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* ***Convention used in the tables:***

" - " *Not applicable or not available*

"..." *Nil or negligible*

* ***Convention used in the Report:***

Aggregate EU-15 figures in this report are generally constructed using purchase parity exchange rates in order to weight the individual national data. However, trade data use actual exchange rates in 1993. Rates and indices (except CPI) are based on 1993 GDP weights, while CPI is based upon consumer spending weights.

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Abbreviations

Countries*

BE	Belgium
DK	Denmark
DE	Germany
GR	Greece
ES	Spain
FR	France
IE	Ireland
IT	Italy
LU	Luxembourg
NL	Netherlands
AT	Austria
PT	Portugal
FI	Finland
SE	Sweden
UK	United Kingdom
JP	Japan
US	United States of America

Currencies

BEF/LUF	Belgian/Luxembourg franc
DKK	Danish krone
DEM	Deutsche Mark
GRD	Greek drachma
ESP	Spanish peseta
FRF	French franc
IEP	Irish pound
ITL	Italian lira
NLG	Dutch guilder
ATS	Austrian schilling
PTE	Portuguese escudo
FIM	Finnish markka
SEK	Swedish krona
GBP	Pound sterling
JPY	Japanese yen
USD	US dollar

* *In accordance with Community practice, countries are listed in the Report using the alphabetical order of the national languages*

Executive summary

Executive summary

This is the first EMI Report to fulfil the requirements of Article 109j (1) of the Treaty establishing the European Community (the "Treaty"). The Report examines both the achievement of a high degree of sustainable convergence and deals with the statutory requirements to be fulfilled for national central banks ("NCBs") to become an integral part of the ESCB, with particular emphasis on central bank independence. Overall, the Report concludes that at present a majority of Member States do not fulfil the necessary conditions for the adoption of a single currency.

In line with the Treaty and the consensus reached at the Madrid and Florence summits of the European Council, Stage Three of Economic and Monetary Union will begin on 1 January 1999. This will necessitate the production of a further report under Article 109j in early 1998. Against this background, the present Report highlights the degree of convergence currently achieved as a step towards the assessment of the outcome of 1997. Hence, this year's procedure can by no means pre-empt the assessment to be made in early 1998.

1 Convergence

1.1 Approach taken

As was the case in its November 1995 report entitled "Progress Towards Convergence" a number of guiding principles are used by the EMI for the application of the convergence criteria. Quoting from that report: "First, the individual criteria are interpreted and applied in a strict manner. The rationale behind this principle ... is that the main purpose of the criteria is to ensure that only those Member States which have economic conditions that are conducive to the maintenance of price stability and the viability of the European currency area should participate in it. Second, the convergence criteria constitute a coherent and integrated package and they must all be satisfied; the Treaty lists the criteria on an equal footing and does not suggest a hierarchy. Third, the convergence criteria have to be met on the basis of current data. Fourth, the application of the convergence criteria should be consistent, transparent and simple."

It is also stressed that compliance with the convergence criteria is essential, not only at a specific point in time, but also on a sustained basis. In this vein, the Report further elaborates on the issue of sustainability. Performance is examined both in terms of each of the convergence criteria outlined in the Treaty and on a country-by-country basis. Consistent with the Treaty, the statistical data to be used for the application of the convergence criteria have been provided by the Commission. In general, data cover the period up to September 1996. Data for fiscal positions also show the latest Commission projections for 1996;[1] no reference is made to forecasts for 1997, nor does the Report assess budget proposals for 1997.

As to the individual criteria, the assessments regarding price and long-term interest rate convergence are based on the average of the three best-performing countries in terms of inflation, as the price performance of the countries with the lowest rates of inflation appears to be broadly similar and compatible with the objective of price stability. With respect to the fiscal criteria,

[1] *The use of projections (instead of final data) should not be seen as prejudging the choice of data to be used for subsequent reports to be prepared in accordance with Article 109j.*

developments are reviewed in relation to the reference values, and indicators underlying the developments are considered. In respect of exchange rate developments, the EMI does not at this stage consider it appropriate to give a precise ex ante operational content to the measurement of exchange rate stability according to Article 109j of the Treaty, which could also mechanically be applied to forthcoming periods. Regarding the Treaty provision of membership of the ERM, there is a strong majority position within the EMI Council that the requirement of ERM membership applies. A minority takes the view that exchange rate stability based on sustainable underlying economic fundamentals is more important than the institutional setting within which stability is achieved.

1.2 The state of convergence

The current environment of low cost and price pressures can be seen as favourable. Most Member States are enjoying relatively low inflation, and many have virtually achieved price stability. Other countries have recorded a slowdown in inflation, which has contributed to a recent tendency towards reduced risk premia in financial markets, and thereby to a higher degree of exchange rate stability and a reduction in long-term interest rate differentials. By contrast, progress in fiscal consolidation has generally been too slow. Most countries have not yet achieved a situation which, in a broader view, might be judged as sustainable in the medium term. With regard to the issue of sustainability it is emphasised that the improvement of the deficit by measures with a one-off effect does not ensure sustainable consolidation and great attention will have to be paid to the substance and not only to the accounting methods used in measuring both deficits and debts; that consolidation efforts need to be all the more resolute, the higher the initial stock of debt; and that sustainable fiscal consolidation will have to cope with two challenges: first, high and persistent unemployment and, second, those arising from demographic trends.

The criterion on price stability

Over the twelve-month reference period to the end of September 1996, the three best-performing countries in terms of the criterion on price stability were Finland, the Netherlands and Germany, with price increases of 0.9%, 1.2% and 1.3%, respectively (measured on the basis of the recently introduced Interim Indices of Consumer Prices - IICPs). These rates have been used to calculate the reference value of 2.6%. Overall, ten Member States (Belgium, Denmark, Germany, France, Ireland, Luxembourg, the Netherlands, Austria, Finland and Sweden) had inflation rates of below the reference value.

Table A

Economic indicators and the Maastricht Treaty convergence criteria

(excluding the exchange rate criterion)

		Inflation [a]		Long-term interest rate [b]		General government lending (+) or borrowing (-) [c]		General government gross debt [d]	
Belgium	1995	***	1.4	***	7.5		-4.1		133.7
	1996 [d]		1.6		6.7		-3.3		130.6
Denmark [e]	1995		2.3		8.3	#	-1.6		71.9
	1996 [d]		2.2		7.4	#	-1.4		70.2[f]
Germany	1995		1.5		6.9		-3.5	#	58.1
	1996 [d]	***	1.3	***	6.3		-4.0		60.8
Greece	1995		9.0		17.4		-9.1		111.8
	1996 [d]		8.4		15.1		-7.9		110.6
Spain	1995		4.7		11.3		-6.6		65.7
	1996 [d]		3.8		9.5		-4.4		67.8
France	1995		1.7		7.5		-4.8	#	52.8
	1996 [d]		2.1		6.6		-4.0	#	56.4
Ireland	1995		2.4		8.3	#	-2.0		81.6[f]
	1996 [d]		2.1		7.5	#	-1.6		74.7[f]
Italy	1995		5.4		12.2		-7.1		124.9
	1996 [d]		4.7		10.3		-6.6		123.4
Luxembourg	1995		1.9		7.6	#	1.5	#	6.0
	1996 [d]		1.3		7.0	#	0.9	#	7.8
Netherlands	1995	**	1.1	**	6.9		-4.0		79.7
	1996 [d]	**	1.2	**	6.3	#	-2.6		78.7
Austria	1995		2.0		7.1		-5.9		69.0
	1996 [d]		1.7		6.5		-4.3		71.7
Portugal	1995		3.8		11.5		-5.1		71.7
	1996 [d]		3.0		9.4		-4.0		71.1
Finland	1995	*	1.0	*	8.8		-5.2	#	59.2
	1996 [d]	*	0.9	*	7.4		-3.3		61.3
Sweden	1995		2.9		10.2		-8.1		78.7
	1996 [d]		1.6		8.5		-3.9		78.1
United	1995		3.1		8.3		-5.8	#	54.1
Kingdom	1996 [d]		3.0		8.0		-4.6	#	56.3

*,**,*** = first, second and third best performer in terms of price stability.
= public deficit not exceeding 3% of GDP; public debt not exceeding 60% of GDP.
(a) Annual rates, for source and explanatory notes see Table 2.1.
(b) In percentages, annual average, for source and explanatory notes see Table 5.1.
(c) As a percentage of GDP, for source and explanatory notes see Table 3.1.
(d) Twelve-month period ending September 1996 for inflation and long-term interest rate; general government lending/borrowing and general government gross debt for 1996 are European Commission autumn 1996 estimates.
(e) See footnote (b) in Table 3.1.
(f) In 1994, 1995 and 1996 Ireland was not the subject of an EU Council decision under Article 104c(6) of the Treaty that an excessive deficit exists. In 1996 this was also the case for Denmark.

Five countries (Greece, Spain, Italy, Portugal and the United Kingdom) had inflation rates above the reference value. Inflation rates were 3.0% in Portugal and the United Kingdom, 3.8% in Spain and 4.7% in Italy. At 8.4%, Greek inflation remained far above the reference value. In Greece, Spain, Italy and Portugal, twelve-month average IICP inflation declined from different levels and at different paces during the course of 1996, and the gap in relation to the reference value narrowed. The difference between inflation in the United Kingdom and the reference value was smaller than in the other countries throughout 1996, and has narrowed slightly in recent months.

In explaining the convergence in inflation rates over the 1990s, a number of structural changes have played an important role, in particular, the increased focus on price stability and the persistent orientation of monetary policies towards that objective. Furthermore, the recession of the early 1990s eased price and cost pressures, and, hence, is another general factor underlying these developments. In the ten Member States where inflation rates were below the reference value, there is no immediate risk that current trends in inflation will prove to be unsustainable. In the other five countries, prospects for sustained progress towards price stability would seem to be favourable, provided that appropriate policies are pursued. Against this background, crucial elements are that Member States conduct a monetary policy which is strictly geared towards price stability and thereby also conducive to stable exchange rates, that growth in unit labour costs is kept subdued and where necessary reduced, and that fiscal deficits are further reduced.

The criterion on the government budgetary position

Each year since the start of Stage Two of EMU in 1994 the Commission and the EU Council have examined the budgetary positions of Member States in order to implement the excessive deficit procedure. As a result of the annual application of the procedure, all Member States except Denmark, Ireland and Luxembourg are currently the subject of an EU Council decision that an excessive deficit exists. Most recently (in June 1996), the excessive deficit decision was abrogated for Denmark, whereas it was re-introduced for Germany. Although debt ratios clearly exceed 60% of GDP also in Denmark and Ireland, account has been taken in the procedure of the progress made in these two countries in reducing the debt ratio.

In respect of fiscal deficits, in 1995 only Denmark and Ireland achieved a ratio of below 3% of GDP, the reference value provided for in the Treaty, while Luxembourg registered a surplus. For 1996, the most recent Commission data indicate that four countries might have deficit ratios of below 3% (Denmark, Ireland, Luxembourg and the Netherlands). All other Member States project reductions, which in some cases could be seen as considerable, with the exception of Germany, where a further rise in the deficit ratio is expected.

As regards government debt, in 1995 out of the ten countries with a debt ratio above the reference value of 60% of GDP, only Ireland and Denmark achieved a major reduction, while Belgium, Italy and Sweden also registered some decline. The Commission forecasts for 1996 are that debt reduction in these Member States will continue, albeit at different paces. In addition, the debt ratio is projected to fall slightly in Greece, the Netherlands and Portugal. In contrast, debt ratios are forecast to rise in Germany, Spain, Austria and Finland. In Germany and Finland the debt ratio is expected to exceed the 60% reference value. Three Member States (France, Luxembourg and the United Kingdom) are expected to maintain a debt ratio of below the 60% reference value.

Progress in fiscal consolidation has generally been too slow. Deficits continue to be a cause of great concern and, in general, faster correction of fiscal imbalances is warranted. Most countries have not yet achieved a situation which, in a broader view, might be judged as sustainable in the medium term. This is clearly shown by worrisome debt developments. Notwithstanding this overall assessment, the latest projections for 1996 suggest that further progress has been made in the consolidation process. However, it is also apparent that this adjustment path needs to be taken further in most countries in a sustainable manner. Taking a medium-term view, the EMI welcomes the undertaking made by all Member States to formalise their sustained efforts towards consolidation in the form of a "Stability Pact". Such a pact cannot be a substitute for convincing fiscal consolidation prior to monetary union.

The criterion on exchange rate behaviour

As stated above, the EMI does not at this stage consider it appropriate to give a precise ex ante operational content to the measurement of exchange rate stability according to Article 109j of the Treaty, which could also mechanically be applied to forthcoming periods. Rather, a detailed record of recent developments is provided and will contribute to an assessment.

ERM currencies followed different patterns of behaviour over the two-year reference period (October 1994 to September 1996). When measured in terms of bilateral rates against the strongest currencies in the ERM, a number of currencies have remained stable. These include the Belgian/ Luxembourg franc, the Deutsche Mark, the Dutch guilder and the Austrian schilling.[2] Several other ERM currencies (the Danish krone, the French franc and the Irish pound) have either once or on several occasions drifted away from their central parities, although by September 1996 market rates again stood close to central rates.

At the beginning of 1995 pressure mounted on the Spanish peseta and in March, following a request by the Spanish authorities, the currency underwent a downward realignment of 7%. Following the decision to change the central rate of the peseta the Ministers and central bank Governors also agreed on a downward adjustment of the central rate of the Portuguese escudo by 3.5%. After the adjustment, both currencies recovered to levels close to those prevailing at the end of 1994 and to the new central parities.

More recent developments, even though partly related to market expectations about EMU participation, can be seen as an indication of progress in the right direction. To the extent that exchange rates reflect markets' perceptions of overall macro-economic convergence, this is to be regarded as a positive signal. A consider-ation of levels of real exchange rates also suggests that recent trends indicate a move towards a more sustainable exchange rate pattern.

As regards the development of the currencies remaining outside the ERM, the Finnish markka[3] remained broadly stable throughout the period under consideration - as did, to a lesser extent, the Greek drachma. In contrast, the Italian lira and the pound sterling underwent periods of turbulence, followed by a complete or partial recovery. The Swedish krona also experienced a period of turbulence but appreciated significantly over the two-year reference period considered.

[2] *The Austrian schilling joined the exchange rate mechanism of the European Monetary System on 9 January 1995.*

[3] *The Finnish markka joined the exchange rate mechanism of the European Monetary System, effective from 14 October 1996 (i.e. after the period covered in this Report).*

The interest rate criterion

Over the reference period (October 1995 to September 1996) ten-year government bond yields in the three best-performing countries in terms of price stability ranged between 6.3% and 7.4%. These rates have been used to calculate the reference value of 8.7%.

Eleven countries had rates below the reference value, i.e. all Member States except for Spain, Italy and Portugal as well as Greece.[4] These were the same Member States as in the case of the price criterion, as well as the United Kingdom. Yields of countries which did not meet the criterion tended to be well above the reference value, although there was a tendency for the gap to narrow over the reference period which was particularly pronounced in the third quarter of 1996.

Recent developments suggest that the process of convergence of long-term interest rates resumed over the twelve-month period considered in this Report. A combination of factors appears to account for this trend. In some countries inflation expectations appear to have decreased, while an important role also seems to have been played by a reduction in risk premia. Improved expectations regarding prospects for Monetary Union have also played a role. Looking at individual countries, the outturns may be interpreted as an indication that markets anticipate broadly similar macro-economic developments in those Member States showing no or only very small differences in long-term interest rates. This is particularly the case for Belgium, Germany, France, Luxembourg, the Netherlands and Austria. In countries whose rates remain above the reference value, namely Spain, Greece, Italy and Portugal, although a significant convergence of yields has occurred, differentials still remain wide, which indicates that progress towards overall convergence needs to be strengthened. However, more recently, a general acceleration of the convergence of long-term interest rates has been observed. This has been particularly the case in those countries whose long-term interest rates stand above the reference value during the twelve-month period considered.

Other factors

In addition to the above-mentioned convergence criteria, consideration is also given in the Report to "other factors". In summary, unit labour costs and other price indices do not provide grounds for reconsidering the judgements regarding the performance of Member States in terms of the price stability criterion; no major current account imbalances are discernible; and progress has been made in terms of the integration of markets. With regard to the integration of markets, indirect taxation and capital income taxation are of particular importance, and there are considerable differences between Member States. Furthermore, while the overall private ECU market contracted further, ECU exchange and interest rate developments since the first quarter of 1996 suggest a decrease in tensions and uncertainties.

