remainder of the chapter, and in particular in Section 5.3, all references to ±2.25% fluctuation range are made with respect to the central rate against the median currency, unless otherwise stated.

4 It should be recalled that the 1987 Basle-Nyborg agreement called for "...a more active, flexible and concerted use of the instruments available, namely exchange-rate movements within the fluctuation band, interest rates and intervention" (Press communiqué of 12 September 1987 from the Committee of Governors of EC central banks). For completeness, any episodes of intervention within the ±2.25% limits have also been examined.

Box: The median currency approach to the assessment of exchange rate stability in the ERM

The median currency approach takes the currency with the median percentage deviation from its ECU central rate as the reference currency to which all other ERM currencies are compared. As daily data are used in this report, the selection of the median currency is made on a day-by-day basis.

Each day, the currencies are ranked according to the percentage deviation of their ECU exchange rate from their ECU central parity. The median currency is selected as the currency at the mid-point in this ranking. Then, for each ERM currency, the percentage deviation of the market bilateral rate against the median currency from the central rate vis-à-vis the median currency is calculated (it will be zero for the median currency itself). These percentage deviations form the basis of the evaluation of exchange rate behaviour, which is assessed in the context of ±2.25% fluctuations around the central rate against the median currency. A breach of this range, in particular on the lower side (which corresponds to relative weakness in the ERM), is interpreted as an indication of possible tensions.

It should be noted that a fluctuation range of ±2.25% around the median currency allows for deviations greater than 2.25% against the exchange rates of the remaining ERM currencies. In the extreme case where two currencies are trading at opposite fluctuation limits against the median currency, their bilateral exchange rate would be about 4.5% from the corresponding ERM central rate.

The median currency approach offers several important advantages:

1. The approach is neutral, in that it allows all currencies in the ERM to be assessed on an equal basis and it does not prejudge the position of any individual currency or bloc of currencies in the mechanism. This would not be the case if the DEM (or any other ERM currency) were taken as the reference currency, a choice that would preclude an assessment of the behaviour of that particular currency.
2. The purpose of this examination is to express a judgement on the stability of a given currency in the context of the ERM. The chosen approach should not lead to conclusions biased by the behaviour of possible outlier currencies. In other words, the method should not consider an outlier currency as the norm and all the others as diverging currencies. In light of recent developments in the ERM, the latter would be the case if, for instance, an approach based on the comparison with the strongest currency were to be adopted.
3. Using the median currency appears most consistent with the actual working of the ERM after the introduction of the ±15% fluctuation bands in 1993. A review of recent developments in the ERM shows that in the presence of a significant appreciation of the Irish punt, monetary authorities in other ERM countries did not feel obliged to take offsetting policy action, as long as stability with respect to a large number of currencies was ensured. Again, this consideration argues against an approach based on the strongest currency in the ERM grid.
4. Reference to the ECU basket appears equally inappropriate, given that its value is significantly affected by movements in exchange rates of non-ERM currencies, in particular sterling.
5. The approach maintains coherence with the realignment procedure which has traditionally used the least divergent currency in the system as a numéraire for its calculations.

5.2. Exchange rate behaviour of Member State currencies

5.2.1. Overall conditions in the EMS

Conditions in the EMS have been generally quite stable in the period from March 1996 to February 1998. The majority of Community currencies have traded in narrow ranges against each other. The more notable exceptions have been the pound sterling and the Irish punt, both of which have appreciated sharply against the other EMS currencies in the same period. Within the EMS, ten currencies have participated in the ERM for at least two years. These are the Belgian franc/Luxembourg franc (BEF/LUF), the Danish krone (DKK), the German mark (DEM), the Spanish peseta (ESP), the French franc (FRF), the Irish punt (IEP), the Dutch guilder (NLG), the Austrian schilling (ATS) and the Portuguese escudo (PTE). The Finnish markka (FIM) entered the ERM in October 1996, while the Italian lira (ITL) re-entered the mechanism in November 1996. The Greek drachma (GRD), the Swedish krona (SEK) and the pound sterling (GBP) did not participate in the ERM during the review period, although the GRD entered the mechanism in March 1998.

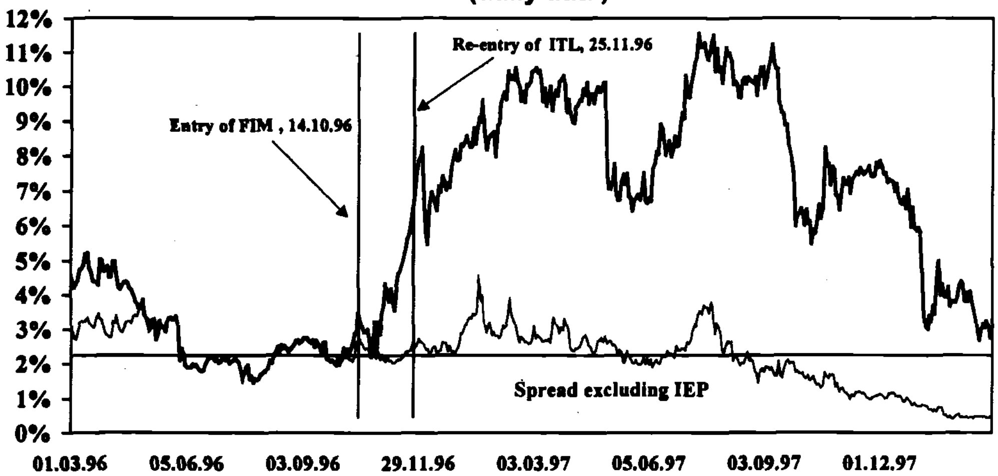
Two main developments since March 1996 have fostered a generally smooth functioning of the ERM, as reflected in exchange rate stability and a simultaneous downward convergence in interest rates among the participating Member States. These are:

- Growing market expectations of a timely launch of EMU with a large participation of Member States. These expectations have reflected (i) the achievements of the Member States in controlling inflation and redressing budgetary imbalances, (ii) the steady progress in legal, technical, and institutional preparations and (iii) the strength of political commitment to EMU in the Member States;

- There has been a substantial appreciation of the USD. Demand for the USD has been largely underpinned by the relative strength of the US economy as mirrored in differentials between Community and US interest rates. A strong USD tends to foster stability in the ERM because it is normally accompanied by a strengthening of other currencies against the DEM within the mechanism. Over the last two years, the USD gained 23% against the DEM, while the DEM declined by 3% in (nominal) effective terms against the other ERM currencies.

The stability of the ERM in the review period meant that there were no realignments of ERM central rates and that the vast majority of participating currencies were clustered around their central rates. The only notable exception was the IEP, which traded well above its central rate for most of the review period and was revalued by 3% against the other ERM currencies in March 1998 i.e. after the close of the review period. Overall conditions in the ERM can be assessed by examining the spread between the strongest and the weakest currency in the grid as illustrated in Graph 5.1 [5]. This spread indicates the extent to which currencies have exploited the ±15% fluctuation margins. Between April and November 1996, the spread remained well below 5%. The spread increased substantially from November 1996 reaching a high of 11.5% in July 1997 [6]. Since then, the spread has narrowed markedly and was below 3% by end-February.

Graph 5.1 ERM spread, with and without the IEP *
(daily data)



*** ITL and FIM included in the calculation only for the period of their participation in the ERM.**
Source **: Commission services**

Graph 5.1 also illustrates how the ERM spread is smaller when the IEP is excluded from the calculation. Excluding the IEP, the spread indicates that for a substantial part of the period under review one or more ERM bilateral exchange rates have deviated by more than 2.25% from the corresponding central rates. There have been three identifiable periods when the spread has tended to widen. The first period was the second quarter of 1996 when the ESP moved to the top of the grid and the spread peaked at 3.6%. The other periods were January 1997 and July 1997 when the FIM strengthened sharply within the grid and the spread peaked at 4.6% and 3.7% respectively.[7] The last period represented a temporary reversal of a steadily narrowing trend in the spread. The narrowing trend resumed subsequently and the spread (excluding the IEP) was below 1% at end-February 1998.

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5 The ERM spread discussed here does not take into account the FIM and the ITL in the period preceding their participation in the mechanism.

6 This figure relates to the maximum deviation of the IEP/FRF market rate from the corresponding central rate. The maximum deviation of the FRF/IEP market rate from the corresponding central rate was above 13%.

7 In both of these periods, the FRF was at the bottom of the grid. However, the width of the spread was attributable to the strength of the FIM rather than to the weakness of the FRF, which at the time was close to its central parity against the median currency.

5.2.2. Developments in the ERM currencies

Table 5.1 presents summary statistics on the general behaviour of each ERM currency with reference to the median currency in the two-year period to end-February 1998. Graph 5.2 shows the percentage deviation of each ERM currency from its central rate against the median currency in the same period. In the case of the FIM and ITL, the sub-period preceding their ERM participation is assessed with reference to their current ERM central rates (while taking into account the absence of a formal commitment by the national authorities to target their exchange rates). This allows all the ERM currencies to be assessed on a comparable basis.

The evidence indicates that a group of six currencies, comprising the BEF/LUF, the DKK, the DEM, the NLG and the ATS, have experienced low and diminishing volatility in the review period. This group of currencies has traded almost continuously within ±1% of their central parity against the median currency in the grid with none exceeding the ±2.25% range at any time. Indeed, one of these currencies has been the median currency during almost the entire period. The stability of exchange rates between these currencies has been reflected in very narrow differentials between both their short-term and their long-term interest rates. At end-February 1998, the DKK was the median currency in the grid, while the other five currencies in the group were within 0.1% of their central rates against the DKK.

Table 5.1

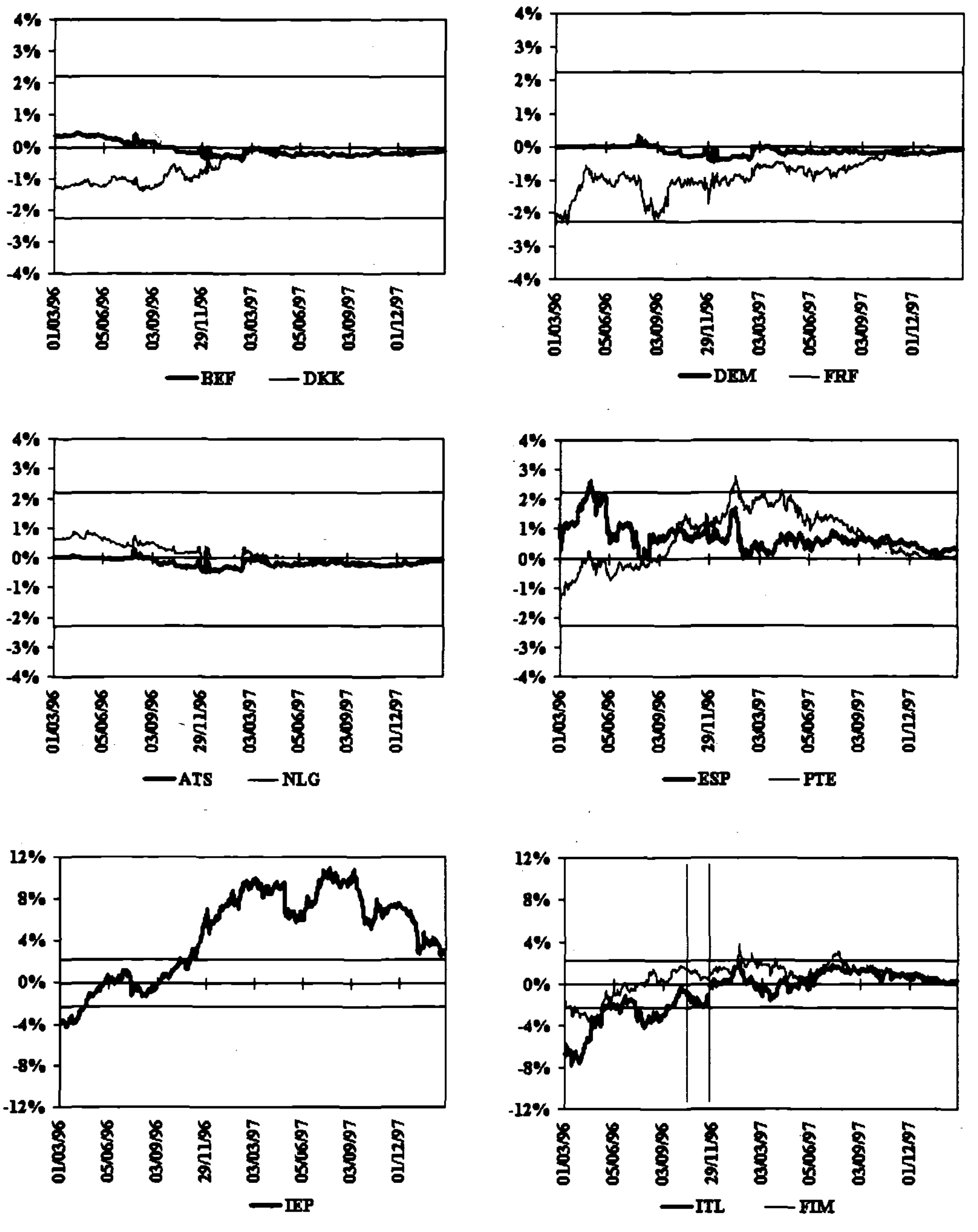
Spread against median currency
(March 1996 –February 1998, daily data)

	Average (%)	Average of absolute values (%)	Maximum (%)	Minimum (%)	Standard deviation	Days < -2.25%	
						Number	As % of trading days
BEF/LUF	-0.08	0.22	0.44	-0.44	0.23	0	0
DKK	-0.46	0.47	0.04	-1.41	0.52	0	0
DEM	-0.13	0.14	0.34	-0.46	0.12	0	0
ESP	0.71	0.71	2.61	0.00	0.47	0	0
FRF	-0.81	0.81	0.05	-2.35	0.56	2	0
IEP	4.56	5.21	10.91	-4.24	4.17	32	6
ITL [a)]	-0.77	1.57	1.84	-7.82	2.13	96	19
NLG	0.15	0.25	0.93	-0.30	0.32	0	0
ATS	-0.15	0.16	0.31	-0.47	0.13	0	0
PTE	0.67	0.86	2.76	-1.36	0.88	0	0
FIM [a)]	0.54	1.26	3.74	-4.21	1.44	39	8

[a)] Figures for ITL and FIM are calculated as if they had participated in the ERM for the whole examination period at their present central parities. All days that ITL and FIM were below -2.25% occurred before participation in the ERM.