[4] *In Greece, long-term interest rates are indexed to the twelve-month Treasury bill rate. They cannot be used for comparisons with other countries, but serve as a rough guide for intertemporal comparisons.*

1.3 The agenda ahead for adopting the single currency

Confirmation of participating Member States in early 1998

The start of Stage Three of Economic and Monetary Union on 1 January 1999 does not require a majority of the Member States to fulfil the necessary conditions. Rather, in early 1998, the Council, meeting in the composition of the Heads of State or Government, shall confirm which Member States fulfil the necessary conditions for the adoption of the single currency. The assessment will be made on the basis of actual data which for public finances will cover the outcome in 1997.

At the same time, the essential requirement of achieving a high degree of sustainable convergence has to be fulfilled. Indeed, agents are beginning to look beyond the year 1999, and are starting to form expectations about likely longer-term developments in the single currency area, inter alia in terms of price stability and fiscal developments. They are also taking into account the global environment, for example in order to assess the relative competitiveness, attractiveness and openness of the euro area both in terms of aspects related to the real economy and the monetary and financial spheres. All these factors are increasingly tending to feed into current long-term interest and exchange rates, and they will ultimately determine the long-term interest rate and exchange rate levels of the euro.

In the light of this, the continuation and, where necessary, strengthening of sound policies is warranted. In respect of monetary policies, the stance adopted in the period ahead will increasingly affect inflation in 1999 and thereafter, and hence influence price expectations for the euro area. In the field of budgetary policies, the fiscal criteria will not only be examined for the purpose of convergence in Stage Two, but will also be applied in Stage Three. Decisive and sustained corrective policies of a structural nature are needed in most countries. The accumulated stock of debt has to be serviced, and these interest payments not only place a burden on current budgets, but will continue to do so until debt levels are substantially reduced. High and persistent unemployment and demographic trends add to this burden. Against this background it is evident that the challenges posed to fiscal policies neither originate from the Maastricht Treaty nor will they ultimately be resolved merely by budgetary improvements over the short term. The authorities are therefore well-advised not only to focus on the achievement of convergence in a single year, but also to demonstrate the political will and the ability to tackle the underlying problems. Recent developments indicate that a number of benefits can arise. First, short-term consistency of fiscal policies with medium-term requirements can enhance confidence, both in the real economy and in financial markets, and any short-term contractionary effects of fiscal consolidation can be at least partially compensated for by growth in private expenditure. Second, there is a link between fiscal consolidation and real long-term interest rates. Restoring sound fiscal balances will contribute to low country-specific risk premia and hence to a general reduction of real long-term interest rates. Finally, there is a need to complement such policies by measures which enhance the functioning of market mechanisms, particularly in the labour market.

Completion of the preparatory work

The ongoing efforts to achieve a high degree of sustainable convergence are being made against the background of intense preparatory work for Monetary Union on all levels. Inter alia, the EMI is currently finalising an important step in the definition of the regulatory, organisational and logistical framework necessary for the ESCB to perform its tasks in the third stage. A

report covering these aspects will be published in early 1997. In parallel, the authorities are elaborating upon the necessary follow-up regarding the changeover to the euro, including its legal status, and the financial and corporate sectors are preparing for the changeover in the light of their particular needs and circumstances. Furthermore, the Member States are setting out the framework for a smooth exchange rate relationship between those countries which will join the euro area from the start and those which will enter later. Finally, as mentioned earlier, enhanced mechanisms to foster fiscal discipline after the start of Stage Three are being developed in the context of the so-called "Stability Pact".

2 Statutory requirements to be fulfilled for NCBs to become an integral part of the ESCB

Article 108 of the Treaty states that Member States shall ensure, at the latest at the date of the establishment of the ESCB, that their national legislation including the statutes of their NCBs is compatible with the Treaty and the Statute of the European System of Central Banks and the European Central Bank (the "Statute"). This obligation of legal convergence does not require harmonisation of NCBs' statutes, but merely implies that national legislation and statutes of NCBs need to be adjusted in order to eliminate inconsistencies with the Treaty. Timely adaptation requires the legislative process to be initiated during Stage Two, which would also allow the EMI and other Community institutions to assess the progress made towards the fulfilment of the requirements for Stage Three. For the purpose of identifying those areas where adaptation of statutes is necessary, a distinction may be made between independence of NCBs and integration of NCBs in the ESCB. In Chapter II of this Report the emphasis lies on legal convergence towards independence of NCBs, whilst it is acknowledged that the integration of NCBs in the ESCB as well as the transition to Stage Three of EMU may require further adaptations of statutes of NCBs and other legislation. This Report is therefore not exhaustive and does not prejudge subsequent assessments of legal convergence as they will be elaborated in future reports which the EMI is required to submit under Article 109j of the Treaty and Article 7 of its Statute.

2.1 Central bank independence

The principle of central bank independence has been elaborated in particular in Article 107 of the Treaty and Article 14.2 of the Statute. Article 107 contains a prohibition of external influence on the ECB, NCBs and the members of their decision-making bodies, and Article 14.2 provides for security of tenure for such members. From these Articles, the EMI has deduced that the following features of central bank independence apply to ESCB-related tasks.

As regards institutional independence, the EMI is of the opinion that rights of third parties (e.g. government and parliament) to:

- give instructions to NCBs or their decision-making bodies;
- approve, suspend, annul or defer decisions of NCBs;
- censor an NCB's decisions on legal grounds;

- participate in the decision-making bodies of an NCB with a right to vote; or
- be consulted (ex ante) on an NCB's decisions

are incompatible with the Treaty and/or the Statute and, thus, require adaptation.

With respect to personal independence, the EMI is of the opinion that the statutes of NCBs should ensure that:

- governors of NCBs have a minimum term of office of five years;
- a governor of an NCB may not be dismissed for reasons other than those mentioned in Article 14.2 of the Statute (i.e. if he/she no longer fulfils the conditions required for the performance of his/her duties or if he/she has been guilty of serious misconduct);
- other members of the decision-making bodies of NCBs involved in the performance of ESCB-related tasks have the same security of tenure as governors;
- no conflicts of interest will arise between the duties of members of the decision-making bodies of NCBs vis-à-vis their respective NCB (and, additionally, of governors vis-à-vis the ECB) and other functions which members of the decision-making bodies involved in the performance of ESCB-related tasks may perform and which may jeopardise their personal independence.

Functional independence requires the statutory objectives of NCBs to be in line with the ESCB's objective as laid down in Article 2 of its Statute. Furthermore, any tasks of NCBs deemed by the Governing Council of the ECB to interfere with ESCB-related tasks should be abolished under Article 14.4 of the Statute.

Financial independence implies that NCBs avail themselves of the appropriate means to fulfil their mandate. Statutory constraints in this field should be accompanied by a safeguard clause to ensure that ESCB-related tasks can be properly fulfilled.

The above specification of features of central bank independence allows an assessment to be made of those provisions in the statutes of NCBs which, in the EMI's opinion, are incompatible with the Treaty and the Statute and which therefore require adaptation. Annex 1 to Chapter II to this Report, which contains a description of the institutional features of NCBs, identifies provisions in statutes of NCBs which are deemed to be incompatible with the Treaty and the Statute.

2.2 Integration of NCBs in the ESCB

The full participation of NCBs in the ESCB will necessitate measures in addition to those designed to ensure independence. In particular, such measures may be necessary to enable NCBs to execute tasks as members of the ESCB and in accordance with decisions by the ECB. The main areas of attention are those where statutory provisions may form an obstacle to an NCB complying with the requirements of the ESCB or to a governor fulfilling his/her duties as a member of the Governing Council of the ECB, or where statutory provisions do not respect the prerogatives of the ECB.

2.3 Developments since late 1995

In the period between publication of the 1995 Convergence Report and the present Report considerable attention has been paid in the Member States to the need to adapt the statutes of their respective NCBs in order to comply with Treaty and Statute

requirements. In several cases this has resulted in the submission to parliament of adapted statutes on which the EMI has been consulted under Article 109f (6) of the Treaty and Article 5.3 of its Statute. Some of the proposed adaptations have been designed to make national legislation consistent with Articles 104 and 104a of the Treaty, whereas in other cases adaptations were in particular intended to strengthen central bank independence. However, the statutes of most NCBs require further adaptations, in particular with a view to integration of NCBs in the ESCB.

Introduction

Introduction

This is the first EMI Report to fulfil the requirements of Article 109j (1) of the Treaty establishing the European Community (the "Treaty"). Under this Article, "the Commission and the EMI shall 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". The Treaty provides that, following these reports, a procedure will be conducted involving the EU Council, the European Parliament and the Council in the composition of the Heads of States or of Government (see Box A).

In accordance with the Treaty, Chapter I of the Report examines the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the criteria mentioned, and also takes into account "other factors" specified in the Treaty. Chapter II deals with the statutory requirements to be fulfilled for national central banks (NCBs) to become an integral part of the ESCB, with particular emphasis on central bank independence. Overall, the Report concludes that at present a majority of Member States do not fulfil the necessary conditions for the adoption of a single currency.

In line with the Treaty and the consensus reached at the Madrid and Florence summits, Stage Three of Economic and Monetary Union will begin on 1 January 1999. As a consequence, the procedure according to Article 109j (4) will apply. This will necessitate the production of a further report under Article 109j in early 1998. In contrast to this year's procedure, which requires a decision as to whether a majority of the Member States fulfil the necessary conditions, whether it is appropriate to enter the third stage and if so, to set a date, in 1998 no such decisions will be taken. Rather, the exclusive objective will be to confirm which Member States qualify to form the group of countries adopting the single currency, irrespective of whether a majority exists. Against this background, the present Report highlights the degree of convergence currently achieved as a step towards the assessment of the outcome of 1997. Hence, this year's procedure can by no means pre-empt the assessment to be made in early 1998.

By addressing the issues of progress towards convergence and the statutory requirements to be fulfilled for national central banks to become an integral part of the ESCB, the Report also covers two of the obligations set out in Article 7 of the EMI Statute, under which the EMI must address a report to the Council on the state of preparations for the third stage once a year. However, the third topic mentioned in Article 7 of the EMI Statute, i.e. "the adaptation of monetary policy instruments and the preparation of the procedures necessary for carrying out a single monetary policy in the third stage", will, instead, be covered in a separate report. This second report will be published in early 1997. It will also comply with Article 109f (3) of the Treaty, which stipulates in its last paragraph the task of the EMI to specify the regulatory, organisational and logistical framework necessary for the ESCB to perform its tasks in the third stage.

BOX A

The procedure according to Treaty Article 109j

"1. The Commission and the EMI shall 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. These reports 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. The reports 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);
- 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.

The four criteria mentioned in this paragraph and the relevant periods over which they are to be respected are developed further in a Protocol annexed to this Treaty. 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.

2. On the basis of these reports, the Council, acting by a qualified majority on a recommendation from the Commission, shall assess:

- for each Member State, whether it fulfils the necessary conditions for the adoption of a single currency;
- whether a majority of the Member States fulfil the necessary conditions for the adoption of a single currency,

and recommend its findings to the Council, meeting in the composition of the Heads of State or of Government. The European Parliament shall be consulted and forward its opinion to the Council, meeting in the composition of the Heads of State or Government.

3. Taking due account of the reports referred to in paragraph 1 and the opinion of the European Parliament referred to in paragraph 2, the Council, meeting in the composition of the Heads of State or of Government, shall, acting by a qualified majority, not later than 31 December 1996:

- decide, on the basis of the recommendations of the Council referred to in paragraph 2, whether a majority of the Member States fulfil the necessary conditions for the adoption of a single currency;
- decide whether it is appropriate for the Community to enter the third stage,

and if so:

- set the date for the beginning of the third stage.

4. If by the end of 1997 the date for the beginning of the third stage has not been set, the third stage shall start on 1 January 1999. Before 1 July 1998, the Council, meeting in the composition of the Heads of State or of Government, after a repetition of the procedure provided for in paragraphs 1 and 2, with the exception of the second indent of paragraph 2, taking into account the reports referred to in paragraph 1 and the opinion of the European Parliament, shall, acting by a qualified majority and on the basis of the recommendations of the Council referred to in paragraph 2, confirm which Member States fulfil the necessary conditions for the adoption of a single currency."

Chapter I

Convergence criteria

1 Key aspects of the assessment of convergence in 1996

Fulfilment of convergence criteria

This chapter examines the progress made in the achievement of a high degree of sustainable convergence in the Member States and highlights areas where the need for further economic adjustment persists. As was the case in its November 1995 report entitled "Progress Towards Convergence" a number of guiding principles are used by the EMI for the application of the convergence criteria. Quoting from that report: "First, the individual criteria are interpreted and applied in a strict manner. The rationale behind this principle ... is that the main purpose of the criteria is to ensure that only those Member States which have economic conditions that are conducive to the maintenance of price stability and the viability of the European currency area should participate in it. Second, the convergence criteria constitute a coherent and integrated package and they must all be satisfied; the Treaty lists the criteria on an equal footing and does not suggest a hierarchy. Third, the convergence criteria have to be met on the basis of current data. Fourth, the application of the convergence criteria should be consistent, transparent and simple."

In this chapter, performance is examined both in terms of each of the convergence criteria outlined in the Treaty and on a country-by-country basis. Consistent with the Treaty, the statistical data to be used for the application of the convergence criteria have been provided by the Commission. In general, data cover the period up to September 1996. Data for fiscal positions also show the latest Commission projections for 1996;[1] no reference is made to forecasts for 1997, nor does the Report assess budget proposals for 1997.

As to the individual criteria, the assessments regarding price and interest rate convergence are based on the average of the three best-performing countries in terms of inflation, as the price performance of the countries with the lowest rates of inflation appears to be broadly similar and compatible with the objective of price stability. With respect to the fiscal criteria, developments are reviewed in relation to the reference values, and indicators are considered which contribute to providing a basis for further addressing the Treaty's notion of deficit ratios "remaining close to the reference value" or debt ratios "sufficiently diminishing and approaching the reference value at a satisfactory pace". In respect of exchange rate developments, the EMI does not at this stage consider it appropriate to give a precise ex ante operational content to the measurement of exchange rate stability according to Article 109j of the Treaty, which could also mechanically be applied to forthcoming periods, but rather aims for an ex post assessment. Regarding the Treaty provision of membership of the ERM, there is a strong majority position within the EMI Council that the requirement of ERM membership applies. A minority takes the view that exchange rate stability based on sustainable underlying economic fundamentals is more important than the institutional setting within which stability is achieved.

[1] *The use of projections (instead of final data) should not be seen as prejudging the choice of data to be used for subsequent reports to be prepared in accordance with Article 109j.*

The issue of sustainability

Compliance with the convergence criteria is essential, not only at a specific point in time but also on a sustained basis. The case for a strong focus on sustainability may be best clarified by taking the example of fiscal policies. Given that government budgets are currently the weakest point of convergence, the public debate is mainly focusing on this issue. This focus is entirely justified, as there are difficult challenges to fiscal policies which must indeed be tackled in a resolute and persistent manner. This holds both for the correction of the effects of past errors and the resolution of future problems. The improvement of the deficit by measures with a one-off effect does not ensure sustainable consolidation and great attention will have to be paid to the substance and not only to accounting methods used in measuring both deficits and debts.

Looking back, many countries have accumulated high or very high levels of public sector debt because they were not able to deal with, for example, economic shocks, problems of distribution or regional divergences. Consequently, the burden has been assumed by government borrowing. Problems typically associated with an unduly high stock of debt have been, inter alia, the crowding-out of non-interest expenditure by large interest payments and a greater burden placed on monetary policy. Looking forward, the accumulated debt has to be serviced, and these interest payments not only place a burden on current budgets, but will continue to do so until debt levels are substantially reduced. Consolidation efforts need to be all the more resolute, the higher the initial stock of debt. In addition, sustainable fiscal consolidation will have to cope with two challenges: first, high and persistent unemployment and, second, those arising from demographic trends, particularly in the fields of health and retirement income provision. Against this background it is evident that the challenges posed to fiscal policies neither originate from the Maastricht Treaty nor will they ultimately be resolved merely by budgetary improvements over the short term. Rather, decisive and sustained corrective policies of a structural nature are needed in most countries, irrespective of the convergence requirements of the Treaty. Moreover, there is a need to complement such policies by measures which enhance the functioning of market mechanisms, particularly in the labour market.

It is noteworthy that issues of sustainability appear to be receiving increased attention, for example in the context of the "Stability Pact". Agents are beginning to look beyond the year 1999, and are starting to form expectations about likely longer-term developments in the single currency area, inter alia in terms of price stability and fiscal developments. They are also taking into account the global environment, for example in order to assess the relative competitiveness, attractiveness and openness of the euro area both in terms of aspects related to the real economy and in the monetary and financial spheres. All these factors are increasingly tending to feed into current long-term interest and exchange rates, and they will ultimately determine the long-term interest rate and exchange rate levels of the euro.

BOX 1.1

Treaty provisions in relation to the convergence criteria

1 Price stability

The Treaty establishing the European Community, Article 109j (1), requires the price criterion to be judged on the basis of the relative inflation performance, which is ''*close to that of, at most, the three best-performing Member States in terms of price stability*''.

The Protocol (No. 6) on the convergence criteria referred to in Article 109j (1) of the Treaty establishing the European Community, Article 1, stipulates:

''*The criterion on price stability referred to in the first indent of Article 109j (1) of this Treaty 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. Inflation shall be measured by means of the consumer price index (CPI) on a comparable basis, taking into account differences in national definitions*''.

2 Public finances

The Treaty establishing the European Community, Article 109j (1), requires that the government financial position be sustainable. This will be apparent from having achieved a government budgetary position without a deficit that is ''*excessive*''. Article 104c defines the criteria for deciding whether an excessive deficit exists, requiring the Commission to prepare a report if one or both of the following conditions are fulfilled:

(a) ''*the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value (*defined in the Protocol on the Excessive Deficit Procedure as 3% of GDP), *unless*:

- *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;*

(b) *the ratio of government debt to gross domestic product exceeds a reference value* (defined in the Protocol on the Excessive Deficit Procedure as 60% of GDP), *unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace*''.

In addition, the report prepared by the Commission should 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*''. The Commission may also prepare a report if, notwithstanding the fulfilment of the requirements under the criterion, it is of the opinion that there is a risk of an excessive deficit in a Member State. The Monetary Committee (or its successor in Stage Three, the Economic and Financial Committee) shall formulate an opinion on the report of the Commission. Finally, on the basis of the recommendation of the Commission, the EU Council shall, acting by a qualified majority, decide whether an excessive deficit exists in a Member State. The criterion on the government budgetary position referred to in the second indent of Article 109j (1) of the 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 the Treaty that an excessive deficit exists.

3 Exchange rate stability

The Treaty establishing the European Community, Article 109j (1), requires *''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''*. In addition, the Protocol to the Treaty (No. 6, Article 3) specifies that the above *''criterion on participation in the exchange rate mechanism of the European Monetary System .... 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''*.

4 Long-term interest rates

The Treaty establishing the European Community, Article 109j (1), requires that the durability of convergence achieved by the Member State and of its participation in the exchange-rate mechanism of the European Monetary System be reflected in the long-term interest rate levels. Defining this criterion, the Protocol (No. 6) stipulates:

''The criterion on the convergence of interest rates referred to in the fourth indent of Article 109j (1) of this Treaty 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. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions''.

5 Other factors

In addition to the Treaty criteria on price stability, fiscal positions, exchange rates and long-term interest rates considered in earlier sections of this Report, reference is also made to the use of a number of *''other factors''* in assessing the degree of convergence among Member States. According to Article 109j (1) of the Treaty establishing the European Community:

''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''.

2 The criterion on price stability

2.1 Consumer price developments in relation to the reference value

Inflation rates for the fifteen EU Member States are presented in Table 2.1. Also shown are reference values based on the arithmetic average inflation rate of the three best-performing countries plus 1.5 percentage points. Price stability may in principle be best reflected by the country with the lowest inflation rate. However, the average of the three best-performing countries may provide a good starting-point for the assessment of compliance with the reference value if there are no outliers. The data used are Interim Indices of Consumer Prices (IICPs), which are developed for the purpose of assessing convergence in terms of price stability and are the first step towards Harmonised Indices of Consumer Prices (HICPs), which will be calculated from the beginning of 1997. It should be stressed that IICPs are not a comprehensive measure of domestic inflation, since significant adjustments are made for comparability purposes. However, they are more comparable than current national indices and thus provide a more uniform basis for assessing convergence (see Annex 1 for further information on the progress towards harmonised statistics on consumer prices).

Over the reference period considered (October 1995 to September 1996), the lowest average inflation rates among the Member States were seen in Finland, the Netherlands and Germany, with price increases of 0.9%, 1.2% and 1.3%, respectively. These rates, which can be regarded as compatible with the objective of price stability, have been used to calculate the reference value. This reference value has remained relatively stable at around 2½% in 1996 (see Chart 2.1).

Ten Member States (Belgium, Denmark, Germany, France, Ireland, Luxembourg, the Netherlands, Austria, Finland and Sweden) had a twelve-month average inflation rate up to September 1996, measured by IICPs, which stood below the reference value of 2.6%.

Five countries (Greece, Spain, Italy, Portugal and the United Kingdom) had inflation rates above the reference value. Inflation rates over the reference period were 3.0% in Portugal and the United Kingdom, 3.8% in Spain and 4.7% in Italy. At 8.4%, Greek inflation remained far above the reference value. In Greece, Spain, Italy and Portugal, twelve-month average IICP inflation declined from different levels and at different paces during the course of 1996, and the gap in relation to the reference value narrowed. The difference between inflation in the United Kingdom and the reference value was smaller than in the other countries throughout 1996, and has narrowed slightly in recent months (see Chart 2.1).

Table 2.1

Interim indices of consumer price inflation

(annual percentage rates)

	1995		Oct 95- Sep 96	Q4 95	Q1 96	Q2 96	Q3 96
Belgium	1.4		1.6	1.2	1.7	1.7	2.0
Denmark	2.3		2.2	2.2	2.0	2.2	2.5
Germany	1.5	***	1.3	1.4	1.4	1.3	1.3
Greece	9.0		8.4	8.0	8.4	8.8	8.3
Spain	4.7		3.8	4.3	3.6	3.6	3.7
France	1.7		2.1	2.0	2.2	2.5	1.9
Ireland[a]	2.4		2.1	2.3	2.1	1.9	2.2
Italy[b]	5.4		4.7	5.8	5.1	4.3	3.5
Luxembourg	1.9		1.3	1.4	1.1	1.5	1.4
Netherlands	1.1	**	1.2	0.7	1.3	1.4	1.5
Austria[c]	2.0		1.7	1.6	1.5	1.7	2.1
Portugal	3.8		3.0	3.5	2.3	3.0	3.4
Finland	1.0	*	0.9	0.3	0.9	1.3	1.1
Sweden	2.9		1.6	2.9	1.4	1.1	0.8
United Kingdom	3.1		3.0	3.3	3.1	2.9	2.9
Memo items: EU-15[b]	3.0		2.7	2.9	2.7	2.6	2.4
Standard deviation[d]	2.1		1.9	2.1	2.0	1.9	1.8
Reference value[e]	2.7		2.6	-	-	-	-
	Apr 96		May 96	Jun 96	Jul 96	Aug 96	Sep 96
Belgium	1.9		1.7	1.7	1.9	2.0	2.1
Denmark	2.2		2.1	2.2	2.6	2.5	2.5
Germany	1.5		1.4	1.1	1.4	1.2	1.3
Greece	9.0		8.9	8.5	8.4	8.3	8.1
Spain	3.4		3.7	3.5	3.7	3.7	3.6
France	2.6		2.6	2.4	2.4	1.7	1.6
Ireland[a]	1.9		1.9	1.9	2.2	2.2	2.2
Italy[b]	4.5		4.5	4.0	3.7	3.5	3.5
Luxembourg	1.6		1.5	1.4	1.4	1.5	1.5
Netherlands	1.6		1.5	1.1	1.7	1.3	1.4
Austria[c]	2.0		1.5	1.7	2.1	2.2	2.2
Portugal	2.6		3.1	3.3	3.5	3.5	3.2
Finland	1.2		1.5	1.2	1.1	1.1	1.2
Sweden	1.3		1.2	1.0	1.0	0.8	0.6
United Kingdom	3.0		2.8	2.9	2.9	2.8	2.9
Memo items: EU-15[b]	2.7		2.6	2.5	2.5	2.3	2.4
Standard deviation[d]	2.0		2.0	1.9	1.8	1.8	1.8

Source: EUROSTAT.

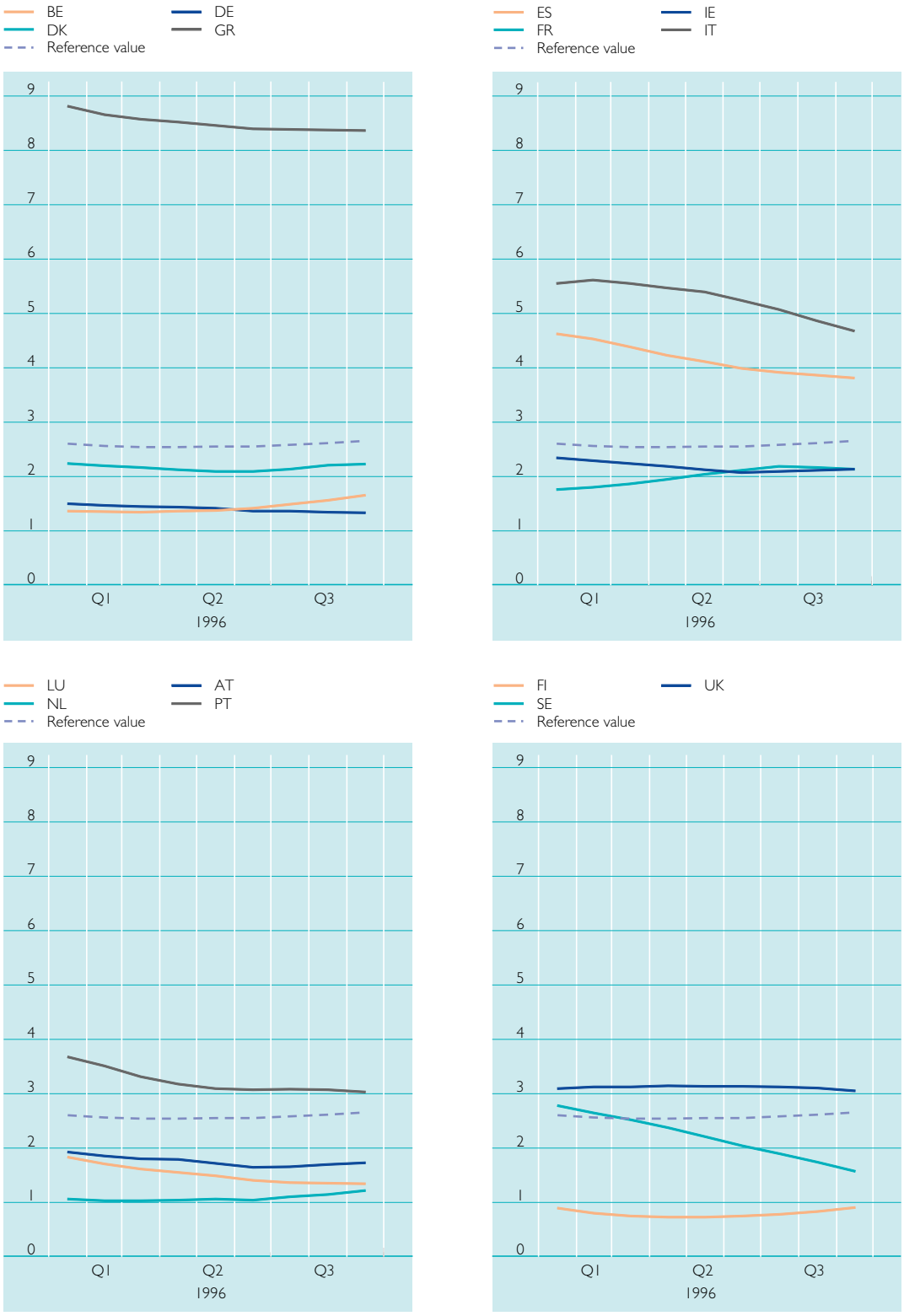
*,**,*** = first, second and third best performer in terms of price stability. Average percentage changes are calculated with a higher number of decimal places than presented in the table. These unrounded results are the basis for the identification of the three best performers as well as the position of all countries in relation to the reference value.

(a) For Ireland only quarterly data are available.
(b) Data for 1996 are provisional.
(c) Data for September 1996 are provisional.
(d) Unweighted standard deviation.
(e) Reference values are calculated as the unweighted arithmetic average of the three best-performing countries according to the price criterion (plus 1.5 percentage points).

Chart 2.1

Reference value* and interim indices of consumer prices

(12-month moving average of annual percentage changes)



Source: EUROSTAT.

* See footnote (e) to Table 2.1.

2.2 Recent consumer price developments in perspective and underlying factors

IICP inflation rates are available only from January 1995 onwards. Accordingly, national consumer price indices (CPIs) have to be utilised in order for longer-term trends to be considered, as part of the assessment of sustainability. As can be seen from Chart 2.2, CPI inflation in the EU countries has clearly been reduced in all Member States since the early 1990s. This has not only led to a significant reduction in average inflation, from 5.3% in 1991 to around 2.5% in the course of the first nine months of 1996, but has also meant a substantial move towards convergence in inflation rates across countries, highlighted by the fall in the standard deviation from 4.6 percentage points in 1991 to around 2 percentage points during the first three quarters of 1996.

Whereas a number of countries had inflation rates at the lower end of the range prevailing in the EU throughout the 1990s, other Member States experienced a marked decline. This applies particularly to Portugal, Sweden and the United Kingdom, where inflation rates dropped significantly from the high levels seen in early 1991. The improvement has also been remarkable in Spain and Italy; inflation fell rapidly from around mid-1995 onwards. While inflation in Greece remains the highest in the Union, it has been reduced by more than half since early 1991.

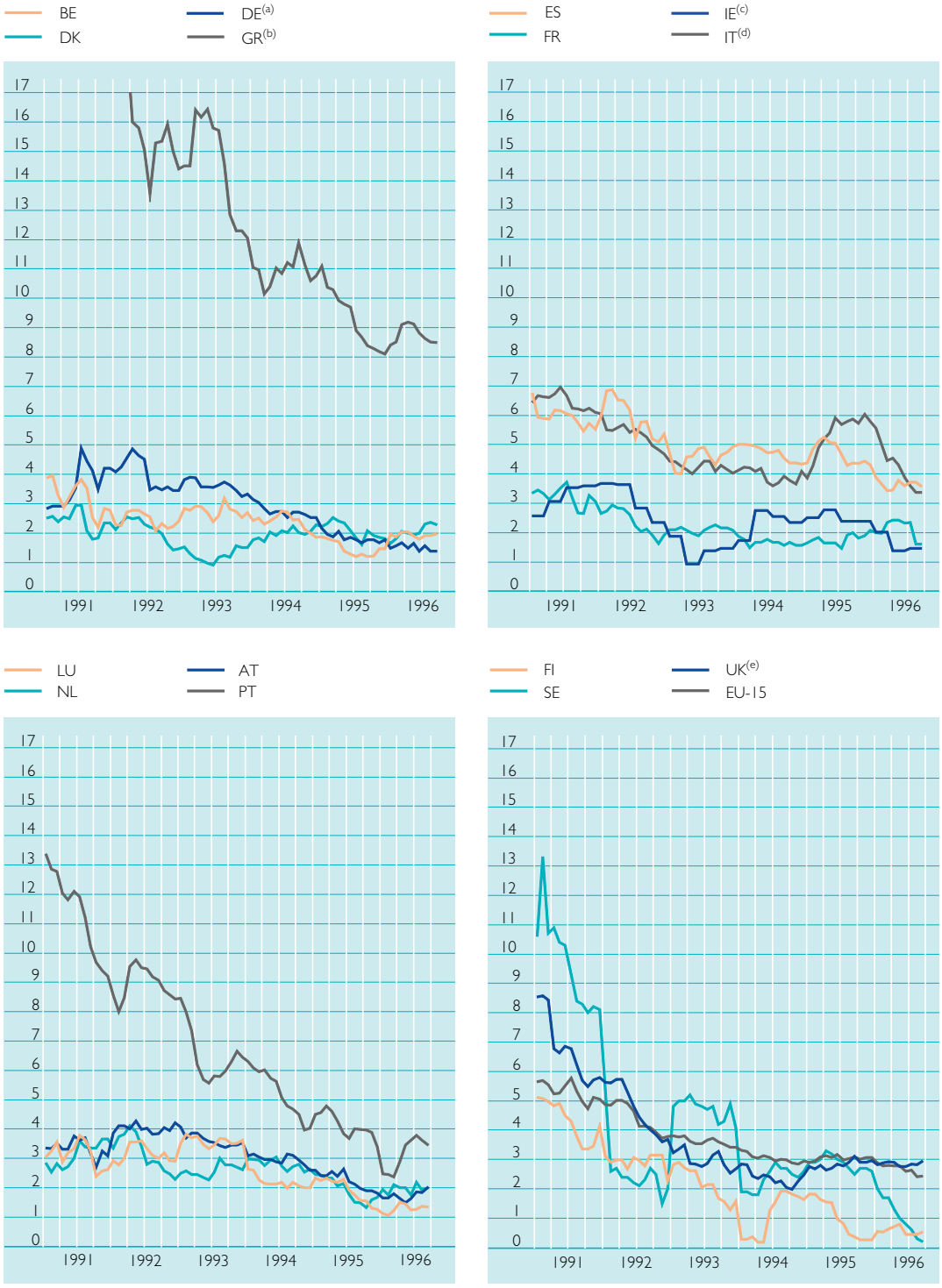
Seen over the longer-term, the major explanatory factors underlying this overall trend have been a growing tendency among Member States to orient their monetary policies increasingly towards the objective of price stability, as well as central bank independence. Increased competition in connection with the development of the single market and globally, the effects of labour market reforms in some countries and the recession of the early 1990s also contributed to an easing of price and cost pressures (see also Box 2.1). Against this background, a number of factors are considered, which typically affect the price climate over the short term. Among these are: (i) commodity price and exchange rate changes affecting import prices; (ii) international and domestic demand trends affecting production and capacity utilisation, as well as autonomous cost pressures, particularly influencing unit labour costs and profit margins; and (iii) effects of fiscal policy.