Source: Commission services.

Graph 5.2
Spread from the central rate against the median currency in the ERM
(daily data)



Note:
The two straight vertical lines in the bottom right chart indicate the entry of the FIM in the ERM on 14.10.96 and the re-entry of the ITL on 25.11.96 respectively. In the period preceding participation, FIM and ITL are assessed with reference with their present ERM central rates.However, these two currencies have not been taken into account in the selection of the reference currency in that period.
A +/- 2.25% band around the central rate is also indicated in all cases.

Source: **Commission services**

At the beginning of the review period, the FRF came under some selling pressure related to the weakness of the economy and in the aftermath of work stoppages in the public sector. The FRF fell more than 2.25% below its central parity against the median currency for two days. However, evidence of economic recovery supported demand for the FRF from March 1996 onward and the French currency has traded less than 1% below its central rate throughout most of the review period. In August 1996, the FRF fell close to -2.25% against the median currency as political uncertainty interacted with thin trading volumes to exaggerate movements in the exchange rate. A trend decline in French short-term interest rates was temporarily interrupted and the Banque de France intervened in support of the currency. Selling pressure on the FRF was short-lived and since then the currency has been stable within the grid. The FRF traded below its central parity against the median currency for almost the entire review period but had practically converged on its central parity by end-February 1998, having been the median currency for a short period in December 1997.

The ESP has been above its central parity against the median currency throughout the review period. In April 1996, the ESP was more than 2.25% stronger than the median currency. The appreciation in the ESP reflected heavy capital inflows to Spain as investors were attracted by improved economic fundamentals and a significant interest rate differential relative to other Member States. In January 1997, the ESP again strengthened rapidly within the grid and the Banco de España intervened to contain the pace of appreciation. By end-February 1998, however, the ESP was within 0.3% of its central rate against the median currency. The stability of the peseta supported the narrowing of long and short-term interest rate differentials between Spain and lower-yielding Member States.

The PTE was never more than 2.25% below its central parity against the median currency in the review period and was continuously above its central rate against the median currency from September 1996 to the end of the examination period. In January 1997, the PTE exceeded +2.25% against the median currency amid a sharp appreciation which was successfully contained by intervention from the Banco de Portugal. Thereafter, the deviation of the PTE from its central rate against the median currency has progressively narrowed and was close to zero by end-February 1998. As in the case of Spain, the stability of the exchange rate has favoured the convergence of Portuguese interest rates towards rates in the lower yielding Member States.

The IEP has made greater use of its fluctuation margins than any other ERM currency in the two years under review. The average deviation in the IEP from its central rate against the median currency was exceptionally high at 4.6% when compared to the other ERM currencies. The IEP was more than 2.25% below its central rate against the median currency for the first 32 days of the review period but appreciated sharply within the ERM between April and November 1996. This trend brought the Irish currency from the bottom to the top of the grid - where it has remained until the end of the examination period - and mirrored a corresponding strengthening in the GBP. The IEP was strong within the grid throughout most of 1997 and its deviation from its central rate against the median currency reached a peak of almost 11%. Amid receding market expectations of a revaluation of its ERM central rate ahead of the decision on participation in EMU, the IEP began to ease towards the end of 1997. Early in 1998, the Irish currency depreciated sharply and was within 3% of its central rate against the median currency by end-February. The IEP was revalued by 3% against the other ERM currencies in March 1998, i.e. after the close of the review period.

The evidence clearly indicates that the variability of the IEP exchange rate has been relatively high in the review period. For most of the period, the IEP was trading outside of a ±2.25% range against the median currency. The main deviation in the IEP against the median currency has been on the positive side, reflecting the relative strength of the currency. As already indicated, the strength of the IEP was attributable to the tendency for the Irish currency to move in phase with the GBP but also to the buoyancy of the Irish economy. The GBP moved sharply higher against the other Community currencies in the period and pulled up the IEP, although the degree of correlation between movements in the two currencies became progressively less strong. Meanwhile, Ireland has enjoyed very high economic growth combined with low inflation and sustained budgetary consolidation.

The ITL has participated in the ERM from 25 November 1996 onward, i.e. for longer than 15 months by end-February 1998. Having depreciated very substantially in 1992/93 after the exit from the ERM and again in the first quarter of 1995, the ITL then experienced an extended appreciation against the other ERM currencies. In March 1996, the ITL reached a low of about 8% below its future central rate against the median currency but by mid-May the deviation had narrowed to 2%. In July and August 1996, the deviation widened again to a peak of 3.4% and the ITL remained more than 2.25% below its future central rate against the median currency for about one month. The temporary weakness of the ITL was linked to a corresponding movement in the USD and brought about a pause in the declining trend in Italian short-term and long-term interest rates. Subsequently, the ITL resumed an appreciating trend without interest rate support or significant foreign exchange intervention[8]. The ITL was more than 2.25% below its central parity against the median currency for a total of 96 days in the review period. However, since re-entering the ERM, the ITL has been within ±2.25% of its central rate against the median currency and was only 0.4% above it by end-February 1998.

The FIM has participated in the ERM from 14 October 1996 onward, i.e. for more than 16 months by end-February 1998. The FIM depreciated in the early part of the period, mainly due to uncertain growth prospects in the Finnish economy. From May 1996, however, an improvement in economic fundamentals resulted in a sharp reversal in trend and the markka moved from about 4.2% to 1.7% below its future central rate against the median currency between May and October 1996[9]. This appreciation occurred in the context of an easing of monetary policy, as very low inflation rates allowed the Suomen Pankki to lower interest rates significantly in the course of 1996. The FIM was more than 2.25% below its central parity against the median currency for a total of 39 days in the review period. However, since entering the ERM, the FIM has always been stronger than its central rate against the median currency and has been more than 2.25% above its central rate against the median currency on two occasions. The deviation from its central rate reached 3.7% in January 1997 when the FIM became the second strongest currency in the ERM amid a generalised appreciation of the Nordic currencies. The strength of the FIM reflected favourable growth prospects in the Finnish economy and the central bank intervened to limit the appreciation in the currency. The FIM again moved more than 2.25% above its central rate against the median currency in August 1997, when markets were speculating that the currency would be revalued. On this occasion, the central bank did not intervene. The FIM had converged to its central rate by end-February 1998.

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8 During the first half of 1996 the Banca d'Italia operated in the foreign exchange market so as to limit the volatility of the lira during the phase of appreciation and to enlarge substantially its holdings of foreign exchange reserves. In July and August 1996, the central bank supported the lira by simply suspending this kind of "smoothing" intervention.

9 When Finland joined the ERM in October 1996 the current market rate against the ECU was about 1% above the central rate.

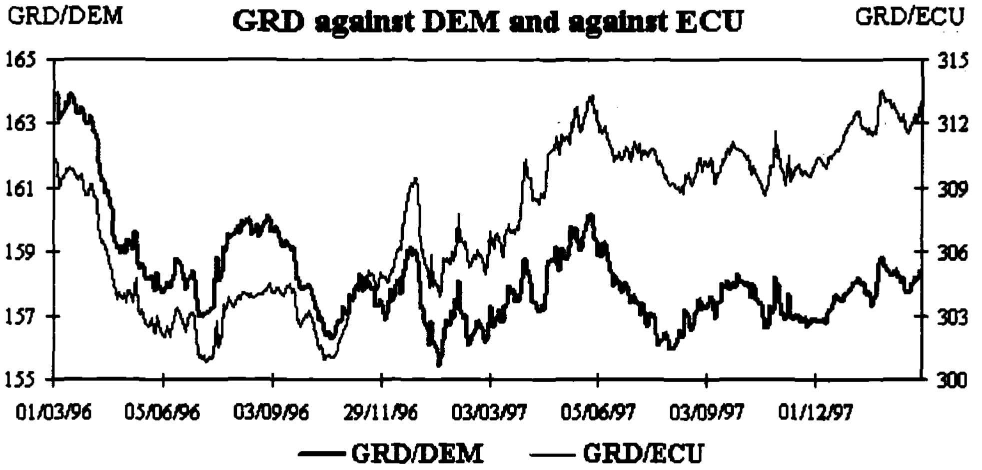
5.2.3. Non-ERM currencies

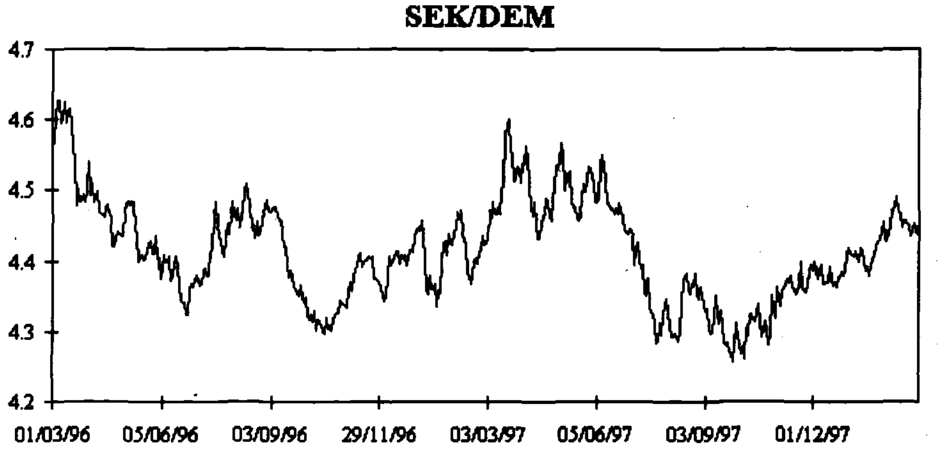
The GRD, the SEK and the GBP did not participate in the ERM during the review period March 1996-February 1998, although the GRD entered the mechanism in March 1998. In the absence of ERM central rates, it was not technically possible to assess their exchange rate behaviour on the same basis as the ERM currencies. Moreover, it seems appropriate that the exchange rate behaviour of these currencies should be assessed in the context of the monetary policy strategies pursued by their respective authorities. The authorities in the United Kingdom and Sweden pursue direct inflation targets and have floating exchange rates, while in Greece exchange rate stability against the ECU has been an integral part of the official anti-inflation strategy. Developments in the exchange rates of these currencies are described making reference to the DEM in Graph 5.3 and to their nominal effective exchange rates in Graph 5.4. In addition, for the GRD, exchange rate behaviour against the ECU is presented in Graph 5.3.

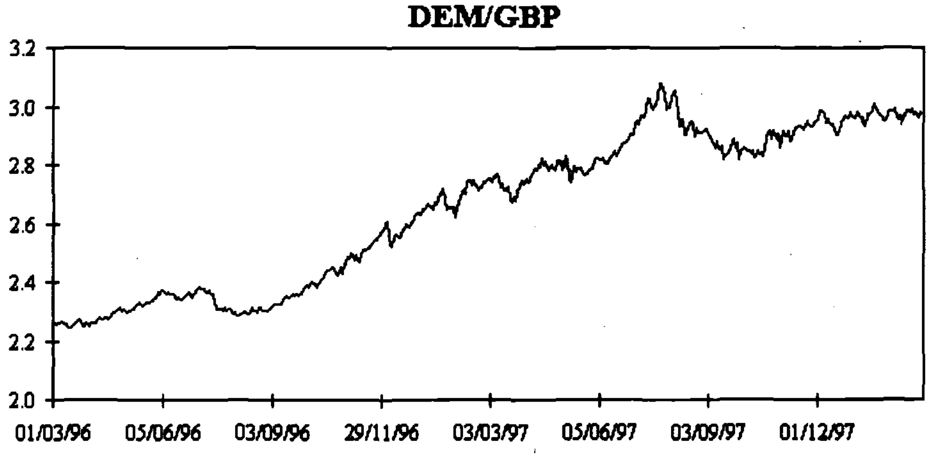
The GRD appreciated against both the DEM and the ECU in the first part of the review period. Since the second quarter of 1996, the GRD traded within a range of 155-160 per DEM. Against the ECU, the drachma drifted lower in the first half of 1997. In nominal effective terms, the GRD was relatively stable throughout the period. The firm commitment, as expressed by the Greek authorities, to participate in EMU and progress in lowering inflation and government deficits has promoted exchange rate stability. However, the GRD experienced considerable selling pressure in October 1997, as financial disturbances spread from emerging markets in Asia. The GRD was defended successfully by temporary interest rate increases and foreign exchange intervention. In March 1998, the GRD entered the ERM at a central rate of 357 per ECU, substantially below the market rate prevailing at the time.

The nominal effective exchange rate of the SEK rose by about 5% between March and October 1996 but fell back in the period to June 1997 on deteriorating growth prospects in the Swedish economy and monetary easing by the Riksbank. The SEK/DEM exchange rate followed a similar trend but with larger amplitude. The trend was reversed again from June 1997, when the SEK began to appreciate on an improved outlook for the Swedish economy. In nominal effective terms, the krona was back to its March 1996 level by the fourth quarter of 1997 and reached a high of 4.25 per DEM in October 1997. By end-February 1998, the SEK was trading at 4.42 per DEM.