Of the ten Member States which have achieved IICP inflation rates of below the reference value, increases in import prices have generally been low or negative during the 1990s in Belgium, Denmark, Germany, France, Luxembourg, the Netherlands and Austria (see Chart 2.3). In the remaining three countries the pattern was more volatile owing to marked depreciations of their currencies during certain periods. Import price increases were high in Ireland in 1993 and 1995, in Finland in 1992 and 1993, and in Sweden in 1993 to 1995. However, with the renewed strength of these countries' currencies, increases have been low or negative in 1996.

Chart 2.2

Consumer price inflation

(monthly data; annual percentage changes)



Source: National non-harmonised data.
(a) Western Germany up to 1994, unified Germany thereafter.
(b) The Greek series is not continuous for reasons of scaling.
(c) Based on quarterly data.
(d) Cost-of-living index.
(e) RPI excluding mortgage interest payments (RPIX).

In the five countries where IICP inflation remains above the reference value, import prices typically rose quite markedly after periods of currency depreciation, although by less than in previous episodes of depreciation. The rate of increase in Spanish import prices was high in 1993 but gradually fell in succeeding years, whereas Italian import prices increased sharply in 1993 and 1995, and, to a lesser extent, in 1994. In Portugal increases were lower than in other countries whose currencies had also depreciated and decelerated over the past few years. In the United Kingdom import prices rose significantly in 1993 and 1995. In 1996 increases are expected to be relatively limited or negative in all four of these Member States. Greece has experienced high but gradually decreasing import price inflation since 1991. The pace of deceleration quickened in 1996, mainly as a result of the tighter exchange rate target.

BOX 2.1

Sustainability of price developments

The requirement of sustainability implies that price stability can be maintained. The following considerations may play a role when assessing the sustainability of price developments in this Report. First, price developments may be analysed with a view to identifying temporary factors that lead to one-off price changes. The most obvious of these is a change in indirect taxes, which would affect consumer prices in the year in question, ceteris paribus. Such factors are often excluded from measures of underlying inflation. Second, there is the more general issue of whether the current rate of inflation is sustainable, given the macroeconomic situation. For example, inflation often tends to decline during a recession and at times of high and growing unemployment. Moreover, in the presence of structural rigidities, an economic recovery may put upward pressure on inflation. Therefore, the rate of inflation viewed over the one-year reference period could be judged in the light of performance over a given period in the past or, alternatively, a number of indicators of inflation could be considered (such as unit labour costs). Third, there may be some situations, such as a debt deflation, where falling prices at a macroeconomic level are a sign of unsustainability. Indicators of such a situation would include a high rate of bankruptcies, a banking crisis, a sharp contraction of money and credit, and rapidly declining commercial or residential property prices.

In the assessment of sustainability there are several features which are of decisive importance over the longer term. First, there is the role of monetary policy. As inflation is a monetary phenomenon in the long run, it is the stringency of monetary policy as reflected in long-term monetary growth which determines the long-term rate of inflation. In this respect, central bank independence and the mandate for central banks to focus primarily on price stability can be seen as major advancements to ensure sustainability. Second, there is the issue of how the economy responds to domestic inflationary pressure. Here the ongoing integration of goods markets and various efforts to reduce rigidities in labour markets may be regarded as contributing to favourable developments. Third, the progressive liberalisation of financial markets, both domestically and internationally, exercises benign forces, which militate against the emergence of inflation, and, finally, as regards fiscal policies the risk of an unsustainable policy mix decreases, with an ongoing focus on containing deficits and reducing debt ratios. These developments are conducive to the maintenance of price stability in the longer term. (As regards the link between the sustainability of inflation and the interest rate criterion, see Box 5.1.)

Chart 2.3

Consumer price inflation* and important determinants

(annual percentage changes)

Source: National non-harmonised data.

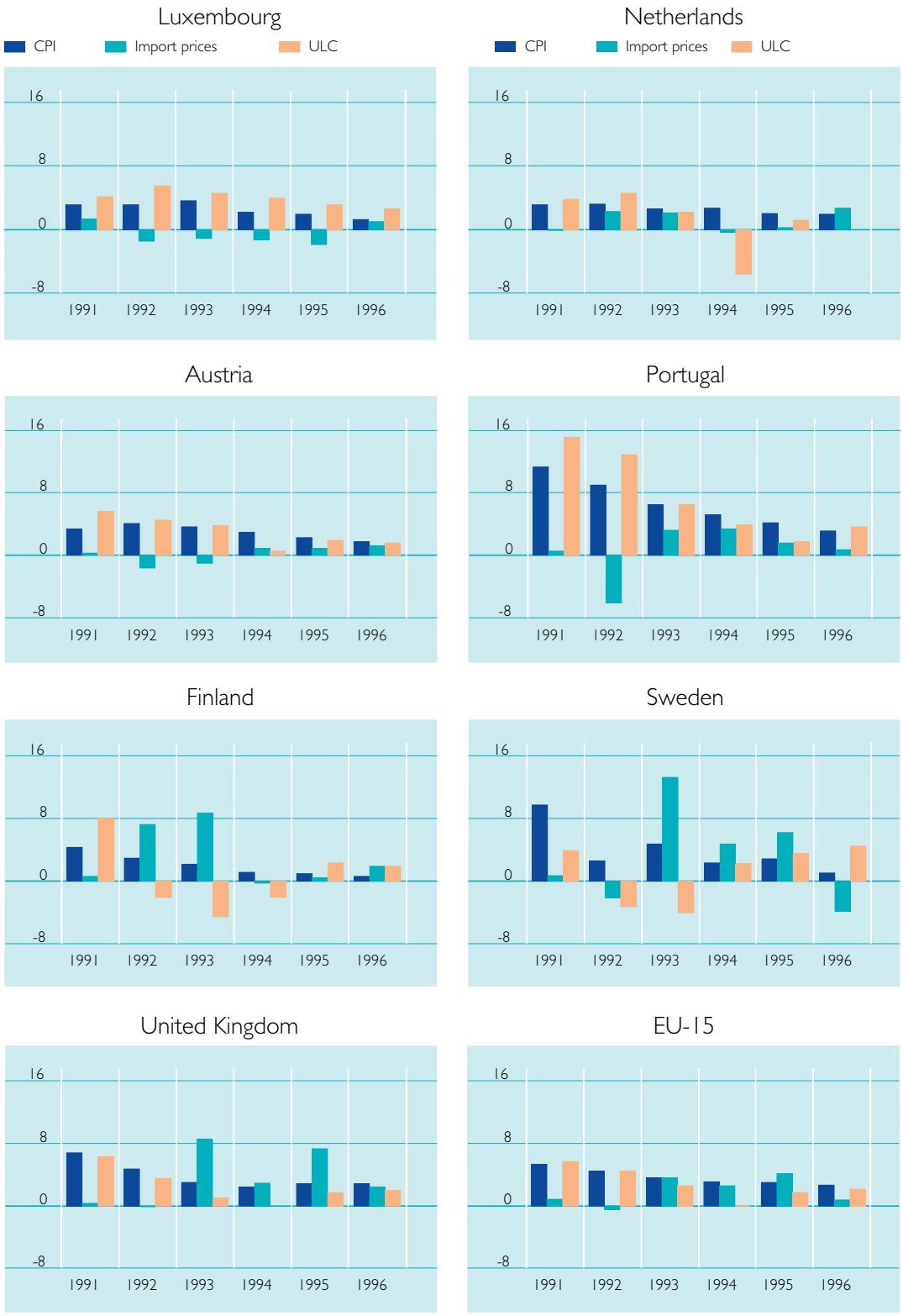
* For further explanation of the consumer price series used see footnotes to Chart 2.2.

(a) Western Germany up to 1991, unified Germany thereafter.

(b) For reasons of scaling the nominal unit labour costs series extends beyond the range. In 1995 it stood at –9.3%

Chart 2.3

Consumer price inflation* and important determinants
(annual percentage changes)



Source: National non-harmonised data.

* For further explanation of the consumer price series used see footnotes to Chart 2.2.

When looking at developments in unit labour costs in the ten Member States with IICP inflation rates below the reference value over the reference period, there seems to be little sign of emerging cost pressures. After an acceleration in the early 1990s in a number of Member States, rates of increase have been much more limited or even negative in recent years (notably in the Netherlands, but also in Belgium, Germany and Austria). Ireland has had low or even sharply decreasing unit labour costs in the 1990s, mainly because of sizable productivity gains. In Denmark and, to a lesser extent, France unit labour cost growth has increased in recent years though it remains modest, while in Finland and Sweden developments have shown large swings from year to year, partially linked to the deep recession of the early 1990s.

Turning to the Member States where further progress in terms of the convergence of inflation rates is required, unit labour cost growth tended to increase in 1995-96 in Spain, Italy and Portugal following a marked deceleration in the preceding years. In the United Kingdom a similar deceleration was observed during the early 1990s; increases in 1996 are also expected to remain low. In Greece unit labour cost increases remained high throughout the period considered, albeit with a tendency to decrease in the last two years.

Estimates of the effect of changes in indirect taxes, under the assumption of a full pass-through to consumer price inflation, are presented in Table 2.2. In most Member States indirect taxes have tended to rise and thus tended to increase consumer prices.

Table 2.2

Effects of indirect tax changes on consumer price inflation*

(percentage points)

	1991	1992	1993	1994	1995	1996
Belgium	0.1	0.1	0.3	0.7	0.0	0.5
Denmark	-0.2	0.0	-0.2	0.4	0.2	0.2
Germany[(a)]	0.3	0.4	0.0	0.3	0.0	0.0
Greece	1.0	1.6	0.5	0.8	0.6	0.9
Spain	-	-	0.0	0.3	1.0	0.2
France	0.3	0.3	0.4	0.2	0.8	0.0
Ireland	0.1	0.3	0.4	0.3	0.1	0.1
Italy	0.4	0.1	0.0	0.3	0.8	0.3
Luxembourg	-	-	-	0.1	0.1	-
Netherlands	0.5	0.6	0.2	0.4	0.2	0.6
Austria	0.0	0.2	0.0	0.2	0.5	0.1
Portugal	-	2.4	1.0	0.2	0.5	-
Finland	1.8	1.3	1.4	0.6	1.1	0.8
Sweden	4.1	-1.6	0.4	0.7	1.3	0.3
United Kingdom	0.1	0.3	0.2	0.7	0.7	0.4

Source: National estimates.

* Estimates are based on the assumption of a full pass-through of changes in indirect taxes to consumer prices.

(a) Western Germany.

2.3 Assessment

There were a number of structural changes which played an important role in explaining the convergence in inflation rates experienced over the 1990s, in particular the increased focus on price stability and the persistent orientation of monetary policies towards that objective. Furthermore, the recession of the early 1990s eased price and cost pressure, and, hence, is another general factor underlying these developments. As to the indicators discussed above, they do not suggest that price developments were severely distorted in the EU as a whole. Import price developments do not signal the existence of upward trends which would warrant special emphasis. Those countries which displayed some elements of debt deflation in the early 1990s (such as Finland, Sweden and the United Kingdom) no longer appear to be experiencing downward pressures on prices from this source. Finally, there were no net reductions in indirect taxes; rather, they were raised in many Member States. A note of caution may be sounded in relation to the tendency towards unit labour cost increases in a number of countries, while for others the limited increase in price and cost pressures must be viewed partly in the light of the recent weakness of demand.

Overall, it is concluded that in the ten Member States where inflation rates were below the reference value, there is no immediate risk that current trends in inflation will prove to be unsustainable. With regard to the five countries which had inflation rates above the reference value (Greece, Spain, Italy, Portugal and the United Kingdom), prospects for sustained progress towards price stability would seem to be favourable, provided that appropriate policies are pursued. Against this back-ground, crucial elements are that Member States conduct a monetary policy which is strictly geared towards price stability and thereby also conducive to stable exchange rates, that growth in unit labour costs is kept subdued and where necessary reduced, and that fiscal deficits are further reduced.

3 The criterion on the government budgetary position

3.1 Fiscal positions in relation to the reference values

Fiscal data published by the European Commission in autumn 1996 are shown in Table 3.1. The figures for 1996 are Commission projections (for the statistical issues see Annex 1). Concentrating first on budget deficits, the data show that in 1995 only Denmark and Ireland achieved a deficit of below 3% of GDP, the reference value provided for in the Treaty, while Luxembourg registered a surplus. In eight of the other countries, government imbalances were reduced in 1995 - in some cases significantly. In contrast, the deficit situation worsened in Germany, Spain, the Netherlands and Austria. For 1996, the most recent data indicate that four countries might have deficit ratios of below 3% (those having lower deficit ratios or a surplus in 1995, together with the Netherlands). All other Member States project reductions, which in some cases could be seen as considerable, with the exception of Germany, where a further rise in the deficit ratio is expected.

Moving on to government debt, the data show that in 1995 five Member States (Germany, France, Luxembourg, Finland and the United Kingdom) maintained a position below the reference value of 60% of GDP. Out of the ten countries with a higher debt ratio, only Ireland and Denmark achieved a major reduction, while Belgium, Italy and Sweden also registered some decline. Forecasts for 1996 are that debt reduction in these Member States will continue, albeit at different paces (see Table 3.1). In addition, the debt ratio is projected to fall slightly in Greece, the Netherlands and Portugal. In contrast, debt ratios will rise in Germany, Spain, Austria and Finland. In Germany and Finland the debt ratio is expected to exceed the 60% reference value. Three Member States (France, Luxembourg and the United Kingdom) are expected to maintain a debt ratio of below the 60% reference value.

Each year since the start of Stage Two of EMU in 1994 the Commission and the EU Council have examined the budgetary positions of Member States in order to implement the excessive deficit procedure set out in Treaty Article 104c and the associated Protocol No. 5. As a result of the annual application of the procedure, all Member States except Denmark, Ireland and Luxembourg are currently the subject of an EU Council decision that an excessive deficit exists; most recently (in June 1996), on the basis of a recommendation by the Commission, the excessive deficit decision was abrogated for Denmark, whereas it was re-introduced for Germany. Although debt ratios clearly exceed 60% of GDP also in Denmark and Ireland, account has been taken in the procedure of the progress made in these two countries in reducing the debt ratio.

Table 3.1

Government budgetary positions

(as a percentage of GDP)

	General government net lending (+) / net borrowing (-)					
	1991	1992	1993	1994	1995	1996[a]
Belgium	-6.5	-7.2	-7.5	-5.1	-4.1	-3.3
Denmark	-2.1	-2.9	-3.9	-3.5	-1.6	-1.4
Germany	-3.3	-2.8	-3.5	-2.4	-3.5	-4.0
Greece	-11.5	-12.3	-14.2	-12.1	-9.1	-7.9
Spain	-4.9	-3.6	-6.8	-6.3	-6.6	-4.4
France	-2.2	-3.8	-5.6	-5.6	-4.8	-4.0
Ireland	-2.3	-2.5	-2.4	-1.7	-2.0	-1.6
Italy	-10.2	-9.5	-9.6	-9.0	-7.1	-6.6
Luxembourg	1.9	0.8	1.7	2.6	1.5	0.9
Netherlands	-2.9	-3.9	-3.2	-3.4	-4.0	-2.6
Austria	-2.6	-1.9	-4.2	-4.4	-5.9	-4.3
Portugal	-6.7	-3.6	-6.9	-5.8	-5.1	-4.0
Finland	-1.5	-5.9	-8.0	-6.2	-5.2	-3.3
Sweden	-1.1	-7.8	-12.3	-10.8	-8.1	-3.9
United Kingdom	-2.6	-6.3	-7.8	-6.8	-5.8	-4.6
EU-15	-4.3	-5.1	-6.2	-5.4	-5.0	-4.4
	General government gross debt					
	1991	1992	1993	1994	1995	1996[a]
Belgium	129.4	130.6	137.0	135.0	133.7	130.6
Denmark[b]	64.6	68.7	80.1	76.0	71.9	70.2
Germany	41.5	44.1	48.2	50.4	58.1	60.8
Greece	92.3	99.2	111.8	110.4	111.8	110.6
Spain	45.8	48.4	60.5	63.1	65.7	67.8
France	35.8	39.6	45.6	48.4	52.8	56.4
Ireland	95.0	92.0	94.5	87.9	81.6	74.7
Italy	101.4	108.5	119.3	125.5	124.9	123.4
Luxembourg	4.2	5.2	6.2	5.7	6.0	7.8
Netherlands	78.8	79.6	80.8	77.4	79.7	78.7
Austria	58.7	58.3	62.8	65.1	69.0	71.7
Portugal	71.1	63.3	68.2	69.6	71.7	71.1
Finland	23.0	41.5	57.3	59.5	59.2	61.3
Sweden	53.0	67.1	76.0	79.3	78.7	78.1
United Kingdom	35.7	41.9	48.5	50.4	54.1	56.3
EU-15	56.1	60.4	66.1	68.1	71.3	73.5

Source: European Commission (autumn 1996).

(a) European Commission projections.

(b) General government gross debt figures are not adjusted for the assets held by the Danish Social Pension Fund against sectors outside general government, nor for government deposits at the central bank for the management of foreign exchange reserves. According to statements 5 and 6 relating to Council Regulation (EC) No. 3605/93 of 22 November 1993, the Council and the Commission agree that, for Denmark, these items shall be specified in the presentation of general government gross debt. They totalled 13.9% of GDP in 1992, 20.8% of GDP in 1993, 16.4% of GDP in 1994, 12.0% of GDP in 1995 and are expected to be 10.0% of GDP in 1996. In addition, the data are not adjusted for the amounts outstanding in the government debt from the financing of public undertakings, which, according to statement 3 relating to the aforementioned Regulation, will be subject to a separate presentation for the Member States. In Denmark this item amounted to 7.0% of GDP in 1992, 7.1% of GDP in 1993, 6.8% of GDP in 1994, 6.5% of GDP in 1995 and is expected to be 6.2% of GDP in 1996. If corrected by these items, the debt level at end-year would stand at 47.7% of GDP in 1992, 52.3% of GDP in 1993, 52.9% of GDP in 1994, 53.4% of GDP in 1995 and an expected 54.0% of GDP in 1996.

3.2 General government deficits

Recent deficit developments in perspective

The first few years of the current decade saw a substantial deterioration in public finances in nearly all Member States. As a result, the average fiscal deficit for the EU as a whole widened rapidly from 2.4% of GDP in 1989 to a high of 6.2% in 1993. At that point in time, most countries faced major challenges in reversing what was clearly an unsustainable trend. Responding to these challenges, national authorities have taken corrective measures in an effort to place their government deficits on a downward path. Focusing on the period since 1993, the fiscal situation has indeed improved on average, but considerable progress is still necessary, given the expected outturn of an EU-wide budget deficit of 4.4% in 1996, according to the Commission's autumn forecast.

Turning to the experience of individual countries, the Commission's data in Table 3.1 show that throughout the first half of the 1990s Ireland and Luxembourg have both stayed below the 3% reference value; in 1996 they are expected to record a 1.6% deficit and a surplus of 0.9%, respectively. Denmark succeeded in reducing the deficit from a peak of 3.9% in 1993 to 1.6% in 1995. For 1996 a small further decline to 1.4% is foreseen. The Netherlands is projected to reduce its deficit ratio to below 3% in 1996. Among the other Member States, where budget deficits in 1996 are expected to stand at a level above 3% of GDP, the recent record is mixed; Belgium and Finland (with ratios of 3.3%) are projected to reach deficit-to-GDP ratios in 1996 that are not far from the reference value. In Germany earlier improvements were reversed and government imbalances widened after 1994 to reach an expected 4.0% in 1996. The Austrian deficit also rose considerably in recent years, reaching a peak of 5.9% in 1995, but it is expected to fall to 4.3% in 1996. For most of the remaining countries, a continuous downward trend in the deficit ratio can be observed since 1993. Despite the general trend of deficit reduction, deficits in 1996 are still expected to remain considerably above 3% in Spain (4.4%), France (4.0%), Portugal (4.0%), Sweden (3.9%) and the United Kingdom (4.6%), and far above the reference value in Greece (7.9%) and Italy (6.6%). Partly reflecting different starting levels of the deficit ratio, the amplitude of reductions up to and including 1996 varies widely, ranging from 1.6 percentage points for France to a substantial 8.4 percentage points in the case of Sweden.

Underlying factors

To gain further insight into the nature of government imbalances, consideration may be given to the influence of the business cycle and one-off factors, as these tend to mask the underlying or structural deficit position. Furthermore, changes in the level and composition of expenditures and revenues are looked at more closely. This information also provides background material for assessing the sustainability of public finances from a longer-term perspective.

Some indications of the effect of the business cycle on the budgetary data can be obtained by comparing (changes in) actual and estimated "cyclically adjusted" or "structural" deficits. However, it needs to be emphasised that any calculations of the structural budget balance are subject to severe methodological and measurement problems. Moreover, as only the cyclical component is removed, the indicator of (changes in) the structural position might contain specific non-recurrent items, which should also be excluded when making judgements about the longer-run sustainability of the budgetary position. Equally, it cannot be assumed that a closing of the output gap will automatically resolve budgetary difficulties. More generally, given

the uncertainty surrounding the calculation, structural balances should not be accorded too much weight in assessing the fiscal position. The overall deficit is the relevant concept for assessing convergence. The concept of structural deficits should thus primarily be used to assess improvements or setbacks in the consolidation process.

Keeping these caveats in mind, the Commission's estimates suggest that, at the EU level, a large part of the improvement in the budget balance between 1993 and 1996 was of a structural nature (namely 1.3 percentage points out of a total deficit reduction of 1.8 percentage points). Most of this progress is expected to occur in 1996 (0.8 percentage point). While this suggests a clear turnaround, the projected EU-wide structural deficit of around 4% in 1996 is still too high. Moreover, caution is warranted by the fact that for some countries part of the reduction of structural deficits follows from a fall in interest rates and not from fiscal retrenchment.

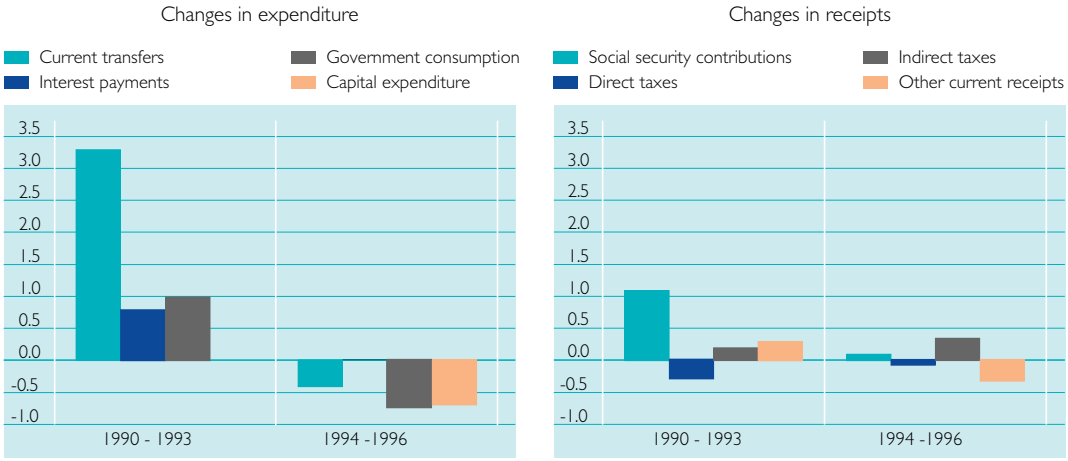
Finally, some further indication of the overall thrust of the consolidation process may be obtained from EU-wide trends in the composition of expenditures and receipts, which are highlighted in Chart 3.1. On the expenditure side, comparing the period 1990-93 with 1994-96, it is evident that there is still an urgent need to correct the sizable increase in total current transfers, and not to let capital outlays bear the brunt. Clearly, one of the major causes of the overall ratchetting-up of government expenditure in the early 1990s lies with the social security sector. This is also evident from the ongoing rise in social security contributions on the revenue side.

Fiscal deficits and investment

Among the other relevant factors to be taken into account, the Treaty explicitly mentions "whether the government deficit exceeds government investment expenditure" (Article 104c (3)). This may

Chart 3.1

Changes in the structure of general government expenditure and receipts in the EU*
(as a percentage of GDP)



Source: European Commission (autumn 1996).
* Data include Luxembourg from 1994 onwards, Western Germany up to 1991 and unified Germany thereafter.

be explained by the presumed self-financing capacity of public investment. In 1995 only Denmark, Ireland and Luxembourg - i.e. countries with a deficit of below 3% or a surplus - maintained a borrowing requirement which was not in excess of public investment. In 1996, the Netherlands is expected to join this group. Due to a relatively high level of catching-up investment, this condition is also expected to be fulfilled in 1996 by Portugal.

3.3 General government debt

Recent debt developments in perspective

In several Member States, the trend towards high and rising government debt-to-GDP ratios persisted in 1995 and 1996 (see Table 3.1), which underlines the urgent need to reinforce consolidation efforts. According to the Commission's autumn forecast, EU-wide government debt is expected to reach 73.5% of GDP in 1996, which is almost twice as high as in 1980. A particularly marked increase occurred in the early 1990s under the influence of a vicious circle of ever-increasing interest payments, deficits and debts.

BOX 3.1

Sustainability of fiscal positions

A sustainable fiscal position is often understood as a budgetary situation consistent with a stable debt-to-GDP ratio over time. However, while stabilising an unduly high and rising debt ratio is important, it can only be an interim objective; it is certainly necessary with a view to future budgetary challenges to aim for a reduction. This may also be advisable as standard national accounts do not include ''contingent liabilities'' of governments, for example unfunded pension liabilities (see also Box 3.3). Furthermore, the objective of stabilising the debt ratio does not take into account major problems associated with an unduly high stock of government debt, such as the requirement of increasing tax receipts or the crowding-out of non-interest expenditure by large interest payments, the potential problems of refinancing maturing debt, the vulnerability to sharp fluctuations in interest rates and exchange rates and the reduced flexibility to respond to adverse economic shocks. A related problem is that high debt levels by themselves may trigger market volatility and seriously complicate the implementation of monetary policy should interest rates need to be raised to ensure price stability, particularly in the case of a high proportion of short-maturity debt or debt indexed to short-term interest rates. In such a case, rising short-term interest rates would be an important factor causing a deterioration in the fiscal position of countries with high public debt. Overall, the argument suggests that highly indebted countries will have to make especially strong efforts to improve their fiscal situation.

Against this background, the Treaty demands a convergence of debt ratios to the 60% reference value or below. In order to assess whether the current stance of fiscal policy suggests that such a debt reduction can be achieved, a first approximation is to consider the difference between the actual primary balance (overall balance excluding interest payments) and the required primary balance (typically a surplus) in order to reduce the debt ratio. This difference indicates whether a so-called ''primary (or debt-convergence) gap'' exists, see Box 3.2. In this context, however, the Treaty does not specify an explicit time horizon within which a country with a debt ratio of above 60% at the time of assessment should have converged to this point. The application of a common horizon leads to an outcome which satisfies the view that the higher the debt ratio is, the more consolidation efforts should be undertaken. In practice, there may be limitations on the speed of national adjustment, suggesting that actual horizons for debt convergence may differ across countries. In either case, however, sustaining a sufficiently high primary

surplus is the only route that offers the prospect of regaining budgetary room for manoeuvre in the medium term. A further in-depth approach would be to examine whether underlying public expenditure programmes and revenue trends suggest the feasibility of sustaining such a primary surplus, thereby also taking account of the balance of permanent as opposed to transitory measures. In this respect it is of particular importance that consolidation should be based on genuine and lasting structural policy measures.

Three Member States are projected to have very high debt levels at the end of 1996, namely Belgium (130.6% of GDP), Greece (110.6%) and Italy (123.4%). Developments in recent years show that Belgium has succeeded in lowering its debt ratio since the peak of 1993, while in Italy the debt ratio has been reduced marginally since 1994. Starting from a much lower level, Germany, Spain and Austria have been on a continuously rising debt path over the period up to 1995, while the Netherlands, Portugal, Finland and Sweden have experienced mixed results in containing debt growth. Current projections suggest that this group of seven countries will see debt ratios moving up in 1996 or decreasing only slightly to stand at a high level of between 60 and 80% of GDP. Denmark and Ireland are in the same high-debt range. In clear contrast, however, they have recorded substantial reductions in recent years. In 1996 their debt-to-GDP ratios are expected to fall to 70.2% (from a peak of 80.1% in 1993) and 74.7% (from 94.5% in 1993), respectively. In France and the United Kingdom government debt increased rapidly in the early 1990s, a trend which has not yet been brought fully under control. With projected debt levels for 1996 of just over 56% of GDP, however, both countries remain below the 60% reference value. Finally, the debt position of Luxembourg has tended to stabilise at around 6% of GDP.

Against the background of a trend rise in debt ratios, the focus of discussion has shifted towards issues related to the sustainability of government finances. In this respect, the major emphasis is on future challenges, i.e. on the need to reduce current high debt ratios and to cope, inter alia, with the growing fiscal burden of social security old-age pensions. The growing burden of debt service obligations tends to crowd out non-interest expenditures and makes national government budgets increasingly vulnerable to exchange rate and interest rate volatility, in particular when the debt is at short maturity or is indexed to short-term interest rates, while at the same time threatening to provoke such volatility (see also Box 3.1). The social security systems in many EU countries are leading to difficulties in public finances, and in the future these problems are likely to be exacerbated by the interaction between population ageing and the scale of benefit promises (see Box 3.3). Problems tend to be more severe in countries where the pension system is largely based on the pay-as-you-go principle rather than on the funding of pensions.

Underlying factors

Several factors explain the evolution of government debt ratios over time. The first is the primary balance, i.e. the overall fiscal deficit corrected for interest payments on the outstanding stock of debt. As can be seen from Table 3.2, there has been a general tendency for primary balances to improve since 1993, particularly in Member States with very high debt ratios, as well as in the Nordic countries and the United Kingdom. In most cases, however, further corrections will have to be made in order to reduce the ratio of debt to GDP.

The second underlying factor is the difference between the interest rate paid on the outstanding debt and nominal GDP growth (the "growth-adjusted effective interest rate"). Since the early 1980s this

difference has on average generally been positive. In principle, this implies that countries needed to maintain a sufficient primary surplus just to prevent the debt ratio from rising.

Table 3.2

General government primary balances and interest payments

(as a percentage of GDP)

	Primary balances						Interest payments					
	1991	1992	1993	1994	1995	1996[a]	1991	1992	1993	1994	1995	1996[a]
BE	3.7	3.6	3.3	4.9	5.0	5.2	10.2	10.8	10.8	10.1	9.1	8.5
DK	5.3	4.0	3.9	3.6	5.0	5.0	7.4	6.8	7.8	7.1	6.7	6.4
DE	-0.6	0.4	-0.2	1.0	0.2	-0.2	2.7	3.3	3.3	3.4	3.7	3.8
GR	-2.1	-0.6	-1.4	2.1	4.0	3.9	9.4	11.7	12.8	14.2	13.1	11.9
ES	-1.0	0.6	-1.6	-1.2	-1.3	1.0	3.9	4.2	5.2	5.1	5.4	5.4
FR	0.9	-0.6	-2.3	-2.0	-1.1	-0.2	3.1	3.2	3.4	3.6	3.7	3.8
IE	5.1	4.4	4.0	4.0	3.0	2.9	7.5	6.9	6.5	5.7	5.0	4.5
IT	0.0	1.9	2.5	1.7	4.1	4.0	10.2	11.4	12.1	10.7	11.2	10.5
LU	2.3	1.1	2.0	3.1	1.9	1.3	0.4	0.4	0.4	0.4	0.3	0.3
NL	3.3	2.3	3.0	2.5	1.9	3.0	6.2	6.3	6.2	5.9	6.0	5.6
AT	1.6	2.4	0.2	-0.3	-1.5	0.3	4.3	4.3	4.3	4.1	4.3	4.5
PT	1.9	4.2	-0.1	0.0	0.5	0.9	8.6	7.8	6.8	5.8	5.6	4.9
FI	0.4	-3.2	-3.4	-1.1	0.1	2.5	1.9	2.6	4.6	5.1	5.4	5.9
SE	4.0	-2.4	-6.1	-4.0	-1.0	3.6	5.1	5.4	6.2	6.8	7.1	7.5
UK	0.3	-3.4	-4.9	-3.5	-2.1	-0.9	3.0	2.9	2.9	3.3	3.7	3.8
EU-15	0.5	0.2	-0.8	-0.1	0.4	1.1	4.9	5.3	5.4	5.3	5.4	5.4

Source: European Commission (autumn 1996).
(a) European Commission projections.