Graph 5.3
Non-ERM currencies: exchange rate against the DEM and (for the GRD only) against the ECU
(daily data)



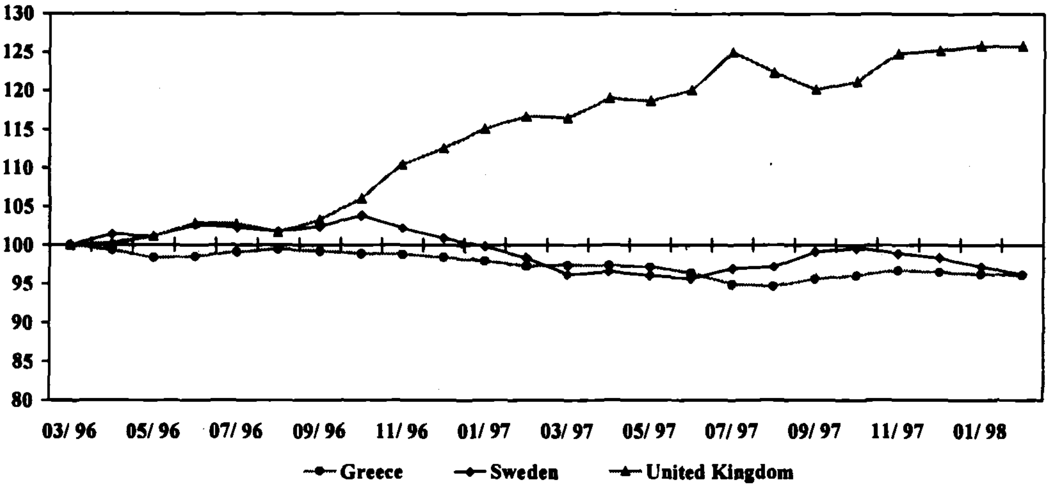




Source : Commission services

Graph 5.4

Nominal effective exchange rates for Greece , Sweden and the United Kingdom (against 23 industrialised countries ;monthly data ; March 1996=100)



Source : Commission services

The GBP appreciated very substantially in the review period. The strengthening of the GBP was a consequence of the advanced cyclical position of the United Kingdom economy relative to most of the other Community economies and accordingly the expectation of higher interest rates. The appreciation was most pronounced in the period from August 1996 to July 1997, when the GBP rose by 25% in nominal effective terms. In the same period, the GBP made even larger gains against the DEM (38%) and other Community currencies. Demand for the GBP was fuelled by a monetary tightening by the Bank of England as inflationary pressures began to emerge and by traditional spillover effects from the rising USD. Already in 1996, accelerating growth in the UK economy provoked market speculation about monetary policy tightening, implying a widening of the already positive differential between United Kingdom and German interest rates. Indeed, the Bank of England increased its official interest rate to 7.25% in six steps during the examination period. The GBP exchange rate was further supported by EMU-related developments as portfolio diversification ahead of EMU has tended to boost investment in GBP-denominated assets. However, there was a short period of selling pressure on the GBP in September/October 1997 amid speculation about early EMU participation for the United Kingdom with an entry rate below the prevailing market rate. Expectations of a monetary tightening in Germany resulted in some weakening of the GBP in the second half of 1997 but it had returned towards 3.0 DEM by end-February 1998.

5.3. Assessment of exchange rate stability in the terms of the Treaty criterion

Ten currencies - the BEF/LUF, the DKK, the DEM, the ESP, the FRF, the IEP, the NLG, the ATS and the PTE - had participated in the ERM for more than two years by end-February 1998. Of these, only the IEP had traded beyond a ±2.25% range around its central rate against the median currency for a sustained period of time. However, the deviation of the IEP had been mostly above its central rate. Accordingly, these 10 currencies are deemed not to have experienced severe tensions in the ERM in the two year period under review.

By the time of the decision by the Council in May 1998, ITL and FIM will have participated in the ERM for about 17 and 18½ months, respectively. In terms of exchange rate behaviour, both currencies have displayed a broadly similar pattern, appreciating in the period before ERM entry and enjoying relative strength and stability in the grid thereafter. For the purpose of this examination, the stability of the ITL and FIM is assessed as if the two currencies had participated in the ERM with their current central rates for the full two-year period. For these two currencies, there was no need of direct monetary policy response in defence of the currency either in the form of raising official interest rates or extensive intervention. Over the examination period, neither currency is deemed to have experienced severe tensions within the ERM.

The GRD, the SEK and the GBP did not participate in the ERM during the examination period. In consequence, the stability of their exchange rates cannot be assessed as for the participating Member States.

Annex: Approaches to the appraisal of exchange rate stability in the ERM

The median currency approach used as the operational framework for assessing fulfilment of the exchange rate criterion is discussed extensively in the box in Chapter 5. This annex focuses on the advantages and drawbacks of possible alternative frameworks[10]. Verification of two-year participation in the ERM and the observance of a ±2.25 range around central rates are assumed to be common to all frameworks. The main differentiating feature of the alternative frameworks is the benchmark against which the exchange rate behaviour of ERM currencies is assessed.

At a general level, the main operational frameworks available involve an assessment of a currency's exchange rate behaviour with respect to its central rate against some reference currency. This reference currency, which may change in the course of the review period, is defined as the benchmark of the assessment. The important issue is how to choose this benchmark. In this annex, operational frameworks using the following possible benchmarks are discussed:

1. the strongest currency in the ERM grid (possibly changing over time);
2. the DEM; and
3. the ECU.

1. Assessment of exchange rate behaviour of ERM currencies with respect to the strongest currency in the grid (Graphs 5.5 and 5.6)

The main advantage of using the strongest ERM currency as a benchmark is that it corresponds to an ambitious interpretation of exchange rate stability. Under this approach, the focus of the assessment is confined to the exchange rate movements of the other ERM currencies with respect to their lower fluctuation margin against the strongest currency. However, there are several drawbacks to this approach.

[10] Exchange rate behaviour of the ERM currencies during the review period, within each framework, is presented in terms of percentage deviations from their central parity against the relevant benchmark currency in Graphs 5.5-5.8, and summary statistics comparing the various methods are provided in Tables 5.2-5.5. In commenting on the results of the various assessments, a brief analysis of each framework will be provided, expanding on the discussion in the box of Chapter 5.

First, the assessment of a currency's exchange rate behaviour relative to the strongest currency in the ERM does not correspond either to the intended nor to the actual functioning of the mechanism. The ERM was conceived as symmetrical and, in this sense, the mechanism is anchored not by the strongest currency but by the currency at the centre. It is irrefutable that the DEM has played the role of *de facto* anchor in the ERM, reflecting its track record of stability and its status as an important international reserve currency. However, the DEM has not always been the strongest currency in the ERM. Indeed, the anchor role of the DEM has been manifested in the tendency of the German currency to be located at or close to the centre of the mechanism. In this context, it is notable that the DEM (or one of the closely linked core currencies) has been the median currency in the ERM for the vast bulk of the review period. In terms of the actual functioning of the ERM, the widening of the fluctuation margins to ±15% has been accompanied by a greater focus on the "centre" of the system as the reference point for exchange rate management. Accordingly, national monetary authorities have been more concerned with avoiding excessive volatility in their currencies rather than with observing a narrow fluctuation margin against the strongest ERM currency. This view is supported by the absence of any response within the mechanism to the appreciation of the IEP in 1996.

Second, the possibility of greater exchange rate variability provided by the ±15% fluctuation margins creates a risk that the use of the strongest currency as the benchmark may produce unreasonable outcomes when examining exchange rate behaviour. As illustrated in Graph 5.5, this drawback is particularly relevant in light of the IEP's behaviour in the review period. All of the other ERM currencies have traded well below their central rates against the IEP for a significant time. However, it would be inaccurate to conclude that these currencies were 'weak' within the ERM. The IEP is easily identifiable as an outlier in view of the extent of its deviation from central rates against the other currencies which were tightly clustered in the grid. However, there is no guiding rule for determining whether the strongest currency is an outlier. Less clear-cut cases than that of the IEP could only be decided on an arbitrary basis.

Graph 5.6, which presents the results of the calculation without the IEP, shows that bilateral spreads larger than 2.25% have not been uncommon during the examination period and have to be seen as a characteristic of the post-1993 ERM.

2. Assessment of exchange rate behaviour of ERM currencies with respect to the DEM (Graph 5.7)

Conventionally, the DEM has been chosen as the benchmark in assessing exchange rate behaviour within the ERM. This reflects the special role of the DEM as *de facto* anchor of the mechanism. However, the use of the DEM as benchmark is inappropriate in the context of this examination since it would pre-judge the exchange rate behaviour of the DEM as stable by definition and so exclude it from the examination. For completeness, however, Graph 5.7 illustrates the exchange rate behaviour of the other ERM currencies with respect to their central rates against the DEM. Given the fact that the DEM or one of the other closely-linked core currencies has occupied the centre position in the ERM grid for the vast bulk of the examination period, it is not surprising to find a close correlation between movements in exchange rates against the DEM and against the median currency. This correlation is particularly evident when comparing the summary statistics provided in Tables 5.1 and 5.4.

3. Assessment of exchange rate behaviour of ERM currencies with respect to the ECU (Graph 5.8)

The ECU might be considered the natural candidate for use as the benchmark in assessing exchange rate behaviour in the ERM. However, two main drawbacks can be identified in this respect. Firstly, fluctuation margins and intervention obligations within the ERM are defined in terms of a grid of bilateral rates. There has never been a formal commitment to target the ECU exchange rate *per se* within the ERM. Secondly, the composition of the ECU basket includes non-ERM currencies. As movements in these currencies can influence the value of the ECU, the exchange rate of ERM currencies relative to the ECU can be affected by developments external to the mechanism. This phenomenon is relevant to this examination because of the sharp appreciation of the GBP since mid-1996. Graph 5.8 shows deviations in the exchange rate of the ERM currencies from their ECU central rates in the examination period. All of the ERM currencies, excluding the ITL and the IEP, have tended to depreciate against the ECU. These movements against the ECU were due mainly to the appreciation of the GBP within the basket, making it difficult to draw meaningful conclusions about exchange rate behaviour within the ERM.

Table 5.2

Spread against strongest currency
(March 1996 –February 1998, daily data)

	Average (%)	Maximum (%)	Minimum (%)	Standard deviation	Days < -2.25%	
					Number	As % of trading days
BEF/LUF	-5.65	-0.24	-12.59	3.88	339	67
DKK	-6.04	-1.47	-12.24	3.29	405	81
DEM	-5.71	-0.29	-12.47	3.77	350	70
ESP	-4.82	0.00	-11.36	3.87	329	65
FRF	-6.41	-1.36	-13.05	3.49	443	88
IEP	-0.61	0.00	-5.50	1.35	56	11
ITL [a)]	-6.32	-1.61	-11.79	2.59	491	98
NLG	-5.42	0.00	-12.40	3.94	334	66
ATS	-5.73	-0.32	-12.48	3.78	350	70
PTE	-4.83	0.00	-11.13	3.08	344	68
FIM [a)]	-4.96	0.90	-10.67	2.95	393	78

[a)] Figures for ITL and FIM are calculated as if they had participated in the ERM for the whole examination period at their present central parities.

Source: Commission services.

Table 5.3

Spread against strongest currency excluding IEP
(March 1996 –February 1998, daily data)

	Average (%)	Maximum (%)	Minimum (%)	Standard deviation	Days < -2.25%	
					Number	As % of trading days
BEF/LUF	-1.43	-0.24	-4.14	0.71	51	10
DKK	-1.82	-0.25	-4.09	0.75	105	21
DEM	-1.49	-0.29	-4.19	0.68	56	11
ESP	-0.63	0.00	-2.85	0.62	3	1
FRF	-2.18	-0.27	-4.77	0.87	259	51
ITL [a)]	-2.13	0.00	-9.13	2.13	205	41
NLG	-1.21	0.00	-3.89	0.71	35	7
ATS	-1.51	-0.32	-4.18	0.68	57	11
PTE	-0.67	0.00	-2.49	0.69	18	4
FIM [a)]	-0.80	0.90	-6.91	1.46	62	12

[a)] Figures for ITL and FIM are calculated as if they had participated in the ERM for the whole examination period at their present central parities.

Source: Commission services.

Table 5.4

Spread against DEM
(March 1996 –February 1998, daily data)

	Average (%)	Average of absolute values (%)	Maximum (%)	Minimum (%)	Standard deviation	Days < -2.25%	
						Number	As % of trading days
BEF/LUF	0.06	0.11	0.44	-0.13	0.15	0	0
DKK	-0.33	0.48	0.24	-1.50	0.58	0	0
DEM	0.00	0.00	0.00	0.00	0.00	0	0
ESP	0.85	0.85	2.61	-0.34	0.46	0	0
FRF	-0.68	0.73	0.25	-2.35	0.60	2	0
IEP	4.68	5.34	11.09	-4.24	4.23	32	6
ITL [a]	-0.64	1.65	2.13	-7.82	2.20	96	19
NLG	0.28	0.29	0.91	-0.07	0.25	0	0
ATS	-0.02	0.02	0.06	-0.08	0.02	0	0
PTE	0.81	1.01	3.05	-1.36	0.95	0	0
FIM [a]	0.68	1.40	4.02	-4.20	1.50	39	8

[a] Figures for ITL and FIM are calculated as if they had participated in the ERM for the whole examination period at their present central parities.
Source: Commission services.

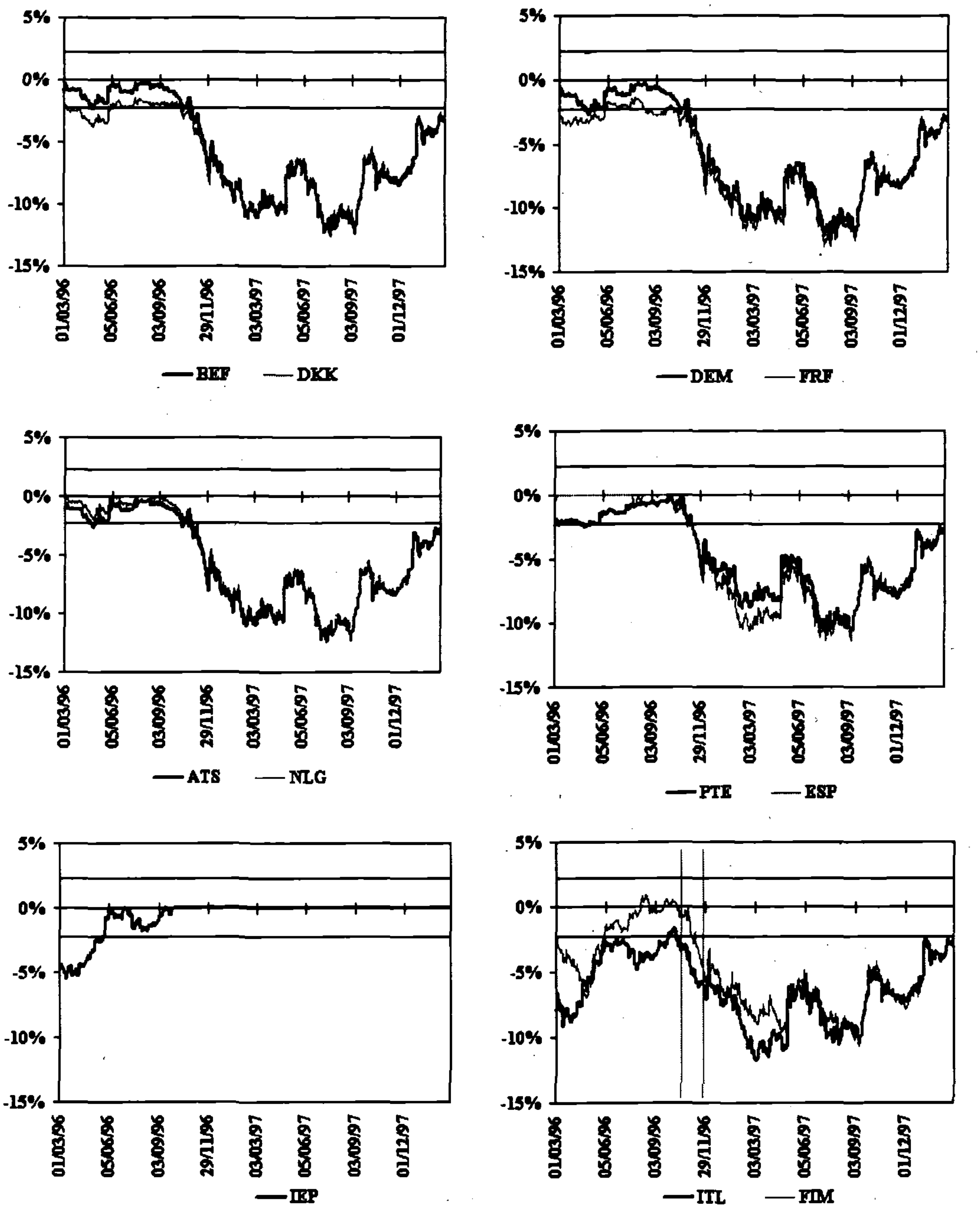
Table 5.5

Spread against ECU
(March 1996 –February 1998, daily data)