A third factor explaining the dynamics of government debt is covered by the heading of "stock-flow adjustments". These encompass a range of adjustments in the gross stock of debt taking place outside the government budget, such as the revaluation of debt issued in foreign currency, the accumulation/decumulation of financial assets through debt issuance/repayment, proceeds from the privatisation of public enterprises leading to debt reduction, debt take-overs from other sectors of the economy, and statistical corrections. For example, in 1996 debt ratios are projected to rise due to stock-flow adjustments in several countries, most significantly in Greece and in Luxembourg (the adjustments are estimated to amount to 2.4% and 2.9% of GDP, respectively).

BOX 3.2

Debt dynamics and the primary gap

The chart below seeks to provide a view on the sustainability of budgetary positions with specific reference to the close relationship that exists between the primary balance and future debt developments. However, it has to be kept in mind that the primary balance is an analytical instrument. It should not be misread so as to understate budgetary difficulties. The chart shows for each individual Member State

whether its debt ratio in 1996 is expected to exceed the 60% reference value. In addition, it indicates whether a so-called ''primary gap'' exists, i.e. to what extent the primary balance projected for 1996 deviates from the primary surplus which would be compatible with maintaining a stable government debt ratio, given a country's growth-adjusted effective interest rate in 1996 and disregarding stock-flow adjustments. A country positioned below the horizontal axis will typically see its debt ratio rise over time, as without further fiscal adjustments its primary surplus is not sufficient to provide for a stabilisation, let alone a decline. Additional policy measures would therefore be warranted to achieve a turnaround. In contrast, a country above the horizontal axis runs a primary surplus of a size which, if sustained, would suggest a continuously falling debt ratio. In the context of the diagram, the speed at which the reference value of 60% is approached depends, first, on the size of the actual primary surplus in relation to the debt-stabilising primary surplus (see vertical axis) and, second, on the initial distance from the reference value (see horizontal axis).

Primary gap and government debt in 1996*

(as a percentage of GDP)

Source: European Commission (autumn 1996).

* The primary gap shows the difference between the actual primary balance and the debt-stabilising primary balance, given each individual country's growth-adjusted effective interest rate and disregarding stock-flow adjustments.

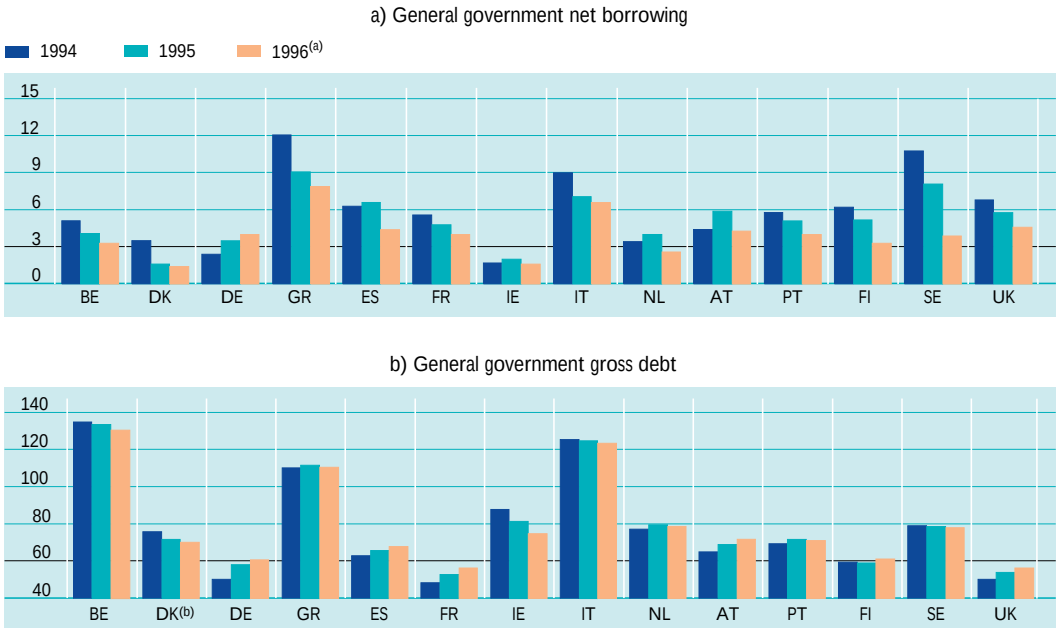
Two important aspects need to be considered in relation to this presentation. First, as mentioned above, no account is taken of stock-flow adjustments. As a result, the individual positions of Member States as shown in the chart are not fully consistent with the actual changes in the debt ratio. Second, the use of the difference between the (effective) interest rate on the outstanding debt and nominal GDP growth, on the one hand, and the primary balance, on the other, for the single year 1996 means that conclusions should be drawn very cautiously. For example, in a forward-looking perspective the favourable effect of fiscal consolidation programmes on the growth-adjusted interest rate could be taken into account. Decisive corrective measures which are primarily directed at cutting public spending may generate positive confidence effects, thereby avoiding persistent output losses (in contrast, tax increases may affect a country's growth potential). In addition, financial markets might reward some governments with lower real interest rates, thereby reducing the interest payable on government debt. Taken together, this would make it easier to achieve a situation in which for a given primary surplus the debt ratio is sufficiently diminishing and approaching the 60% reference value at a satisfactory pace. But, of course, other exogenous influences on the real interest rate can lead to adverse developments. The application of the analytical approach must bear this and the other caveats mentioned above in mind when drawing conclusions.

3.4 Assessment

The above analysis shows that progress in fiscal consolidation has generally been too slow. In eleven EU countries (all except Denmark, Ireland, Luxembourg and the Netherlands), deficits in 1996 are still projected to stand at above 3% of GDP and continue to be a cause of great concern, even though eight of them reduced budgetary imbalances in 1995 and ten are expected to do so in 1996 (see Chart 3.2). In general, faster correction of fiscal imbalances is warranted. Most countries have not yet achieved a situation which, in a broader view, might be judged as sustainable in the medium term. This is clearly shown by worrisome debt developments. Only France, Luxembourg and the United Kingdom are expected to maintain a debt ratio of below 60% in 1996. In the other EU countries the debt ratio is higher and is in many cases expected to increase further in 1996, or to decrease only slightly. In Belgium the debt ratio is expected to fall by 3% and in Ireland by 7% of GDP. To trigger a virtuous circle of a continuously diminishing debt ratio, the authorities will need to achieve and maintain a sufficiently high primary surplus; decisive corrective measures, which are primarily directed at cutting expenditure, might also be expected to reward governments with lower interest rates, thereby reducing the interest payable on government debt. For countries with a legacy of high debt ratios, this implies aiming for an extended period of overall budget balance or surpluses to correct earlier fiscal excesses. This would also help to cope with future challenges posed by the interaction between population ageing and social security systems.

Chart 3.2

Performance in relation to Maastricht fiscal reference values
(as a percentage of GDP)



Source: European Commission (autumn 1996).
For reasons of scaling no data are shown for Luxembourg. Throughout 1994-1996 Luxembourg was below the reference values for general government net borrowing and gross debt.
(a) European Commission projections.
(b) For Denmark see footnote (b) to Table 3.1

Notwithstanding this overall assessment, the latest projections for 1996 suggest that further progress has been made in the consolidation process. However, it is also apparent that this adjustment path needs to be taken further in most countries in a sustainable manner. The improvement of the deficit by one-off measures does not in itself ensure sustainable consolidation. Taking a medium-term view, the EMI welcomes the undertaking made by all Member States to formalise their sustained efforts towards consolidation in the form of a "Stability Pact".

BOX 3.3

The growing fiscal burden of social security old-age pensions

Social security pensions offered to retirees in many EU countries are leading to difficulties for public finances, given their contribution to overall deficits on the social security account, and/or the unprecedented levels of contributions which they necessitate. However, future difficulties are likely to be much more severe, owing to the interaction between population ageing and the scale of benefit promises.

Demographic projections (see Table below) show that ageing will be particularly marked in the years from 2010 onwards. In Germany, Italy and the Netherlands, for example, the elderly dependency ratio (the ratio of those 65 and over to those aged 15 to 64) is expected to rise from around 20% in 1990 to over 45% in 2030. There is also expected to be an increasing proportion of very old individuals, who may need additional, and costly, health care as well as pensions. The share of young dependants is expected to decline - but they tend to affect public finances to a lesser degree, and the decline in youth dependency is in any case smaller than the increase for the old. The total dependency ratio (including those under 15 as well as those 65 and over in the numerator) will be over 70% in 2030, inter alia in Germany, Italy, the Netherlands and Sweden. This demographic pattern results largely from declining birth rates. Greater longevity and changes in immigration will also play a role in the overall pattern of ageing.

Projections of elderly dependency ratio 1990-2030

(Population aged 65 and over as a percentage of the population aged 15 - 64)

	BE	DK	DE	GR	ES	FR	IE	IT	LU	NL	AT	PT	FI	SE	UK	EU[a]
1990	22.4	22.7	21.7	21.2	19.8	20.8	18.4	21.6	19.9	19.1	22.4	19.5	19.7	27.6	24.0	21.4
2010	25.6	24.9	30.3	28.8	25.9	24.6	18.0	31.2	25.9	24.2	27.7	22.0	24.3	29.1	25.8	25.9
2030	41.1	37.7	49.2	40.9	41.0	39.1	25.3	48.3	44.2	45.1	44.0	33.5	41.1	39.4	38.7	40.6

Source: Bos, E. (1994), "World population projections 1994-95"; World Bank, Washington DC.
(a) Arithmetic average.

Illustrating the likely scale of the future burden, the OECD (Roseveare et al., 1996), for example, has estimated future public pension expenditures for EU countries on a comparable basis. It constructed detailed simulation models for each country based on known features of the pension schemes (retirement age, indexation provisions, etc.) as well as utilising demographic projections as in Table above. The OECD naturally used a number of simplifying assumptions, which imply that the figures may not take fully into account the distinctive features of national pension systems and economic developments. With this caveat in mind, a number of interesting patterns can be discerned. As shown in Table below, the estimates suggest that public pension expenditure will rise by 7 percentage points or more of GDP over 1995-2040 in Germany, Italy, Portugal and Finland. By 2040, peak ratios of public old-age pension payments to GDP, with unchanged policies, would be 15% of GDP or more in Belgium, Germany, Spain, Italy, Portugal and Finland. At the same point, they would be only 2.9% in Ireland and 5% in the United Kingdom. It is notable that problems tend to be more pronounced where there is a greater dependence on the pay-as-you-go principle rather than on the funding of pensions.

Projections of public pension costs*

(as a percentage of GDP)

	BE	DK	DE	ES	FR	IE	IT	NL	PT	FI	SE	UK
1995	10.4	6.8	11.1	10.0	10.6	3.6	13.3	6.0	7.1	10.1	11.8	4.5
2000	9.7	6.4	11.5	9.8	9.8	2.9	12.6	5.7	6.9	9.5	11.1	4.5
2010	8.7	7.6	11.8	10.0	9.7	2.6	13.2	6.1	8.1	10.7	12.4	5.2
2020	10.7	9.3	12.3	11.3	11.6	2.7	15.3	8.4	9.6	15.2	13.9	5.1
2030	13.9	10.9	16.5	14.1	13.5	2.8	20.3	11.2	13.0	17.8	15.0	5.5
2040	15.0	11.6	18.4	16.8	14.3	2.9	21.4	12.1	15.2	18.0	14.9	5.0

Source: Roseveare, D.; Leibfritz, W.; Fore, D. and Wurzel, E. (1996), "Ageing populations, pension systems and government budgets: simulations for 20 OECD countries", Economics Department Working Paper No. 168, OECD, Paris.

* Note: Estimates from national authorities may diverge from those indicated in the OECD study.

If policies regarding benefits are unchanged and if contribution rates are not adjusted in the future, social security pension contributions would fall far short in most EU countries, implying sizable public sector deficits and rising public debt/GDP ratios. In the meantime, real interest rates could increase, which, together with adverse debt dynamics, could trigger a ''snowball'' effect of rising debts and interest payments.

In the light of these potential burdens, governments are seeking to limit social security pension commitments directly. Reforms have already been introduced in many countries, but in most cases the scale of the problem suggests that more action is needed.

The overall burden will be compounded or alleviated by the initial state in which public finances enter the period when population ageing begins to take effect. A country with a high and rising existing debt would clearly run a much greater risk of a financing crisis, where rising interest obligations cause deficits and debts to ''snowball'', than one with a more sustainable fiscal position. For example, in a separate exercise, the OECD (Economic Outlook, June 1995) shows that a permanent 1% better primary balance from 2000 would reduce the net debt by 40-55% of GDP by 2030. This underlines the importance of early steps to consolidation. Consolidation also ''buys time'', allowing reforms to be introduced gradually (to allow individuals to adjust their plans appropriately) and defers the point at which adverse debt dynamics emerge.

4 The criterion on exchange rate behaviour

4.1 Exchange rate developments since October 1994

On the basis of the Treaty the focus is on exchange rate developments according to Article 109j over the two years preceding the examination: i.e. for the purpose of this Report the period from October 1994 to September 1996. This period was characterised by progressively diminishing tensions within the ERM, although occasional tensions occurred. The development of non-ERM currencies also broadly followed this pattern. Four main periods can be distinguished (see Charts 4.1 to 4.3).

October to December 1994. In the ERM, the final quarter of 1994 was a period of relatively smooth functioning of the system, with the maximum width of the band between the strongest and weakest currencies generally around 6%. The Dutch guilder, which has a bilateral agreement to maintain a ±2.25% band vis-à-vis the Deutsche Mark, was the strongest currency of the system over this period. The Belgian/Luxembourg franc, the Deutsche Mark and the Irish pound were, on average, less than 1% below their central parities against the strongest currency; the Danish, French and Portuguese currencies showed deviations of around 3-4%, while the Spanish currency's deviation was around 6%. Short-term interest rate differentials at the end of the year - measured by monthly averages against the Deutsche Mark - stood close to zero in Belgium and the Netherlands, between 0.5 and 1 percentage point in Denmark, France and Ireland, at below 3 percentage points in Spain and at around 5 percentage points in Portugal (see Table 4.1).

Among non-ERM currencies, the Austrian schilling, which joined the ERM on 9 January 1995, remained firmly pegged to the Deutsche Mark; the Finnish markka[2] and the pound sterling were broadly stable, as was the Swedish krona. In contrast, the Italian lira continued to weaken, as did the Greek drachma, albeit to a lesser extent.

January to May 1995. Within the ERM, tensions grew significantly from end-1994 until the spring of 1995. With the exception of the Portuguese escudo, which remained in a median position, member currencies clustered in two groups: the Belgian/Luxembourg franc, the Deutsche Mark, the Dutch guilder (which was the strongest currency in the system throughout 1995) and the Austrian schilling remained firmly pegged to each other, while the Spanish peseta, the Irish pound, the French franc and the Danish krone underwent considerable pressure, with the deviation from their central parities vis-à-vis the strongest currency peaking in March and averaging 5-10%. Short-term interest rate differentials widened, and tensions were also reflected in long-term interest rates. In March, following a request by the Spanish authorities, the peseta underwent a downward realignment of 7%. Following the decision to change the central rate of the peseta, the Ministers and central bank Governors also agreed on a downward adjustment of the central rate of the Portuguese escudo by 3.5% in line with the market rate that had prevailed since August 1993. This provided no immediate relief for the system as a whole and pressures switched to the Irish pound and the French franc. In April and May tensions eased somewhat. With the ebbing of tensions, currencies initially followed different paths: the Danish, Spanish and Portuguese currencies recovered significantly, returning to 3-4% below their central parities, whereas the Irish and French currencies remained relatively weak, standing some 5-6% below their central rates against the strongest currency.

[2] *The Finnish markka joined the exchange rate mechanism of the European Monetary System, effective from 14 October 1996.*

Chart 4.1

Deviations from ERM central parities

(monthly averages; in percentages; measured against the strongest currencies)
(October 1994 to September 1996)

Source: National data.
Vertical green lines indicate the Austrian schilling's entry into the ERM (9 January 1995) and realignments of the Spanish peseta and Portuguese escudo (5 March 1995).

Chart 4.2

Maximum deviation from ERM central parities*
(daily observations; October 1994 to September 1996)

Source: National data.
* Deviation of the strongest against the weakest currency of the ERM, measured as the percentage difference between the market exchange rate and the bilateral central parity. The vertical line indicates the realignments of the Spanish peseta and Portuguese escudo on 5 March 1995.

Among non-ERM currencies, the Italian lira, the Swedish krona and the pound sterling underwent significant pressure in the first few months of 1995, and short and long-term interest rate differentials vis-à-vis the strongest currencies also widened; the Greek drachma, too, weakened, albeit without fully accommodating inflation differentials. In contrast, the exchange rate of the Finnish markka was only modestly affected by the prevailing turbulence of the first part of the year, with Finnish interest rate differentials widening to a lesser extent than those for other non-ERM currencies.

Chart 4.3

Nominal effective exchange rates*

(monthly data; in percentages; deviation from October 1994 levels)

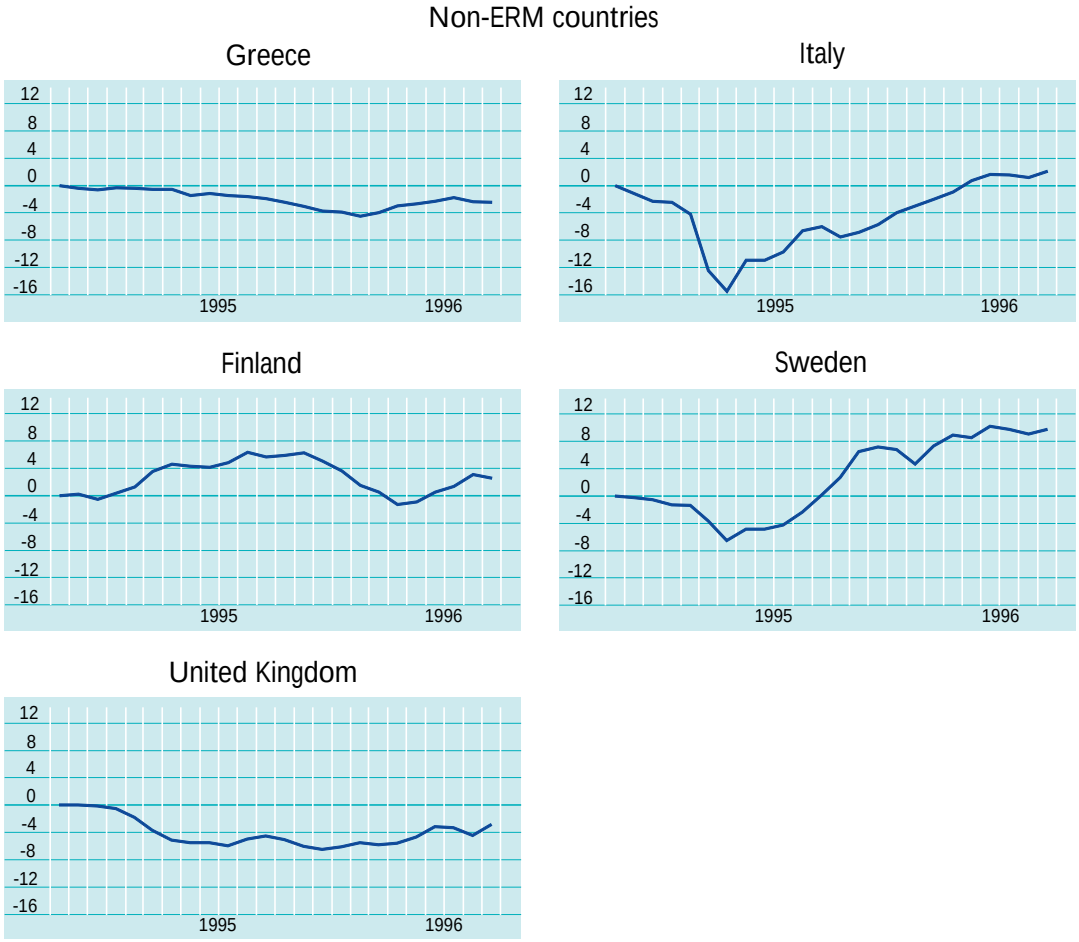
Source: BIS.

* Against a basket comprising the currencies of 26 industrialised countries.

Chart 4.3

Nominal effective exchange rates*

(monthly data; in percentages; deviation from October 1994 levels)



Source: BIS.

* Against a basket comprising the currencies of 26 industrialised countries.

June to December 1995. The second half of the year witnessed an alternation of calm conditions and bouts of pressure, but tensions remained below the peaks of spring 1995. During the summer months, conditions in the ERM eased considerably, with the Danish krone, the Spanish peseta and the Portuguese escudo moving within a range of 1-2% below their respective central rates, followed in mid-August by the French franc and the Irish pound, which moved to around 3% and 4%, respectively, below their central parities against the strongest currency. Likewise, interest rate differentials narrowed significantly. Later, in September and October, repeated bouts of tension were observed, focusing particularly on the French franc, but also affecting the Irish, Portuguese and Spanish currencies; French short-term interest rate differentials widened, reflecting these strains. From late October until the end of the year, a return to calmer conditions took place, except for smaller and short-lived pressures in early December on the French franc. By the end of the year, currencies had in most cases recovered, to stand closer to their central parities.

Table 4.1

Short-term interest rate differentials and volatility of exchange rates and short-term interest rates*

		ERM countries							
		94Q4	95Q1	95Q2	95Q3	95Q4	96Q1	96Q2	96Q3
Belgium	Int. rate differentials	0.0	0.7	0.5	0.1	0.1	-0.0	-0.0	0.0
	Exch. rate volatility	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0
	Int. rate volatility	4.5	15.9	7.2	5.2	3.4	2.7	2.4	2.5
Denmark	Int. rate differentials	1.0	1.4	2.2	1.6	1.3	0.9	0.5	0.5
	Exch. rate volatility	0.1	0.3	0.2	0.1	0.1	0.0	0.0	0.0
	Int. rate volatility	5.6	18.0	5.5	5.2	6.2	4.9	3.7	3.3
Germany	Int. rate differentials	-	-	-	-	-	-	-	-
	Exch. rate volatility	-	-	-	-	-	-	-	-
	Int. rate volatility	2.9	3.1	1.7	1.8	2.1	2.4	1.6	2.3
Spain	Int. rate differentials	2.7	4.0	4.9	5.2	5.4	5.3	4.2	4.0
	Exch. rate volatility	0.1	0.7	0.5	0.3	0.2	0.2	0.2	0.2
	Int. rate volatility	3.6	11.6	4.7	2.7	5.3	4.8	4.6	2.9
France	Int. rate differentials	0.5	1.6	2.9	1.8	2.2	1.1	0.7	0.6
	Exch. rate volatility	0.1	0.4	0.4	0.2	0.3	0.1	0.1	0.1
	Int. rate volatility	4.7	22.7	13.7	7.8	21.6	6.5	3.4	6.0
Ireland	Int. rate differentials	0.6	1.5	2.2	1.9	1.7	1.8	1.8	2.4
	Exch. rate volatility	0.2	0.6	0.6	0.4	0.4	0.3	0.2	0.3
	Int. rate volatility	6.0	15.4	5.7	4.8	4.6	4.5	3.0	4.1
Netherlands	Int. rate differentials	0.1	0.1	-0.1	-0.3	-0.2	-0.2	-0.4	-0.3
	Exch. rate volatility	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	Int. rate volatility	3.2	2.6	2.3	1.7	1.9	2.5	2.5	2.8
Austria	Int. rate differentials	-0.1	-0.0	0.1	0.0	0.2	0.1	-0.0	0.2
	Exch. rate volatility	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	Int. rate volatility	1.5	1.7	1.1	1.8	3.1	2.8	2.1	1.4
Portugal	Int. rate differentials	5.0	5.5	5.9	5.1	5.2	4.8	4.0	4.1
	Exch. rate volatility	0.1	0.3	0.2	0.2	0.2	0.1	0.1	0.1
	Int. rate volatility	32.9	28.8	19.9	19.2	10.6	7.8	5.9	5.0
		Non-ERM countries							
		94Q4	95Q1	95Q2	95Q3	95Q4	96Q1	96Q2	96Q3
Greece	Int. rate differentials	13.7	13.0	11.9	11.0	11.7	10.9	10.9	10.4
	Exch. rate volatility	0.1	0.3	0.2	0.2	0.2	0.2	0.2	0.2
	Int. rate volatility	9.6	24.7	8.4	6.5	30.2	7.1	7.3	12.4
Italy	Int. rate differentials	3.7	4.7	6.2	6.3	6.7	6.6	5.8	5.4
	Exch. rate volatility	0.3	1.3	0.8	0.7	0.6	0.5	0.4	0.3
	Int. rate volatility	9.5	18.7	9.8	6.8	6.9	9.1	7.5	7.1
Finland	Int. rate differentials	0.3	0.9	1.4	1.7	1.1	0.8	0.5	0.2
	Exch. rate volatility	0.4	0.4	0.3	0.4	0.3	0.3	0.3	0.2
	Int. rate volatility	6.5	4.5	3.8	2.9	6.6	4.6	1.4	3.0
Sweden	Int. rate differentials	2.8	3.1	4.4	4.8	4.8	4.3	2.8	1.9
	Exch. rate volatility	0.5	0.8	0.7	0.7	0.6	0.6	0.4	0.4
	Int. rate volatility	6.3	6.4	5.0	3.3	3.6	6.7	4.0	2.6
United Kingdom	Int. rate differentials	0.9	1.6	2.1	2.4	2.7	2.8	2.7	2.5
	Exch. rate volatility	0.3	0.7	0.7	0.4	0.4	0.3	0.3	0.4
	Int. rate volatility	5.4	5.5	7.9	3.3	2.3	3.0	2.6	1.4

Source: National data.

* Three-month money market interest rate differential against Germany; quarterly averages in percentage points. Volatility of the exchange rate against the DEM: over each quarter, standard deviation of daily observations (logarithmic first differences), multiplied by 100. Three-month money market interest rate volatility: standard deviation of daily observations (first differences).

Among non-ERM currencies, the Italian lira recovered a large part of its earlier losses over this period and the Swedish krona, which strengthened steadily in the second half of the year, ended 1995 with a substantial net appreciation against the strongest ERM currencies. Similarly, during the summer months the Finnish markka appreciated significantly and ended the year at a higher level against the strongest ERM currencies than at mid-year. In contrast, the pound sterling remained weak in June and July, recovered somewhat in August and September, but slipped back to new lows in November. Over the year, the Greek drachma depreciated by 3% against the ECU, in line with its target for 1995.

January to September 1996. In 1996 the ERM enjoyed very quiet conditions, with the width of the ERM band declining steadily from 5-6% at the outset to around 2% from the end of May onwards, reaching its lowest level since the widening of the fluctuation margins in August 1993. From January onwards, the Spanish peseta benefited from a rally and turned out to be, almost uninterruptedly, the strongest currency of the grid. Throughout the period one group of currencies - the Belgian/ Luxembourg franc, the Deutsche Mark, the Dutch guilder and the Austrian schilling - remained closely aligned; the short and long-term interest rate differentials among these currencies, already small, narrowed further. For other ERM currencies, calm conditions prevailed; from the end of May onwards, all currencies were within the former narrow band vis-à-vis one another. The sudden depreciation of the US dollar and the related market instability in mid-July had virtually no negative effect on the functioning of the ERM grid. The Portuguese escudo recovered against the strongest ERM currencies, reaching a level close to its bilateral central rates and similar to that prevailing in October 1994. Only at the end of the reporting period did some temporary pressure emerge on the French franc. The tendency towards calm conditions was reflected in the evolution of short and long-term interest rate differentials, which narrowed significantly.

In 1996 non-ERM currencies followed different paths. The Italian lira and, to a lesser extent, the pound sterling appreciated significantly, with the Italian currency returning at the end of June to levels above those prevailing at the end of 1994. The Greek drachma was broadly stable in the first quarter, while the Finnish markka tended to weaken, but both currencies appreciated between April and June; the Swedish krona was relatively volatile in the first quarter but has been broadly stable since. In July and August the appreciation of non-ERM currencies came to a temporary halt and most of them lost some ground vis-à-vis the strongest currencies, but by the end of September all currencies had returned to levels at or above their previous highs. 1996 saw a narrowing of short-term interest rate differentials in most of these countries, in particular in Sweden.

The ebb and flow of tensions in foreign exchange markets over the reference period was reflected in the evolution of the volatility of exchange and interest rates (see Table 4.1). As regards 1995, exchange rate variability for some currencies rose to levels close to the peaks observed in past episodes of tension; in contrast, interest rates were in general less volatile than in past episodes, partly reflecting the tendency of some monetary authorities to rely more on exchange rate flexibility within the widened bands rather than on the interest rate instrument. As regards foreign exchange intervention, with the exception of a few ERM members which made significant use of this instrument, the amounts involved in 1995 were in general considerably smaller than in 1992-93. In 1996, as tensions subsided, exchange rate and interest rate volatility declined significantly, for most currencies to below the levels of 1994. Foreign exchange market intervention was in general rather limited, with the exception of

a few central banks which bought foreign reserves either in order to replenish reserves, or in order to preserve orderly market conditions.

4.2 Underlying factors

Between October and December 1994, as in the year as a whole, the ERM operated in an environment characterised by an easing of monetary conditions in most Member States and a stronger than expected pick-up in economic activity.

An important factor underlying the widespread unrest in world currency markets in the first half of 1995 was a reassessment of the prospects for the US economy against the background of an increasing external imbalance; the Mexican crisis also played a non-negligible role in generating world-wide turbulence. These factors altered market expectations concerning short-term interest rate differentials and contributed to a sharp fall in the value of the dollar, triggering capital flows towards the Japanese yen and stronger European currencies.

However, the fact that the unrest within the ERM was related to factors originating outside the Union should not be interpreted as implying that internal factors were unimportant. On the contrary, increased general uncertainty in the financial markets seems to have prompted a renewed focus on certain economic fundamentals and domestic imbalances prevailing in several Member States. Political uncertainty also contributed. There was perceived to be a link in several countries - but not in others - with the current and prospective state of public finances. Furthermore, currencies of countries with a less favourable record of price stability appeared more vulnerable. Nevertheless, in contrast with previous episodes of tension within the ERM, the need to correct imbalances in the competitive positions of individual countries does not seem to have played a significant role.

Subsequently, both the prevailing macro-economic context and the progress achieved in the preparations for Stage Three of Monetary Union contributed to smooth the functioning of the ERM and to enable currencies outside the exchange rate mechanism to recover. Markets expected the process of interest rate reduction to continue, and focused on the positive conclusions of both the Spanish and Italian EU presidencies. Furthermore, perceptions of progress in terms of price stability and budget consolidation (see also Box 4.1) may have helped to contribute to the increased credibility of ERM exchange rates and the overall strengthening of currencies outside the ERM, notwithstanding some temporary fluctuations at the end of the period under consideration. This overall trend is also confirmed by a tendency towards narrower short-term interest rate differentials and the easing of exchange rate volatility from mid-1995 onwards.

BOX 4.1

Exchange rate developments and sustainability of convergence

Exchange rate stability according to Article 109j of the Treaty can be seen as a device for testing the ''credibility'' of the exchange rate in relation to its past and future ''fundamental'' determinants and for signalling markets' views of a country's commitment to cope with asymmetric shocks by means other than the exchange rate, i.e. by internal adjustment. The exchange rate criterion is thus a means to capture markets' perceptions of overall macroeconomic performance, by analogy with long-term interest rates; in general a country's currency can be expected to be stable if markets consider the authorities' anti-inflationary commitment to be credible, if they are confident of the sustainability of fiscal policy and if they deem that these two elements do not endanger the external competitiveness of the country.

However, a satisfactory performance in terms of exchange rate stability must be seen against the background of sustained price stability, since exchange rate stability could in principle also be achieved in a world of similar but high inflation rates, or similar but deep-seated structural problems. Therefore, exchange rate stability must always be assessed in the light of the overall economic environment. Increased exchange rate stability among a number of currencies could reflect market expectations about their prospects of reaching Stage Three. Furthermore, the widening of the ERM bands in August 1993 created a new market environment, and experience of these changes has to be gained in a learning process.

In an ex post assessment of exchange rate stability, two questions may be of relevance; first, issues related to the ''equilibrium level'' and second, issues related to ''volatility''. Clearly, it is extremely difficult to define and identify an ''equilibrium'' exchange rate precisely. Nonetheless, on the basis of a range of indicators it may be possible to judge whether severe misalignments of exchange rates exist. As to the issue of volatility, account may be taken of the fact that foreign exchange markets attach considerable importance to economic fundamentals (such as macroeconomic variables, economic policies, demand and supply shocks) and that expectations of the future (and especially of future fundamentals) are at the heart of exchange rate determination. This forward-looking nature of exchange rates is part of the explanation of the volatility of foreign exchange markets, as the continuous flow of new information leads to a continuous reassessment of perceived future fundamentals (abstracting from the case of ''excess'' volatility to the extent that, at times, speculative bubbles develop which are unrelated to fundamentals).

4.3 The evolution of effective exchange rates

In the first half of 1995 effective exchange rates of currencies within the ERM were affected by exchange rate turbulence, although by less than the bilateral rates owing to offsetting movements of the dollar and of the currencies of some EU trading partners. With the easing of exchange rate tensions, however, exchange rates started corrective counter-movements, so that in the summer of 1996 the positions of late 1994 were by and large restored.