	Average (%)	Average of absolute values (%)	Maximum (%)	Minimum (%)	Standard deviation	Days < -2.25%	
						Number	As % of trading days
BEF/LUF	-0.90	1.65	2.18	-3.31	1.59	146	29
DKK	-1.29	1.33	0.55	-2.99	0.93	108	21
DEM	-0.96	1.55	1.85	-3.20	1.47	137	27
ESP	-0.11	1.53	3.35	-2.36	1.68	7	1
FRF	-1.64	1.64	0.21	-3.70	1.00	170	34
IEP	3.82	4.08	8.91	-2.38	3.14	2	0
ITL [a]	-1.57	1.60	0.62	-5.83	1.12	74	15
NLG	-0.68	1.67	2.48	-3.14	1.70	133	26
ATS	-0.98	1.57	1.88	-3.21	1.47	143	28
PTE	-0.14	1.12	1.77	-2.54	1.30	51	10
FIM [a]	-0.26	1.11	2.55	-3.35	1.30	32	6

[a] Figures for ITL and FIM are calculated as if they had participated in the ERM for the whole examination period at their present central parities.
Source: Commission services.

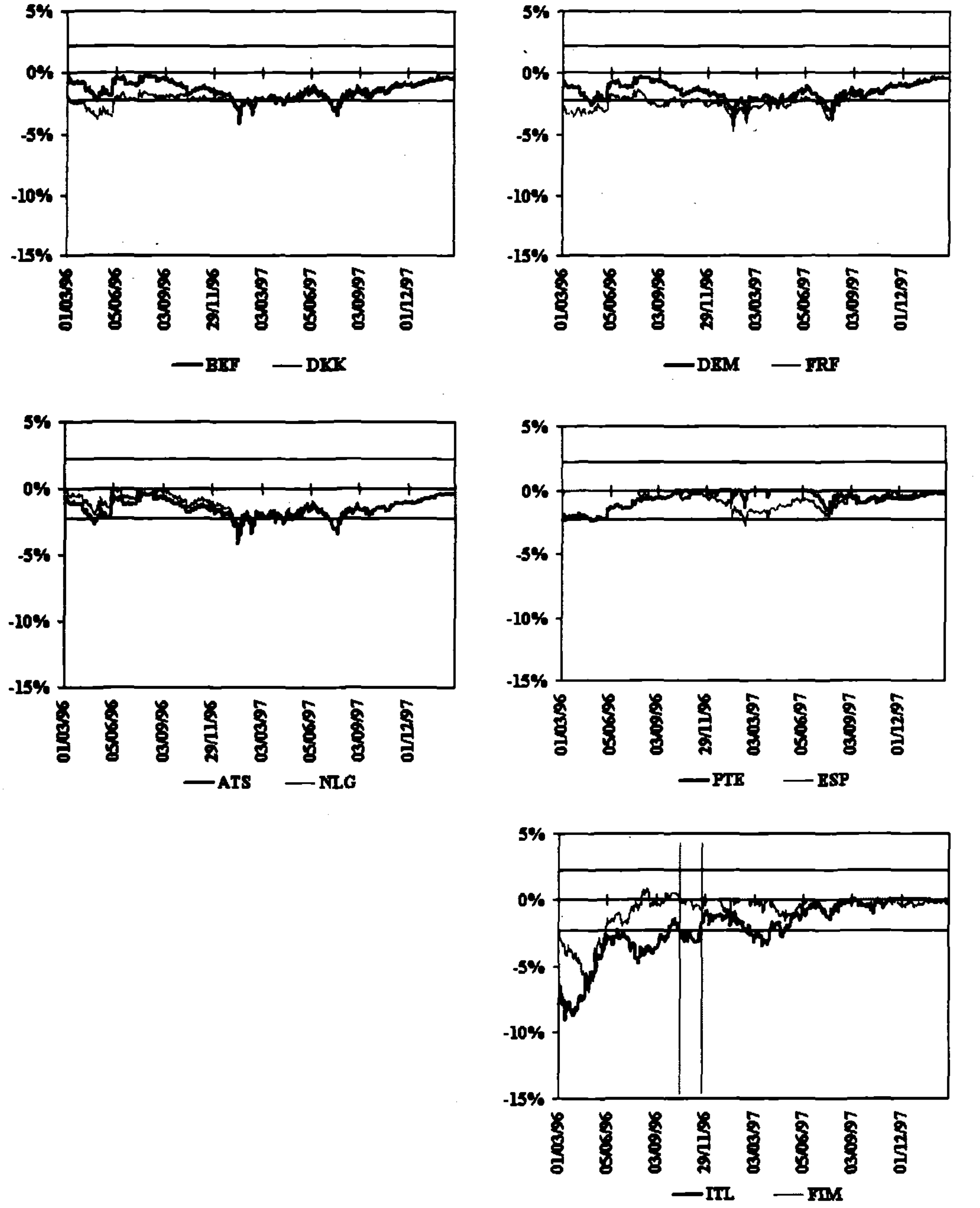
Graph 5.5
Spread from the central rate against the strongest currency in the ERM
(daily data)



Note:
The two straight vertical lines in the bottom right chart indicate the entry of the FIM in the ERM on 14.10.96 and re-entry of the ITL on 25.11.96 respectively. In the period preceding participation, FIM and ITL are assessed with reference with their present ERM central rates.However, these two currencies have not been taken into account in the selection of the reference currency in that period.
A +/- 2.25% band around the central rate is also indicated in all cases.

***Source*: Commission services**

Graph 5.6 Spread from the central rate against the strongest currency in the ERM, excluding IEP
(daily data)



Note:

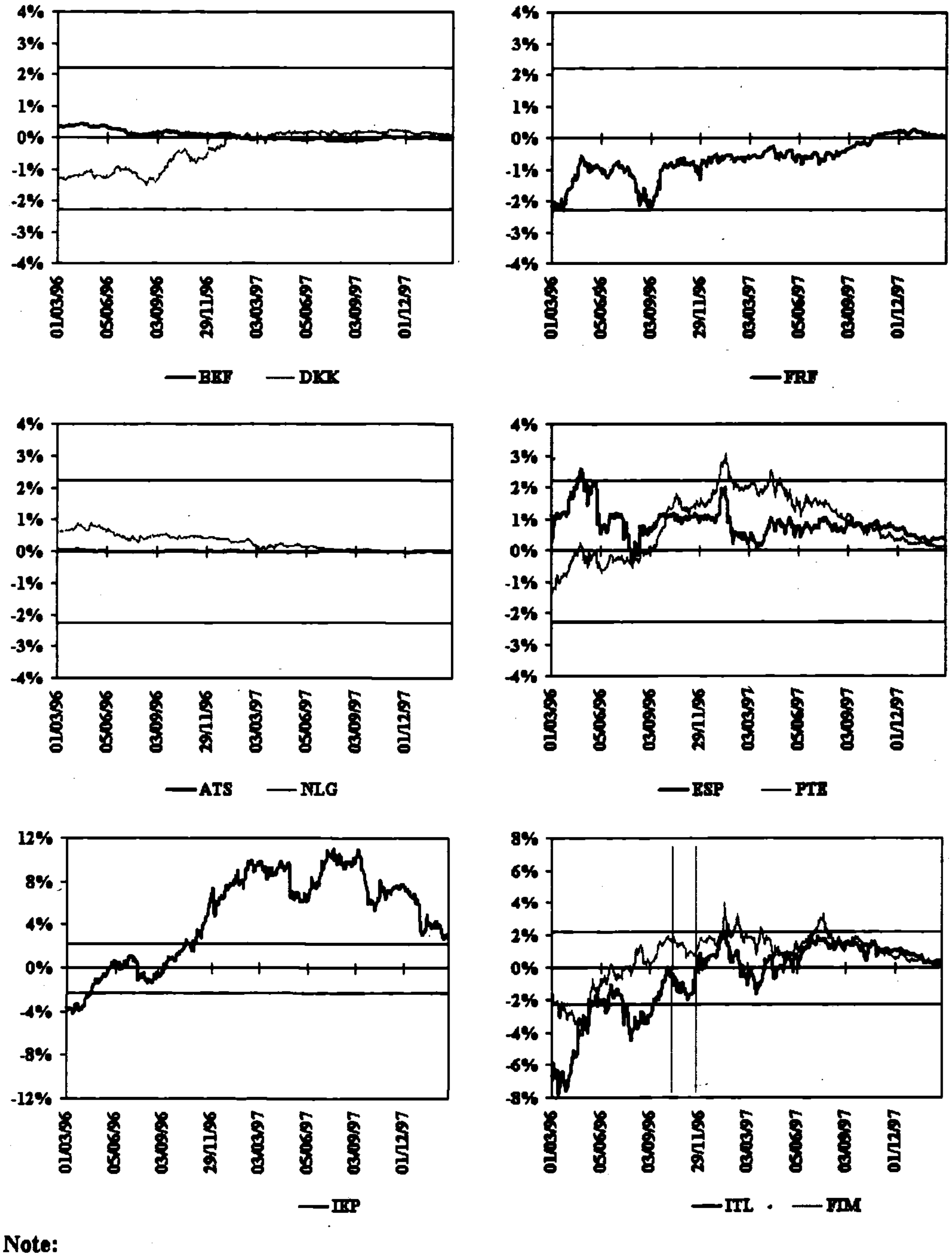
The two straight vertical lines in the bottom right chart indicate the entry of the FIM in the ERM on 14.10.96 and the re-entry of ITL on 25.11.96 respectively. In the period preceding participation, FIM and ITL are assessed with reference with their present ERM central rates.However, these two currencies have not been taken into account in the selection of the reference currency in that period.

A +/- 2.25% band around the central rate is also indicated in all cases.

***Source*: Commission services**

Graph 5.7

Spread from the DEM central rate
(daily data)



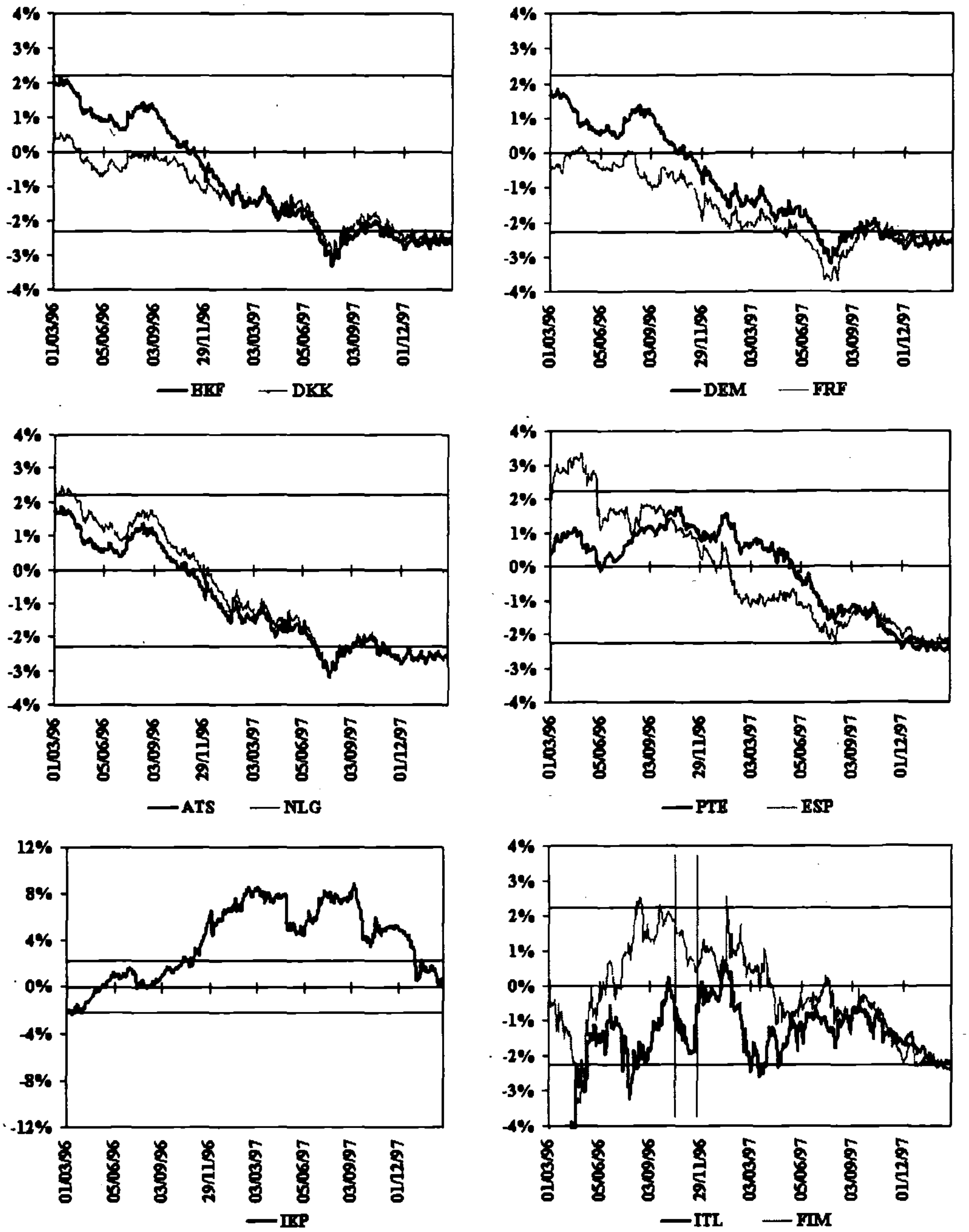
Note:

The two straight vertical lines in the bottom right chart indicate the entry of the FIM in the ERM on 14.10.96 and the re-entry of the ITL on 25.11.96 respectively. In the period preceding participation, FIM and ITL are assessed with reference with their present ERM central rates.

A +/- 2.25% band around the central rate is also indicated in all cases.

***Source*: Commission services**

Graph 5.8 Spread from the ECU central rate
(daily data)



Note:

The two straight vertical lines in the bottom right chart indicate the entry of the FIM in the ERM on 14.10.96 and the re-entry of the ITL on 25.11.96 respectively. In the period preceding participation, FIM and ITL are assessed with reference with their present ERM central rates.

A +/- 2.25% band around the central rate is also indicated in all cases.

***Source*: Commission services**

6. LONG-TERM INTEREST RATES

6.1. Treaty provisions

The fourth indent of Article 109j(1) of the Treaty refers to:

> *"the durability of convergence achieved by the Member State and of its participation in the exchange-rate mechanism of the European Monetary System being reflected in the long-term interest-rate levels".*

Article 4 of Protocol No 6 on the convergence criteria elaborates further, stating that:

> *"The criterion on the convergence of interest rates...shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions."*

Long-term interest rates can also be seen as forward-looking indicators, which reflect the financial markets' assessment of underlying economic conditions and cannot be directly influenced by national authorities. The level of the long-term interest rate is a function of the underlying real rate, the expected inflation rate, and risk premia (related mainly to default on repayment of debt, expected exchange-rate movements and uncertainty attached to inflation rate and exchange rate expectations). With liberalised capital markets in the Community, real long-term interest rates would tend to equalise across the Member States. Therefore, differentials between the corresponding nominal rates mainly reflect how financial markets assess the prospects - in terms of inflation, soundness of public finances and exchange-rate stability - of each Member State relative to the others[1]. Thus, for each Member State, fulfilment of the interest rate criterion is evidence of the Treaty's requirement that nominal convergence and exchange rate stability have been achieved on a durable basis.

1 Differentials will also reflect differences in tax treatment and market liquidity.

6.2. Interest rate developments in the Member States

Interest rate developments in the Member States cannot be assessed without reference to developments outside of the Community. In recent years, the absence of significant inflationary pressures has led to generally stable monetary conditions in the larger industrialised economies. In the United States, the inflation rate has remained below 3.3% since end-1994, despite emerging capacity constraints and a tightening labour market. Since 1994, the US Federal Reserve has increased its federal-funds target rate by only 75 basis points to 5.5%. The low-inflation environment, reinforced by the prospect of medium-term budgetary consolidation and flexible supply-side conditions, has boosted the US bond market. Bond yields[2], which had risen by more than two percentage points in 1994, have followed a generally declining trend since end-1994, except in the first half of 1996 when yields rose temporarily amid (unfulfilled) market expectations of a monetary tightening. The yield on the benchmark 10-year bond has declined from about 7.8% at end-1994 to 5.6% in February 1998, more recently helped by heavy capital inflows due to the financial disturbances in Asia.

In Japan, the weakness of the economy has restrained the inflation rate to below 1% during most of the 1994-1997 period and has required a growth-supportive monetary policy. The official discount rate has been at an historical low of 0.5% since September 1995. Japanese bond yields have also fallen to historical lows since late 1997. The yield on the benchmark 10-year bond was 1.8% in February 1998.

Within the Community, the German inflation rate has been below 2% for most of the period since end-1994.[3] The increase in the Bundesbank's repo rate by 30 basis points to 3.3% in October 1997 was the first change in official rates since mid-1996 and the first increase since 1992. With inflation subdued and budgetary consolidation proceeding, German bond yields have moved broadly in phase with the corresponding US yields. However, the differential between German and US yields switched from positive to negative in April 1996 as cyclical conditions in the US economy remained relatively favourable. Having risen from 5.8% to 7.5% between January 1994 and January 1995, the yield on the German benchmark 10-year bond declined to 5.0% in February 1998.

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2 Unless otherwise stated, all yields discussed in this section are monthly averages. For the Community countries, harmonised series (as described in the box) have been used. For non-Community countries, the yield on the benchmark 10-year government bond has been used.

3 See Chapter 3.

In the rest of the Community, inflation rates have also been generally low and decelerating since end-1994. The basic stance of monetary policy has been similar among the Member States, although the trend in short-term interest rates has been more varied. In the group of countries comprising Belgium/Luxembourg, Denmark, France and Austria, the stance of monetary policy has corresponded closely to that of Germany. Money market rates in these countries are now at very similar levels. In Spain, Italy and Portugal, a decline in inflation rates allowed a gradual reduction of official interest rates from end-1994 but money market rates in these countries remain relatively high, although to different degrees. There were increases in official interest rates in Ireland and in the Netherlands early in 1997, and in Finland in September 1997, as pre-emptive responses to possible inflation pressures. Within this group, money market rates vary widely, with the rates in the Netherlands among the lowest in the Community and rates in Ireland among the highest. In the United Kingdom money market rates are far above the lowest rates, as monetary policy was tightened on a sustained basis in 1997 in an effort to moderate domestic demand pressures and to bring the inflation rate back to the official target.

Since end-1994, long-term interest rates in the Community have converged downward as shown in Graph 6.1. The favourable evolution is attributable to developments in corresponding US rates, and the combination of moderate inflationary pressures and sustained progress in budgetary consolidation. A high degree of exchange rate stability[4], particularly among the ERM currencies, has also been a contributory factor. The Community average long-term interest rate[5] has fallen by about 390 basis points from 9.2% in January 1995 to 5.3% in February 1998, with a more pronounced decline in those countries with relatively high interest rates at the beginning of the period.

Germany, France and the Netherlands have enjoyed the lowest long-term interest rates during most of the period. Belgium, Luxembourg, and Austria have had rates consistently within one percentage point of the lowest rate in the Community. By February 1998, the rates in these six Member States were clustered within a range of only 15 basis points. Outside of this group, Denmark and Ireland have experienced moderately higher long-term interest rates. In Finland, long-term interest rates were quite high until 1995 but since then have converged sharply toward the lowest levels. In Portugal, Spain, Italy and Sweden, long-term interest rates were also higher but have converged lower since 1995. The rates in these latter Member States peaked in March-April 1995 but since then have declined by 800 basis points in Italy, 710 basis points in Spain, 690 basis points in Portugal, and 590 basis points in Sweden. In the United Kingdom the decline in long-term interest rates has been notably smaller than in other higher-yielding Member States. In Greece, long-term interest rates remain well above the Union average although they have declined from very high levels.

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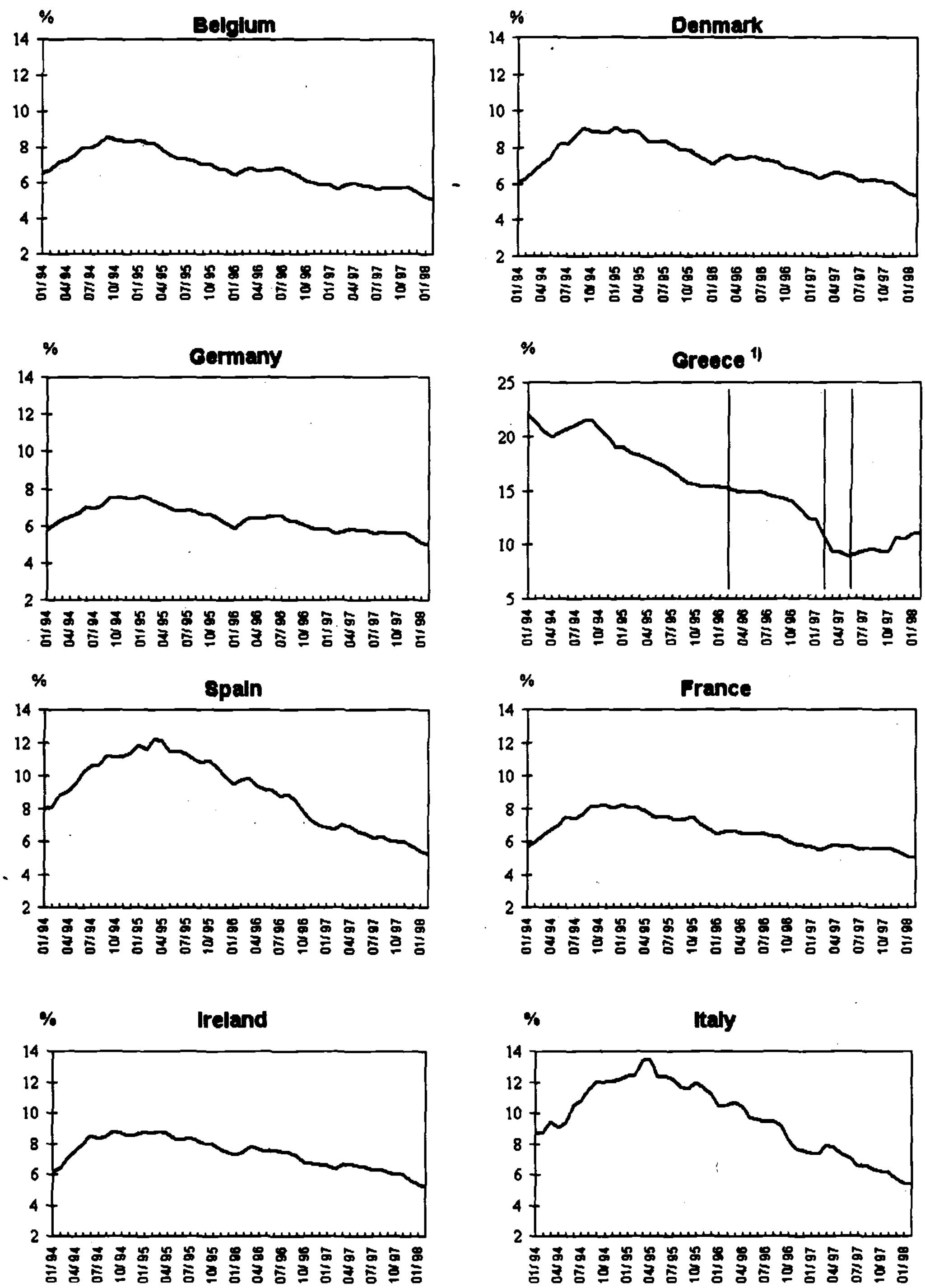
4 See Chapter 5.

5 Arithmetic mean of domestic rates, weighted using shares of EC GDP in 1995. (See the box for details on the national interest rates).

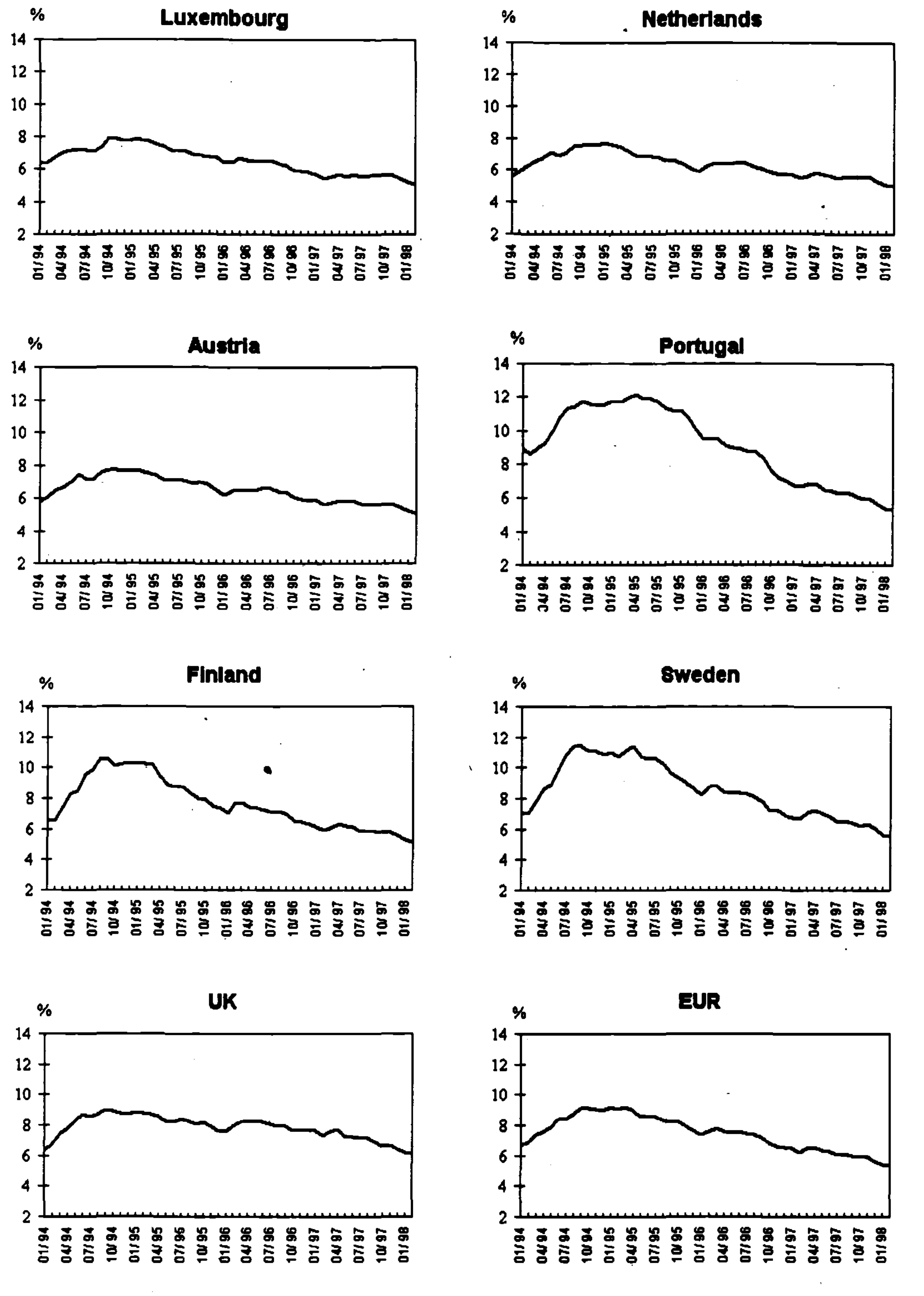
Graph 6.1 Nominal long-term interest rates

(monthly averages of daily data)



1) The time series for Greece has three breaks (vertical lines) due to changes in the definition of the representative interest rate (see the box).

Graph 6.1 continued



***Source*: EMI , Eurostat**

6.3. Assessment of long-term interest rate convergence in terms of the Treaty criterion

For the assessment of the criterion on the convergence of interest rates the yield on benchmark 10-year bonds has been used[6]; details about the interest rates used for the Member States are given in the box. The long-term interest rates are averaged over periods of 12 months. The reference value is calculated from the simple average of the average long-term interest rates of the three best performing Member States in terms of price stability[7] plus 2 percentage points. As explained in Chapter 3, the three best performing Member States in terms of price stability are selected using the harmonised indices of consumer prices (HICPs); average inflation rates based on the HICPs can only be calculated from December 1996 and are not available beyond January 1998, and so the reference value for long-term interest rates can only be derived on a consistent basis for this same period, even trough interest rate data are available before December 1996 and already for February 1998.

Average long-term interest rates for the 12-month period from February 1997 to January 1998 are shown in the final column of Table 6.1. The reference value (derived from the average interest rates in France, Ireland and Austria, the three best performing Member States in terms of price stability[8] was 7.8%. Average long-term interest rates in 14 Member States (all except Greece) were below the reference value in January 1998, and therefore all Member States except Greece fulfilled the criterion on the convergence of interest rates.

The reference value has tended to decline since December 1996, when it was 9.1% (see Graph 6.2). As well as the general downward trend in long-term interest rates, changes in the constituents of the three best performing Member States in terms of price stability also affect the reference value and caused shifts in its level in October and December 1997. Thirteen Member States have had average long-term interest rates below the reference value ever since December 1996, which represents an additional indicator of sustainability. In particular, the pronounced narrowing during 1996 in interest rate differentials for Spain, Portugal and Sweden ensured that these countries already respected the reference value by December 1996. The average long-term interest rate for Italy fell below the reference value from February 1997 onwards. In Greece the average long-term interest rate has exceeded the reference value throughout the period since December 1996, but the difference has narrowed substantially.

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6 Data for Greece are not fully comparable.

7 It should be noted that the best performing Member States in terms of price stability do not necessarily have the lowest interest rates.

8 Again, see Chapter 3.

Box: Data for the interest rate convergence criterion

The fourth indent of Article 109j(l) of the Treaty requires that the durability of nominal convergence and exchange rate stability in Member States should be assessed by reference to long-term interest rates. Article 4 of Protocol No 6 on the convergence criteria adds that these *"Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions."*

Article 5 of Protocol No 6 requires that the Commission should provide the statistical data used for the application of the convergence criteria. However, in the context of the interest rate criterion, the European Monetary Institute has developed a harmonised series of yields on benchmark 10-year bonds on behalf of Eurostat and collects the data from the central banks. The selection of bonds for inclusion in this series has the following characteristics:

- a residual maturity close to 10 years at the time the bond was selected;
- issued by central government;
- adequate liquidity, which is the main selection criterion; the choice between a single benchmark or the simple average of a sample is based on this requirement;
- yield gross of tax;
- fixed coupon.

For the vast majority of the Member States, the representative interest rates used in this examination incorporate all of the above characteristics. This ensures cross-country comparability. As of December 1997, 11 Member States were using a single benchmark bond and four Member States were using a sample of bonds (Germany, Spain, Portugal, Sweden). The harmonised series for Greece starts in mid-1997, as a 10-year benchmark bond has been available only since June 1997. Before this date, the representative interest rate was based on available best proxies: the yield on a seven-year bond with fixed coupon from March to June 1997, rates at issue of seven-year bonds from February 1996 to January 1997, and rates at issue of five-year bonds from September 1992 to January 1996.

Table 6.1

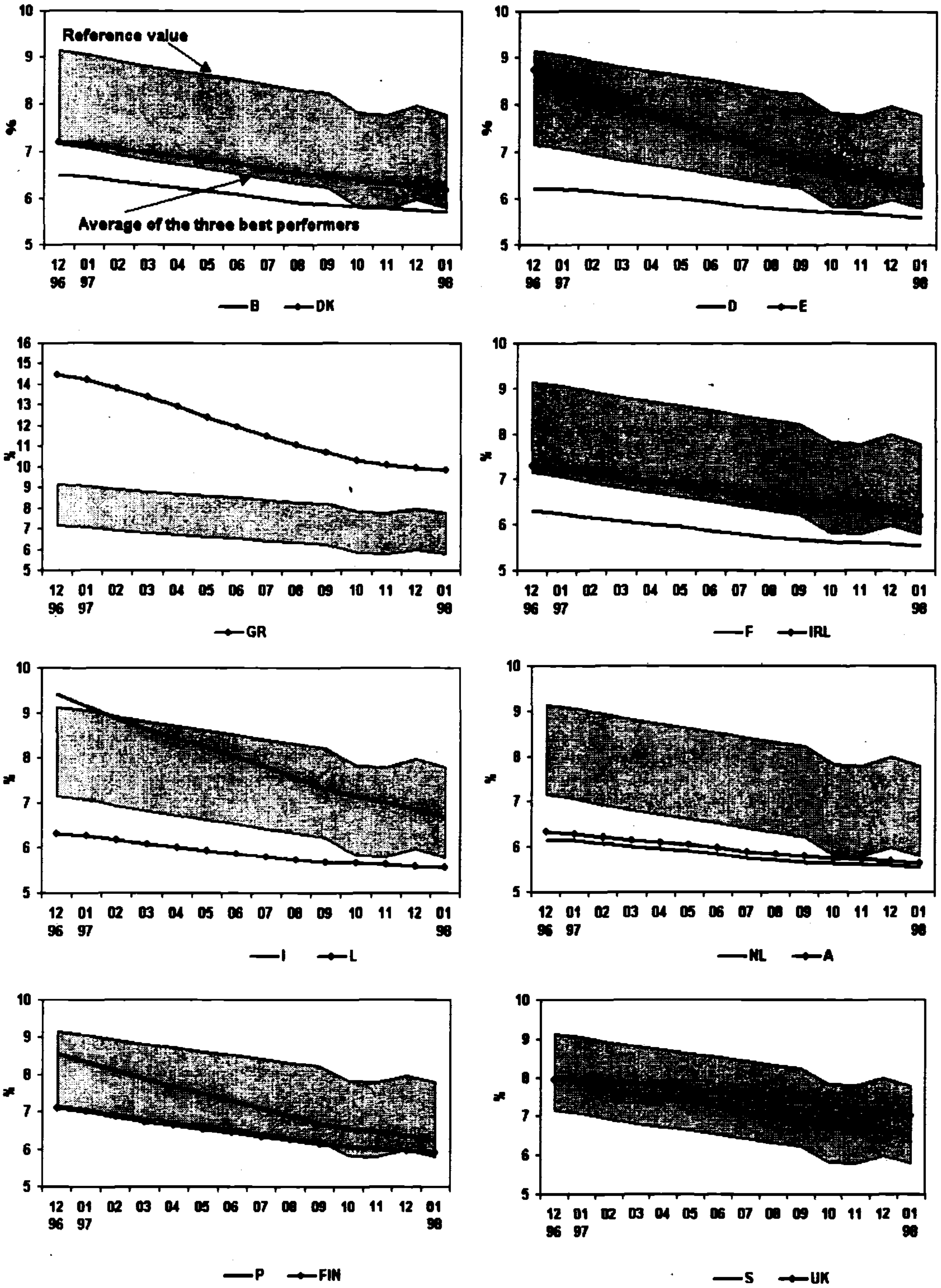
Development of long-term interest rates
(12-month averages)

	1993 [a]	1994	1995	1996	1997	January 1998 [b]
B	7.2	7.8	7.5	6.5	5.8	5.7
DK	7.3	7.8	8.3	7.2	6.3	6.2
D	6.5	6.9	6.9	6.2	5.6	5.6
EL [c]	23.3	20.8	17.4	14.4	9.9	9.8
E	10.2	10.0	11.3	8.7	6.4	6.3
F	6.8	7.2	7.5	6.3	5.6	5.5
IRL	7.7	7.9	8.3	7.3	6.3	6.2
I	11.2	10.5	12.2	9.4	6.9	6.7
L	6.8	7.2	7.2	6.3	5.6	5.6
NL	6.4	6.9	6.9	6.2	5.6	5.5
A	6.7	7.0	7.1	6.3	5.7	5.6
P	11.2	10.5	11.5	8.6	6.4	6.2
FIN	8.8	9.0	8.8	7.1	6.0	5.9
S	8.5	9.7	10.2	8.0	6.6	6.5
UK	7.6	8.2	8.3	7.9	7.1	7.0
EUR [d]	8.0	8.2	8.5	7.3	6.2	6.1
Reference value [e]				9.1	8.0	7.8
Average of 3 best price performers				7.1	6.0	5.8
Dispersion rate [f]	1.6	1.3	1.8	1.0	0.5	0.5

[a] For 1993, data are not comparable for Luxemburg, Portugal and Greece.
[b] Average of February 1997-January 1998.
[c] For Greece data are not comparable.
[d] Weighted average based on GDP.
[e] Average of interest rates of the three best performing. Member States (underlined) in terms of price stability plus 2 percentage points.
[f] Measured by the standard deviation (Greece omitted in all years).

Source: EMI, Eurostat.

Graph 6.2
Comparison of average long-term interest rates with the reference value



Note: The grey band represents a 2 percentage points interval between the average interest rate in the three best performers in terms of price stability (bottom of the band) and the reference value (top of the band).

Source: Commission services

7. ADDITIONAL FACTORS

This chapter examines four areas associated with economic integration and convergence which Article 109j(1) stipulates shall also be taken account of in the report:

- the development of the ECU;
- the results of the integration of markets;
- the situation and development of the balances of payments on current account;
- an examination of the development of unit labour costs and other price indices.

7.1. Development of the ECU

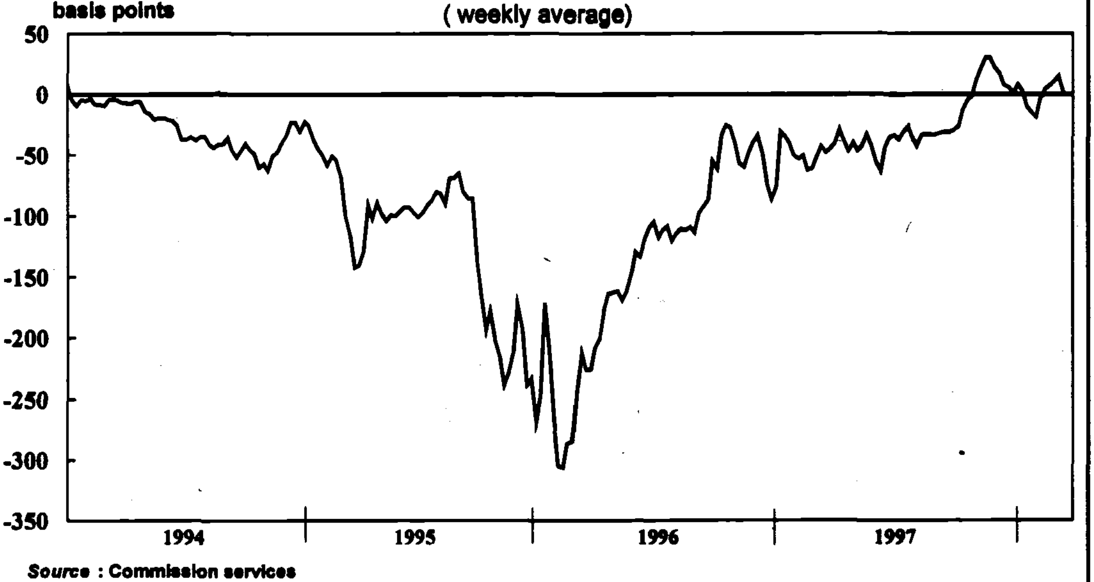
Since the peak of the ECU markets, in 1993, there has been a gradual decline in activity. The ECU has suffered from a general lack of liquidity and from the adverse impact of the troubles in the EMS in 1992 and 1993. The ECU markets continued to contract in 1996 and in 1997. In general, activity in all ECU markets was low but there was a slight pick-up in the bond market during the first half of 1997. Nevertheless, due to continued high levels of maturing paper the total level of outstanding ECU-denominated bonds continued to fall. In the first two months of 1998 there has been a marked increase in ECU bond issuing activity reflecting growing confidence in the euro. The spread between the exchange rate value of the ECU and its theoretical value also gradually contracted during 1997, and moved from a negative to a positive spread in November 1997. These modest improvements in the ECU markets reflected growing market confidence in the EMU timetable and increased legal clarity concerning the position of the ECU flowing from the approval, in June 1997, of the Council Regulation (EC) No 1103/97, which provides for the conversion of the ECU into the euro at one-to-one.

One manifestation of the ECU markets' underperformance was the development, from the middle of 1994, of a negative spread, in excess of 50 basis points, between the market exchange rate value of the ECU and its theoretical value. In an historical context, ±20 basis points had been considered to be the normal trading range of the spread. With the resurfacing of tensions in the ERM in early 1995 and increasingly pessimistic market perceptions of the EMU process the spread widened to unprecedented levels, reaching over 300 basis points in December 1995 (see Graph 7.1). Since then, the spread has contracted, returning to beneath 50 basis point by the second half of 1997. From 3 November to the end of 1997 the ECU traded at a premium to the basket on the foreign exchange market, reaching a high of +37 basis points on 25 November. By the end of 1997 the spread was trading at close to parity with the basket, and during January and February 1998 the exchange rate value of the ECU continued to fluctuate around parity with the theoretical rate.

A number of factors have influenced the behaviour of the spread. In a very thin ECU market the balance between supply and demand for ECU can be affected by the intervention of an individual major player. Without a central bank for the ECU there is no monetary policy and ECU interest rates play a very weak role. In addition to these structural factors, a major factor has been market sentiment towards the EMU project. In this regard, improved market sentiment towards EMU, coupled with the approval of Council Regulation (EC) No 1103/97, which has provided the markets with legal clarity and certainty concerning the ECU, has resulted in market operators taking more active interest in the ECU. The markets are now convinced that at the start of Stage Three the ECU will convert at one-to-one with the euro. Thus the markets are pricing the ECU as a definite "in" currency the exchange value of which is already fixed against the euro. Nevertheless, market operators do not foresee any large upswing in the overall performance of the ECU markets.

During 1996, bond issues denominated in ECU were significantly lower than maturing paper with the result that the stock of outstanding debt in ECU declined by 7% to ECU 118 billion (excluding Greek ECU-linked bonds). This compares with a historic peak of ECU 140 billion stock outstanding in 1993. In 1997 some ECU 14.8 billion was issued and ECU 19.1 billion of ECU-denominated bonds matured. The net amount outstanding of ECU bonds therefore contracted to ECU 114 billion at the end of 1997, an annual reduction of 11%.

Graph 7.1. **ECU exchange rate spread**
(weekly average)



Source : Commission services

(14)

From the start of 1997 demand for ECU from institutional investors gradually increased, although from a very low level. Issue activity increased, compared with the average level of activity observed in 1996. A number of innovative issues were brought to the market reflecting growth in issuer and investor interest in the possibility of taking on euro positions ahead of the start of Stage Three through the use of the ECU. Amongst the advantages for issuers are the avoidance of the need to redenominate bonds and the creation of a borrowing profile in euro prior to the introduction of the euro. The latter is seen as potentially giving an issuer a head start in issuing debt in the future euro-denominated market. In particular, the European Investment Bank launched a Eurobond denominated in euro with a nominal value of 1 billion. Until the introduction of the euro, all monetary rights and obligations in respect of these notes will be performed in ECU, at the one-to-one conversion rate.

Taking into account the steady contraction of the ECU bond markets, secondary ECU markets have performed relatively well. Though the overall trend has been for a gradual reduction in activity, the secondary markets have achieved periods of relative stability and some temporary growth.

For example, the value of turnover in ECU bonds, cleared through Euroclear and Cedel, has modestly increased year on year since 1993. However, the ECU's market share of total turnover has decreased each year. From 5.6% of the total in 1993 to 5.2% in 1994 and 1995, to 4.3% in 1996, and to 3.4% in 1997. This decline in share is in part due to the strong growth in other markets but does highlight the ECU's failure to perform to its full potential.

The approximate measure of commercial and financial activity provided by the daily average turnover in the ECU Banking Association's ECU Clearing System has indicated a modest fall in activity, from ECU 50.0 billion during 1994 to ECU 46.8 billion during 1995, and to ECU 46.3 billion during 1996. However, in 1997 a modest increase in activity has been observed, with average daily turnover rising to ECU 46.8 billion.

During 1994 it was agreed that the Commission, in conjunction with the EMI, would carry out a study of the ECU flows passing through the EBA's ECU Clearing System that were of a commercial rather than financial nature. Three annual studies have now been completed. The results of the third study confirm the findings of the first and second, and suggest that commercial ECU payments represent less than one percent of the total value of ECU payments. The annual amount of ECU commercial payments must therefore be in the region of ECU 50 billion to ECU 75 billion.

In conclusion, activity in the ECU markets continues to decline gradually. In part this reflects the focusing of market operators on the euro and the core currencies that will convert on 1 January 1999. The ECU is not seen as an essential key to enter the euro-denominated markets. Whilst the conversion rate of the ECU to the euro is known, one-to-one, in other respects core currencies provide a better route to the euro in terms of market size, liquidity and range of available hedging instruments. Whilst the increase in bond issuing activity observed in January and February 1998 and issues such as that of the EIB denominated in euro suggest that some market operators are turning to the ECU as part of their preparations for the euro, many prefer to use other market instruments issued in a core currency. The gradual decline in activity in the ECU should not therefore be seen as a negative development, but rather as a signal that market operators have moved beyond the ECU and are preparing to switch to the euro on 1 January 1999.

7.2. Results of the integration of markets

Article 109j(1) requires the Commission to consider the results of the integration of markets in its examination of convergence between Member States. This therefore necessitates examining the Single Market Programme because of its highly significant impact on market integration in the Community. Furthermore, by increasing competition in product markets, the Single Market may also have helped improve the efficiency of Member States' markets and their adaptability to major economic shocks.

Introduction of the single currency is likely to stimulate further market integration. Firstly, by enhancing cross-border price transparency and comparability, it will probably intensify competition in product markets across the Community. Secondly, it will eliminate exchange rate fluctuations, a source of difficulty for the operation of the Single Market in the past.

In this section[1], evidence is presented on developing market integration inside the Community through trade, foreign investment and industrial restructuring. Some of the consequences of this developing integration, the most important remaining problems and the measures taken to combat them are also discussed.

7.2.1. Evidence of market integration in the Community

Trade

By eliminating many trade and investment barriers inside the Community, the Single Market has encouraged integration of Member State markets; intra-EC manufacturing trade volumes are estimated to have grown by 20-30% since 1985. Furthermore, intra-EC trade has grown more rapidly than trade between Member States and third countries, which is evidence of deepening regional integration. Table 7.1 gives detailed evidence of this, giving for each Member State the share of total trade accounted for by intra-EC trade.

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1 This section draws an information (updated where possible) from the Commission's Single Market Review, a synthesis of which was presented in "Economic Evaluation of the Internal Market", *European Economy, Reports and Studies*, No 4, 1996.

Between 1985 and 1997, most Member States have experienced increasing trade integration with Community partners (the average intra-EC trade ratio rose 2.6 percentage points). Much of this appears to have occurred between 1985 and 1990, when intra-EC trade ratios rose (by 6.1 percentage points on average) in all the 15 current Member States, and especially in the southern Member States (Portugal, Spain, Greece and Italy). Subsequently, the integration process appears to have slowed, but two reasons suggest that this slowdown could be exaggerated: firstly, trade data since 1993 significantly and consistently underestimate actual trade flows inside the Community[2]; secondly, the intra-EC trade ratio is sensitive to factors other than trade integration, and such factors probably boosted it in the late 1980s and decreased it after 1990[3].

Table 7.1

Share of trade within the Community in total trade[a]

	1997[b] (%)	1985-90 Share change	1985-97[b] Share change
B/L	72.6	4.0	0.3
DK	68.5	4.8	4.3
D	56.8	3.8	-2.3
EL	58.6	14.0	4.9
E	67.0	16.8	19.3
F	63.9	7.5	4.7
IRL	64.4	2.5	-8.7
I	57.3	10.9	6.1
NL	67.9	3.6	-0.4
A	68.6	7.8	7.0
P	76.6	17.6	18.0
FIN	57.0	9.2	6.0
S	57.9	3.0	-1.7
UK	52.1	3.3	-1.1
EUR	61.2	6.1	2.6

[a] Average of imports and exports of goods.
[b] First nine months.

Source: Eurostat.

2 The Single Market eliminated frontier formalities in 1993 to reduce "red tape" and speed up cross-border deliveries. However, as intra-Community trade data had always been collected at these frontiers, a new collection system was needed. The new system, based on a survey approach, appears to significantly under-record actual flows. Consequently, the ratio of intra-EC trade relative to extra-EC trade (for which collection methods remain unchanged) is also underestimated.

3 Oil price falls in the late 1980s will have increased the intra-EC trade ratio by cutting the value of extra-EC imports. Community growth at the same time will have reinforced the effect: strong market demand will have led Community producers to supply Member State markets in preference to third country markets. Recession in the early 1990s will have had the opposite effect.

Today, well over half of every Member State's trade is with other Member States (the Community average was 61.2% in the first nine months of 1997). Portugal, Belgium and Luxembourg are most integrated within the Community in trade terms, with ratios above 70%. The United Kingdom, with a ratio of 52.1% in 1997, is the least integrated, but that ratio rose over 3 points between 1985 and 1990. Even the newest Member States are already well integrated (their intra-EC trade ratios range between 57.0% and 68.6%), despite only becoming Member States in 1995.

Increasingly, Member States are trading similar products of varying price and quality with each other. This has a number of beneficial effects. Firstly, there is more intense competition on Member States' markets, squeezing firms' profit margins, especially in sectors where trade barriers were most significant in 1985. Secondly, there are benefits to consumers in the form of a wider choice of products to buy.

Foreign direct investment

Foreign direct investment is another way through which markets become more closely integrated. In recent decades, but especially in the 1980s, foreign investment flows world-wide have expanded very rapidly, and the Community has attracted a remarkably high and increasing share of these – 44% between 1991 and 1993, up from just over 28% between 1982 and 1987. Foreign investment activity inside the Community grew vigorously between 1986 and 1991 (on average, nominal inflows grew 41% annually) before slowing between 1992 and 1996 (on average, growing just 7% annually in nominal terms).

Table 7.2 shows that during the 1986 to 1991 period, the United Kingdom was by far the prime target for foreign investors, absorbing 32% of all foreign investment received by the Community. Its record particularly reflected its success in attracting investment from non-Member States (receiving 45% of all such flows). Other important recipients of foreign investment in the period were France, Spain, the Benelux countries and Germany.

Table 7.2

Origin of foreign direct investment inflows

	1986-91 Share of flows originating from			1992-96 Share of flows originating from		
	EUR12	Rest of world	The world	EUR15	Rest of world	The world
	57% of total inflows	43% of total inflows	100% of total inflows	65% of total inflows	35% of total inflows	100% of total inflows
B/L	15	6	11	12	8	11
DK	1	2	1	2	2	2
D	14	4	10	13	7	11
EL	1	1	1	1	1 [a)]	1 [a)]
E	12	10	11	8	6	7
F	12	13	12	12	18	14
IRL	5	3	4	4	3 [a)]	4 [a)]
I	5	7	6	7	3	6
NL	11	9	10	17	9 [a)]	14 [a)]
A	--	--	--	3	1	2
P	2	2	2	2	1	1
FIN	--	--	--	1	0	1
S	--	--	--	5	10	7
UK	22	45	32	15	30 [a)]	20 [a)]
EUR	100	100	100	100	100	100

[a)] estimated.

Source: Eurostat.

Since 1992, however, foreign investment flows inside the Community have been more evenly distributed. The United Kingdom has continued to receive most, but no longer a disproportionately large share (over 17% of total flows between 1992 and 1996), followed by the Netherlands, France and Germany. The United Kingdom's performance reflects falls in its share of both total intra-EC and extra-EC foreign investment (to 15% and about 30% respectively).

Investment flows between Member States are becoming increasingly important, providing 65% of the Community's total foreign investment between 1992 and 1996 as against 57%% between 1986 and 1991. The United Kingdom, Benelux, Germany and France have enjoyed the largest shares of this throughout the 1986-96 period, but the Netherlands' share has significantly increased since 1992 whilst the United Kingdom's has decreased.

Mergers and acquisitions

The evolution of merger and acquisition activity inside the Community reflects the pattern of foreign investment. In 1996, the number of mergers and acquisitions was less than in 1995, and well below the peak year of 1990, although their value has actually climbed steadily since 1994. Nearly 70% of all operations inside the Community are purely domestic affairs, involving companies from the same Member State. About 18% are between companies from different Member States, and less than 14% involve companies from the Community and a third country (especially the United States, but also Switzerland). However, the importance of the last type of operation is growing fastest. Generally, merger and acquisition activity by companies in Denmark, Ireland, the Netherlands, Finland, Sweden and the United Kingdom is well above the share of their national economies in Community GDP.

All this merger and acquisition activity is changing the structure of manufacturing, increasing average levels of Community-wide industrial concentration (on average, the share of total sales by the largest four manufacturing firms in all sectors rose 2.3 percentage points between 1987 and 1993), but causing some declines at the Member State level (in France, the United Kingdom and Belgium, the average sales shares of the four leading firms in all industries fell 0.1, 0.9 and 1.7 percentage points, respectively, between 1987 and 1993). An explanation for this could be that while large-scale operators are becoming fewer and bigger, taking greater shares of the total Community market, they also have wider geographical coverage, intensifying competition at the level of each Member State. Services have not so far undergone such a transformation, especially in sectors which remain heavily regulated. Furthermore, deregulation of services has lagged behind deregulation of goods markets, so mergers and acquisitions among service operators have become important only in the most recent period. Any impact this may have on the services sector is therefore only just starting.

7.2.2. Consequences of the Community's market integration

On competition conditions

Evidence on firms' profit margins indicates that market integration has intensified competition; average margins were estimated to be some 0.5 percentage points lower between 1987 and 1991 than they would have been in the absence of the Single Market, but the impact was even stronger in sectors where trade barriers had been traditionally most significant (e.g. consumer electronics or motor vehicles). Competition has therefore helped to restrain price inflation throughout the Community, but also stimulated Community-wide consumer price convergence for both goods and services (again especially in the most deregulated sectors); the coefficient of price variation (including taxes) in consumer goods between Member States dropped from 22.5% in 1985 to 19.6% in 1993. For services, the drop was from 33.7% to 28.6%. On the other hand, in the energy sector, where deregulation has hardly begun, the coefficient of price variation between Member States actually increased strongly (from 21.1% to 31.7%). Overall, however, competition has increased, with positive effects on Community GDP, investment and employment.

On the Community's financial markets

Abolition of exchange controls and of other restrictions to capital flows, together with deregulation of financial markets, is starting to have effects. Already there have been significant increases in cross-border saving and investment flows. In 1993, foreign portfolio investment outflows were equivalent to an (unweighted) average of 4.2% of GDP, compared with just 1.8% of GDP in 1985. In the same period, foreign portfolio investment inflows increased from an (unweighted) average of 2.0% of GDP to 7.1%. Increased flows imply growing foreign asset stocks.

7.2.3. Implementation of the Single Market

Although market integration among Member States has intensified, the Single Market still remains legally incomplete. On 1 February 1998, 21.1% of all relevant measures were still not applied in all Member States. Non-implementation is worst in the fields of transport, public procurement and intellectual and industrial property rights. Finland, the United Kingdom and Sweden have the best transposition records (2.5% or less of legislation still to be transposed), Belgium, Austria and Germany the worst (over 7% still needing transposition). To improve the situation and reap the full potential of market integration, the Commission and Member States agreed an Action Plan for the Single Market in June 1997.

Beyond legislation, however, other problems are also delaying market integration (and therefore are the target of Community action). These include technical trade barriers (estimated to cover around 63% of internal Community trade), tax distortions (harmful tax competition between Member States, double taxation, incoherent national VAT systems), and state aids (representing between 0.4% and 2.6% of GDP in the various Member States between 1992 and 1994).

7.3. Situation and development of balances of payments on current account

Article 109j(1) of the Treaty requires that this report shall take into account the situation and development of the balances of payments on current account. This requirement reflects the need to ensure that a sustainable current account position exists in the Member States entering EMU.

The liberalisation of capital movements has increased private sector access to international credit and saving opportunities. In consequence, the inter-temporal optimisation of private sector spending and saving has improved with the result that the current account balance reflects to a larger extent than previously the saving/investment behaviour of the private sector. Current account deficits are not evidence of macro-economic disequilibria so long as they are sustainable in the longer term. However, if current account deficits (coinciding with high levels of external debt) are perceived to be unsustainable, confidence in the exchange rate may be undermined. Such exchange-rate considerations will be less relevant in the single currency environment of EMU, but the current account balance remains a vital indicator of national debt sustainability. In this sense, a review of the current account balance supplements the Treaty criteria by providing a broader assessment of the Member States' capacity to sustain their overall - public and private sector - indebtedness. The following analysis sheds some light on the current account positions of the Community as a whole and the Member States.

Table 7.3 presents the trends in the current account balance of the Community as a whole and of the Member States in recent years. The current account surplus of the Community has increased progressively since 1994; this contrasts with the situation of the late 1980s and early 1990s when significant deficits were recorded. The Community's external performance has benefited from a strong USD and growth in its main export markets. Meanwhile, import growth has been constrained by relatively subdued domestic demand, particularly in some of the larger Member States. The improved current account balance is also the counterpart of higher national saving in many Member States as budgetary consolidation has proceeded. In 1997, the Community current account surplus is estimated to have reached 1.3% of GDP, comprising a substantial trade surplus (about 2.% of GDP), partly offset by deficits in factor income and transfers. A surplus of this magnitude is unusual and was last recorded in 1986.

As might be expected, the improvement in the external position of the Community mainly reflects corresponding trends in the larger Member States as deficits in Germany and the United Kingdom have narrowed toward balance and surpluses in France and Spain have widened. The current account trends in the other Member States have been mixed. In 1997, the current account balances of the Member States ranged from +6% to -3% of GDP. A notable exception is Luxembourg, where a surplus of 15% of GDP (although declining from levels of 30% in the mid-1980s) was recorded.

In considering current account developments in the Member States, three groups can be distinguished.

Table 7.3

Current account of the balance of payments
(national accounts definition , as % of GDP)

	1993	1994	1995	1996	1997	1998 *
B	3.3	3.9	4.5	4.5	4.9	5.2
DK	3.0	1.5	0.8	0.8	0.1	0.0
D	-1.1	-1.5	-1.4	-1.2	-0.6	0.1
EL	-2.6	-0.8	-2.1	-2.6	-2.3	-2.8
E	-1.0	-1.3	0.4	0.3	0.6	0.7
F	1.0	1.0	1.5	1.6	2.9	2.9
IRL	5.3	3.6	4.5	3.8	3.9	3.1
I	1.0	1.4	2.4	3.4	3.1	3.1
L	20.1	18.2	15.4	16.3	14.4	17.0
NL	4.9	5.4	5.5	5.8	5.8	5.6
A	-0.4	-0.9	-1.8	-2.1	-1.9	-1.6
P	-2.3	-2.7	-2.0	-1.4	-2.8	-2.7
FIN	-1.3	1.3	4.1	3.8	5.3	6.0
S	-1.4	-0.5	1.2	1.5	2.1	2.2
UK	-2.4	-1.9	-1.9	-1.5	-0.9	-2.2
EUR	-0.1	0.0	0.4	0.8	1.2	1.1

* Spring 1998 economic forecasts.

Source: Commission services.

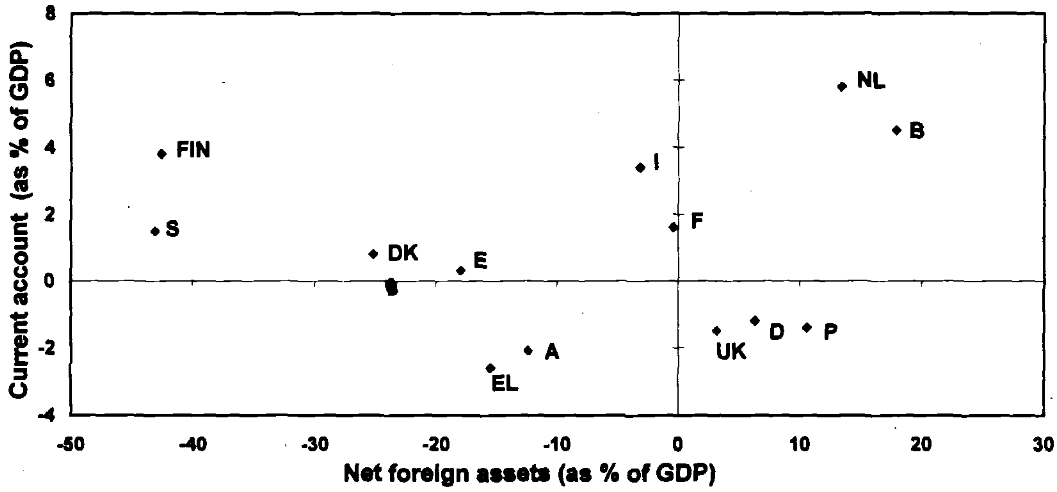
- The first group is Denmark, Germany, Spain, Austria, and the United Kingdom, where the current account was more or less in balance. Denmark is at an advanced stage of its economic cycle and the current account has moved from strong surplus in the early 1990s to near balance in 1997. Given Denmark's relatively high level of external indebtedness, a balanced current account would seem appropriate. In Germany, the current account has been moving closer to balance, having been in significant deficit since unification. High levels of consumption in the eastern part of the country have reduced export supply to third countries. Improved competitiveness should reduce the current account imbalance in coming years. However, surpluses on the pre-unification scale are unlikely to emerge as the cyclical upswing in the economy feeds through to domestic demand. Germany still enjoys a positive net external asset position. In Spain, the current account balance has been steadily improving. Sustained disinflation and budgetary consolidation have raised economic confidence which, together with low interest rates, has tended to stimulate domestic demand. In the United Kingdom, the current account has moved from substantial deficit since the mid-1980s into balance in 1997, despite the advanced cyclical position of the economy. However, the significant appreciation of sterling since end-1996 is likely to lead to a deterioration in the current account position in 1998. In Austria the current account deficit is mainly the consequence of a sharp deterioration in the services balance.

- A second group, comprising Belgium, France, Ireland, Italy, the Netherlands, Sweden and Finland, has achieved current account surpluses of more than 2% of GDP in 1997. In Belgium, the weakness of domestic demand relative to external demand is likely to have increased the already wide current surplus, while relative demand conditions will have also underpinned the French surplus. In Ireland, the current account surplus reflects a very wide trade surplus and is further supported by substantial receipts from the structural funds. The improvement in the current account balance of Italy has been particularly striking. The widening in the surplus to over 3% of GDP since 1996 primarily reflects higher national saving as budgetary imbalances have been reduced. However, the prospect of lower interest rates in coming years may prompt a decline in the very high saving rate of private households (15% of gross disposable income in 1997) with a consequent boost to domestic demand and import growth. The Netherlands has reached a fairly mature stage in the economic cycle and the "output gap" appears to have narrowed significantly. In these circumstances, the large current account surplus would seem to reflect very favourable competitiveness rather than relative demand. A similar situation prevails in Finland, where the level of competitiveness seems to be favourable. In Sweden, the current account has moved from deficit into surplus in recent years, reflecting a strong export performance,

- There were current account deficits of more than 2% of GDP in Greece and Portugal in 1997. Greece still has a relatively large government deficit reducing the level of national savings. Thus, budgetary consolidation will have a positive impact on the balance of current account. In Portugal, rapidly rising import growth due to a domestically led recovery explains most of the current account deterioration. Portugal is, however, experiencing high productivity growth in the exposed sector compensating for unit labour cost increases in the overall economy. Furthermore, inflows of foreign direct investment remain strong in Portugal, indicating that the current account deficit is sustainable at least for the foreseeable period.

Among the Member States, the Nordic countries have a significant net external debtor position (Denmark: 25% of GDP in 1996, Finland and Sweden: both 43% of GDP, see Graph 7.2). The current account surplus prevailing in Sweden and Finland will reduce this exposure over time, making these economies less vulnerable to external monetary developments. However, other countries with an even higher current account surplus (Belgium, the Netherlands) also have a sizeable external creditor position. The other Member States have either a small external creditor position (the net asset positions of Germany and the United Kingdom have been shrinking) or a net liability position (Italy's position has come close to balance).

Graph 7.2 **Current account - net foreign assets [1] - 1996**



[1] *Data on net foreign assets not available for Ireland and Luxembourg.*
All data for 1996 except NL net foreign assets (figure for 1995).

Sources: EMI (net foreign assets), spring 1998 economic forecasts (current account balance)

7.4. Examination of development of unit labour costs and other price indices

Indices of final consumer prices constitute accurate and timely indicators for assessing the trend in the general level of prices, since they capture price developments at the end of the economic process. However, they are less appropriate for the assessment of the causes of price inflation and the sustainability of the inflation performance. Therefore, the Treaty (Article 109j(1)) also requires that "the development of unit labour costs and other price indices" should be considered.

7.4.1. Unit labour costs

As a key factor underlying trends in consumer prices, developments in unit labour costs have been examined in detail in Section 3.4.2 of the present report. The major conclusion from this analysis is that, at the Community level, moderate increases in unit labour costs have been one of the major contributory forces behind the favourable inflation performance during the second stage. Developments at the country level show a clear convergence between Member States toward a low rate of growth of unit labour costs.

The appropriate behaviour of unit labour costs does not result from an acceleration in labour productivity growth but from moderate growth in nominal compensation per employee. This has been common to all Member States and can be attributed to three main factors: low inflation expectations, heightened awareness of supply constraints and an improvement in labour supply. These factors constitute important structural changes, which are likely to ensure wage developments consistent with the objective of price stability in the coming years.

7.4.2. *Import prices*

Like unit labour costs, import prices are an important determinant of price developments and have therefore also been analysed in Chapter 3. Increases in international commodity prices were moderate during the second stage of EMU, but the beneficial effect on domestic prices has depended very much on the evolution of exchange rates. In countries whose currencies remained strong, import prices had a moderating impact on domestic inflation. In countries whose currencies were subject to considerable downward pressure during the mid-1990s, import prices rose by less than could be expected. Moreover, the rise in import prices was passed on to consumer prices to a limited extent only, thanks to a vigorous implementation of anti-inflationary macroeconomic policies complemented by structural policies aimed at a more efficient functioning of product, service and labour markets.

7.4.3. *Producer prices*

As a measure of price trends at an early stage of the distribution process, the producer price index (PPI) may signal inflationary pressures before the latter is clearly perceptible in the consumer price index. In addition, the coverage of the PPI includes some goods like raw materials or semi-finished goods, which are sensitive to variations in some important underlying factors of inflation, like international prices, exchange rates or labour costs.

Table 7.4

Producer prices

Domestic output of total industry excluding construction
(national currency , percentage change)

	1993	1994	1995	1996	1997 [a]
B	-1.0	1.4	2.3	0.6	1.7
DK	-1.1	0.7	3.8	1.6	2.2
D	0.2	0.6	1.7	-0.4	1.1
EL	11.4	7.2	9.5	7.4	3.5
E	2.4	4.3	6.4	1.7	1.0
F	-1.0	0.3	2.2	0.5	0.2
IRL	2.3	2.0	3.7	1.8	0.1
I	3.8	3.7	7.9	1.9	1.3
L	0.9	2.0	3.4	-0.4	1.7
NL	-1.6	0.7	3.0	1.8	2.7
A [b]	-0.4	1.3	0.4	0.0	0.4
P	3.6	2.8	3.8	3.1	1.6
FIN	2.8	1.9	1.8	-0.1	1.3
S	2.0	4.3	8.0	0.6	1.0
UK	3.9	2.5	3.7	0.8	0.4
EUR	1.7	1.9	3.9	0.8	1.0

[a] Average until November 1997 over same months 1996.
[b] General wholesale price index.

Source: Commission services , OECD.

Developments in PPI over the last two years may therefore give some indication on the prospects for inflation. At the Community level, the increase in PPI has remained very subdued, less than 1 per cent both in 1996 and 1997[4]. This modest rise is common to nearly all the Member States (see Table 7.4) The most remarkable feature is the sharp deceleration in produce price inflation in Member States where inflation was still relatively high in 1995 (Spain, Italy, Portugal). With the exception of Greece, only Denmark and the Netherlands show an increase in PPI above 2 per cent, due to the high level of activity experienced by these two economies in recent years.

7.4.4. Indirect taxes

During Stage Two, all Member States have relied, but to a varying extent, on increases in indirect taxes to reduce their government deficits. In several countries, these increases were important and have contributed significantly to increases in inflation, as is suggested in Table 7.5 which shows estimates of the direct mechanical impact of indirect tax changes under the assumption of a full pass-through of changes in indirect taxes to consumer prices.

The most important contributions have been observed in Belgium (1994), Ireland (1994), France (1995), Italy (1995), United-Kingdom (1994-95), Finland (1995-1996), and Sweden (1997). However, more than the mechanical impact - which is by definition a one-off effect - what matters is the risk that increased indirect taxes raise inflation expectations and thus trigger a wage/price spiral. This does not seem to have been the case in any of these countries. After showing a blip, inflation came down swiftly in all countries which have experienced significant increases in indirect taxes.

Table 7.5

Effects of indirect tax changes on consumer price inflation
(percentage points)

	1994	1995	1996	1997
B	0.8	0.0	0.6	0.2
DK	0.4	0.4	0.4	0.4
D	0.3	0.0	-0.2	0.4
EL	0.8	0.6	0.8	n.a
E	0.3	1.0	0.2	0.3
F	0.1	1.1	0.1	0.4
IRL	0.7	0.2	0.2	0.4
I	0.3	0.8	0.1	0.1
L	0.1	0.1	0.0	0.0
NL	0.2	0.1	0.4	0.2
A	0.2	0.5	0.2	0.1
P	0.2	0.5	-0.2	-0.3
FIN	0.7	1.1	1.0	0.3
S	0.3	0.5	0.2	1.0
UK	0.7	0.6	0.4	0.5

Source: Commission services.

4 Regarding 1997, only the first 11 months of the year are available.