If nominal effective exchange rate levels in October 1994 are compared with those prevailing in September 1996 (see Chart 4.3), it can be seen that the changes were generally very limited: three currencies, namely the Danish krone, the Irish pound and the French franc, experienced an appreciation of around 2%, whereas the others (the Belgian/Luxembourg franc, the Deutsche Mark, the Spanish peseta, the Dutch guilder, the Austrian schilling and the Portuguese escudo) were broadly stable.

Among non-ERM currencies, changes in nominal effective exchange rates after October 1994 were more pronounced: the Swedish krona appreciated by almost 10%, the Italian lira and the Finnish markka by 2-3%, whereas the pound sterling and the Greek drachma depreciated by some 2-3%.

BOX 4.2

Real exchange rate developments

Given that inflation differentials adjust more slowly than exchange rates, movements in nominal exchange rates translated in the short term to a considerable extent into changes in real effective exchange rates, i.e. into shifts in measured price and cost competitiveness (the table below presents one set of estimates). In a longer-term view, for most ERM currencies, current competitiveness levels are relatively close to those prevailing in 1987, a year in which most EU Member States' economies appeared to be broadly in both internal and external balance. Partial exceptions may be represented by some currencies, using specific indices; in other cases, large shifts in domestic demand may cast doubt on using 1987 as a reference for real exchange rate comparisons. Therefore, caution would suggest taking the whole range of information available into account.

In the case of non-ERM currencies a more differentiated pattern can be observed, in that while the data suggest that the Italian lira and the Finnish markka may on balance have depreciated in real effective terms compared with 1987, the Greek drachma has appreciated. Indications for the Swedish krona and pound sterling suggest that current competitiveness levels are relatively close to those of 1987.

Summary of changes in real effective exchange rates of EU-15 currencies up to September 1996*

(monthly data; in percentages)

	Since 1987				Since April 1992				Since October 1994			
	CPI[a]	ULC[b]	XPI[c]	PPI[d]	CPI[a]	ULC[b]	XPI[c]	PPI[d]	CPI[a]	ULC[b]	XPI[c]	PPI[d]
BEF	0.6	9.4	-1.4	1.4	4.8	9.9	-6.8	3.8	-0.1	1.3	-4.1	0.7
DKK	1.0	11.0	-1.0	6.1	5.8	13.8	1.7	7.5	2.2	6.3	-2.2	2.8
DEM	4.8	19.9	-3.9	4.3	8.1	17.1	-1.0	4.1	-0.3	3.6	1.3	-0.8
ESP	4.7	2.4	-1.2	3.8	-13.1	-20.8	-13.2	-10.1	2.8	-1.2	0.8	4.9
FRF	-1.5	-6.5	1.8	-0.5	4.1	-1.2	-1.4	3.1	0.4	-3.9	-7.1	-0.6
IEP	-6.6	-26.9	-6.0	-1.5	-1.5	-16.5	-3.0	0.9	1.6	-7.4	-1.0	1.9
NLG	-1.8	-6.8	-2.6	3.1	5.9	1.3	1.8	4.8	-0.1	-2.0	-1.2	0.3
ATS	2.4	-10.2	-20.3	-0.9	5.8	-2.1	-11.9	-0.3	0.7	-2.9	-10.8	-4.5
PTE[e]	27.2	-	-4.6	-	0.5	-	-2.4	-	3.1	-	-0.9	-
GRD[f]	26.0	30.9	-	12.9	11.3	15.0	-	5.6	8.2	16.1	-	5.1
ITL	-10.4	-12.8	12.8	-11.2	-15.8	-20.6	8.1	-12.8	6.6	4.7	19.5	7.2
FIM	-13.1	-22.5	6.3	-8.9	-7.7	-12.6	7.5	-0.5	-0.9	1.7	5.2	0.6
SEK	-1.0	-10.5	3.2	2.5	-12.9	-21.9	-0.5	-2.7	7.3	8.3	11.5	11.2
GBP	-3.6	-8.9	3.1	3.7	-15.0	-11.3	-2.9	-7.9	-1.5	0.5	-1.6	-0.2

Source: BIS.

* Real effective exchange rates against 26 trading partners; a negative sign indicates a depreciation of the real effective exchange rate. Some of the price/cost indices used for calculating real exchange rates are derived from quarterly series.

(a) Deflated by consumer prices (CPI).
(b) Deflated by unit labour costs (ULC).
(c) Deflated by export prices (XPI).
(d) Deflated by producer price indices (PPI).
(e) ULC and PPI indicators are not presented because reliable series are not available for Portugal.
(f) XPI indicators are not presented because reliable series are not available for Greece.

4.4 Assessment

At this stage, the EMI does not consider it appropriate to give a precise operational content to the measurement of exchange rate stability according to Article 109j of the Treaty, which could mechanically be applied also to forthcoming periods. Rather, a detailed record of recent developments is provided in this section and will contribute to an assessment. Regarding the Treaty provision of ERM membership, there is a strong majority position within the EMI Council according to which the requirement of ERM membership applies. This is also reflected in the analysis. A minority takes the view that exchange rate stability based on sustainable underlying economic fundamentals is more important than the institutional setting within which stability is achieved.

As shown above, ERM currencies followed different patterns of behaviour. When measured in terms of bilateral rates against the strongest currencies in the ERM, a number of currencies have remained stable over the whole two-year time span under consideration. These include the Belgian/ Luxembourg franc, the Deutsche Mark, the Dutch guilder and the Austrian schilling. Several other ERM currencies (the Danish krone, the French franc and the Irish pound) have either once or on several occasions drifted away from their central parities, although by the end of the two-year period considered in this Report market rates again stood close to central rates.

At the beginning of 1995 pressure mounted on the peseta and in March, following a request by the Spanish authorities, the currency underwent a downward realignment of 7%. Following the decision to change the central rate of the peseta the Ministers and central bank Governors also agreed on a downward adjustment of the central rate of the Portuguese escudo by 3.5%. After the adjustment, both currencies recovered to levels close to those prevailing at the end of 1994 and to the new central parities.

More recent developments, even though partly related to market expectations about EMU participation, can be seen as an indication of progress in the right direction, notably for those countries where long-term interest rate differentials have practically been eliminated. To the extent that exchange rates reflect markets' perceptions of overall macroeconomic convergence, this is to be regarded as a positive signal. A consideration of levels of real exchange rates also suggests that recent trends indicate a move towards a more sustainable exchange rate pattern. In effect, evidence regarding current real exchange rates does not suggest misalignments in the ERM which could by themselves trigger major corrective forces.

The development of the currencies remaining outside the ERM has been described in more detail above. The Finnish markka remained broadly stable throughout the period under consideration - as did, to a lesser extent, the Greek drachma; in contrast, the Italian lira and the pound sterling underwent periods of turbulence, followed by a complete or partial recovery, whereas the Swedish krona also experienced a period of turbulence but appreciated significantly over the two-year period considered. The Finnish markka joined the ERM effective from 14 October 1996.

5 The interest rate criterion

5.1 Recent performance against the reference value

Long-term interest rate developments for the fifteen Member States are presented in Table 5.1. The data used are harmonised interest rates (see Annex I for further information on the statistical aspects). Over the reference period (October 1995 to September 1996) ten-year government bond yields in the three best-performing countries in terms of price stability ranged between 6.3% and 7.4%. These rates have been used to calculate the reference value of 8.7%. Overall, the reference value for the long-term interest rate criterion demonstrated a tendency to decline during 1996.

Eleven countries had rates below the reference value, i.e. all Member States except for Spain, Italy and Portugal as well as Greece[3]. These were the same Member States as in the case of the price criterion, as well as the United Kingdom. With the exception of Sweden, which had an average yield of 8.5% over the twelve-month period considered, and thereby just met the reference value, other countries' long-term interest rates have remained below the reference value since early 1996. Yields of countries which did not meet the criterion tended to be well above the reference value, although there was a tendency for the gap to narrow over the reference period which was particularly pronounced in the third quarter of 1996 (see Chart 5.1).

[3] *In Greece long-term interest rates are indexed to the twelve-month Treasury bill rate. They cannot be used for comparisons with other countries, but serve as a rough guide for intertemporal comparisons.*

Table 5.1

Long-term interest rates

(period averages; in percentages)

	1995		Oct 95-Sep 96	Q4 95	Q1 96	Q2 96	Q3 96
Belgium	7.5		6.7	6.9	6.6	6.7	6.6
Denmark	8.3		7.4	7.6	7.3	7.4	7.3
Germany	6.9	***	6.3	6.3	6.2	6.5	6.3
Greece[a]	17.4		15.1	15.4	14.8	-	-
Spain	11.3		9.5	10.5	9.7	9.2	8.7
France	7.5		6.6	7.1	6.6	6.5	6.3
Ireland	8.3		7.5	7.7	7.5	7.6	7.4
Italy	12.2		10.3	11.6	10.5	9.9	9.4
Luxembourg	7.6		7.0	7.4	7.0	6.7	6.8
Netherlands	6.9	**	6.3	6.3	6.2	6.4	6.3
Austria	7.1		6.5	6.7	6.4	6.5	6.4
Portugal	11.5		9.4	10.7	9.5	9.0	8.6
Finland	8.8	*	7.4	7.6	7.5	7.3	7.1
Sweden	10.2		8.5	9.0	8.6	8.4	8.1
United Kingdom	8.3		8.0	7.9	7.9	8.2	8.0
Memo items: EU-15	8.9		7.7	8.2	7.8	7.8	7.5
Standard Deviation[b]	2.8		1.0	2.5	2.3	1.2	1.0
Reference value[c]	9.7		8.7	-	-	-	-
	Apr 96		May 96	Jun 96	Jul 96	Aug 96	Sep 96
Belgium	6.7		6.7	6.8	6.8	6.6	6.5
Denmark	7.3		7.4	7.5	7.4	7.3	7.2
Germany	6.4		6.5	6.6	6.5	6.3	6.2
Greece[a]	-		-	-	-	-	-
Spain	9.3		9.2	9.1	8.8	8.9	8.4
France	6.5		6.5	6.6	6.4	6.3	6.2
Ireland	7.6		7.5	7.6	7.5	7.4	7.2
Italy	10.3		9.7	9.6	9.4	9.5	9.2
Luxembourg	6.7		6.7	6.8	6.9	6.8	6.8
Netherlands	6.3		6.3	6.5	6.4	6.2	6.1
Austria	6.4		6.5	6.6	6.6	6.4	6.3
Portugal	9.1		9.0	8.9	8.7	8.7	8.3
Finland	7.5		7.4	7.2	7.1	7.2	6.9
Sweden	8.3		8.4	8.3	8.3	8.1	7.8
United Kingdom	8.2		8.2	8.2	8.1	8.0	8.0
Memo items: EU-15	7.9		7.8	7.8	7.6	7.6	7.4
Standard Deviation[b]	1.3		1.1	1.1	1.0	1.1	1.0

Source: National harmonised data.

*,**,*** = first, second and third best performer in terms of price stability. The precise identification of all countries in relation to the reference value is based on data with a higher degree of precision than those presented in the table. Data refer to primary issues, they are only presented if there was a primary issue in the period in question.

(a) Precise data on long-term interest rates are not available. The data refer to variable coupon rates adjusted annually. As such, they cannot be used for comparisons with other countries, but only as a rough guide for intertemporal comparisons.

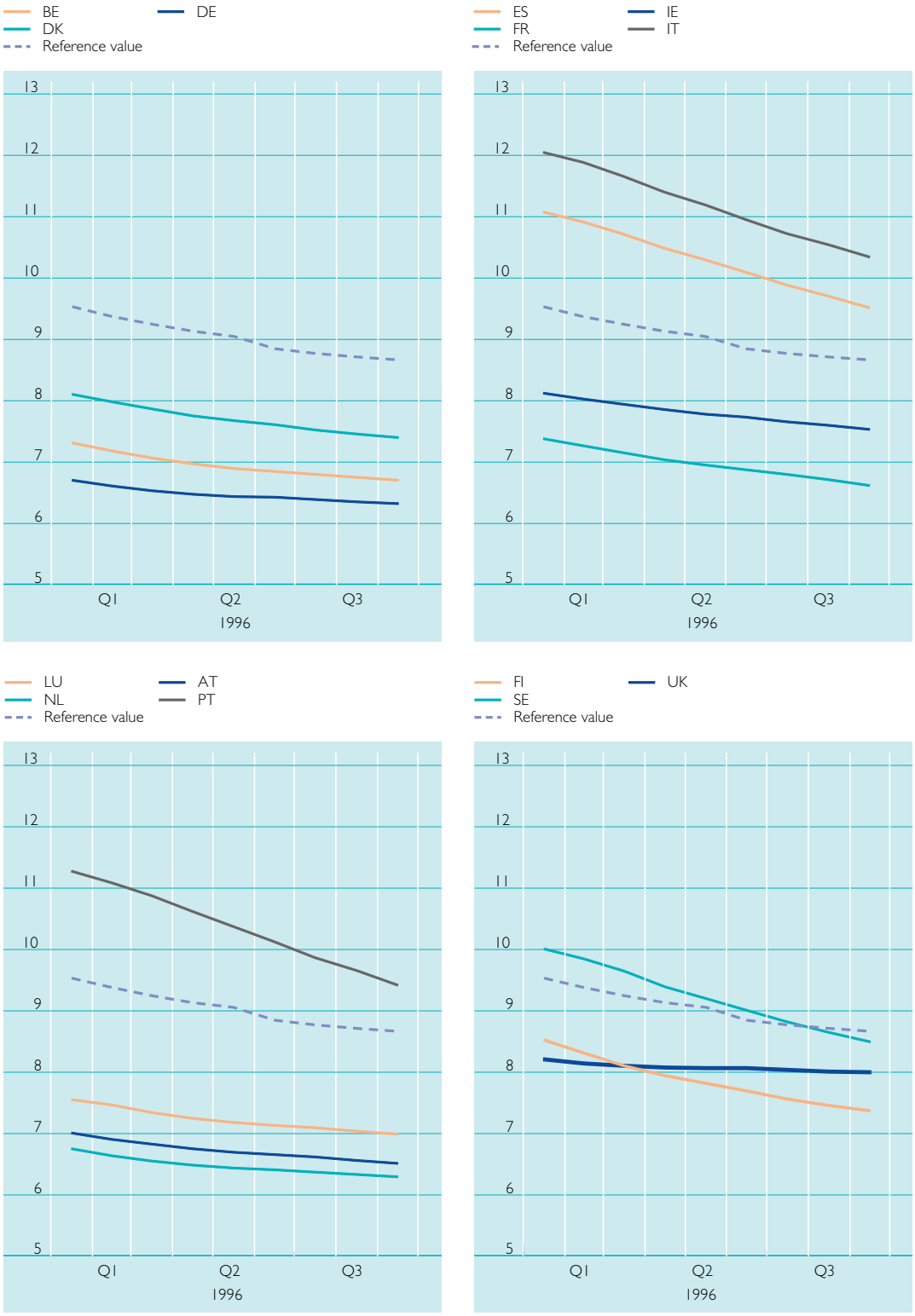
(b) Unweighted standard deviation.

(c) Reference values are calculated as the unweighted arithmetic average of the long-term interest rates of the best three countries according to the price criterion (plus 2.0 percentage points), see Table 2.1.

Chart 5.1

Reference value* and long-term interest rates**

(12-month moving average in percentages)



Source: National harmonised data.

* See footnote (c) to Table 5.1.

** No data for Greece are shown. See footnote (a) to Table 5.1.

5.2 Recent developments in long-term interest rates in perspective and underlying factors

As may be seen from Chart 5.2, long-term interest rates of Member States declined over the period 1990-93. The general downtrend was interrupted during 1994; reflecting a strong correlation with yields on the US market, comparable long-term interest rates in the EU rose steeply. During 1995, long-term interest rates began to trend downwards again. This process underwent a pause in early 1996. Subsequently long-term interest rates in a number of EU countries fell further, particularly in the third quarter, while others remained linked to global trends which were led by a broadly sideways movement of US yields. There was a narrowing of differentials within the EU.

A number of market factors may account for the pause in the declining trend of yields in international bond markets in early 1996. First, as reflected in a steepening of the yield curve, a revision of expectations regarding economic activity led to fears that inflation might not remain under control over the course of the business cycle in the United States. This contributed to renewed upward pressure on long-term interest rates, although the extent of the pass-through to yields in EU countries was more limited than in previous episodes. Second, as the Japanese economy showed some signs of emerging from a prolonged recession, expectations of an increase in official interest rates in that country had an important influence on global developments, to the extent that investors in US and EU bonds had financed such purchases in yen at historically low short-term Japanese interest rates. Other, more country-specific, factors accounted for the narrowing of differentials within the Union, as detailed below.

5.3 Recent evolution of interest rate differentials and underlying factors

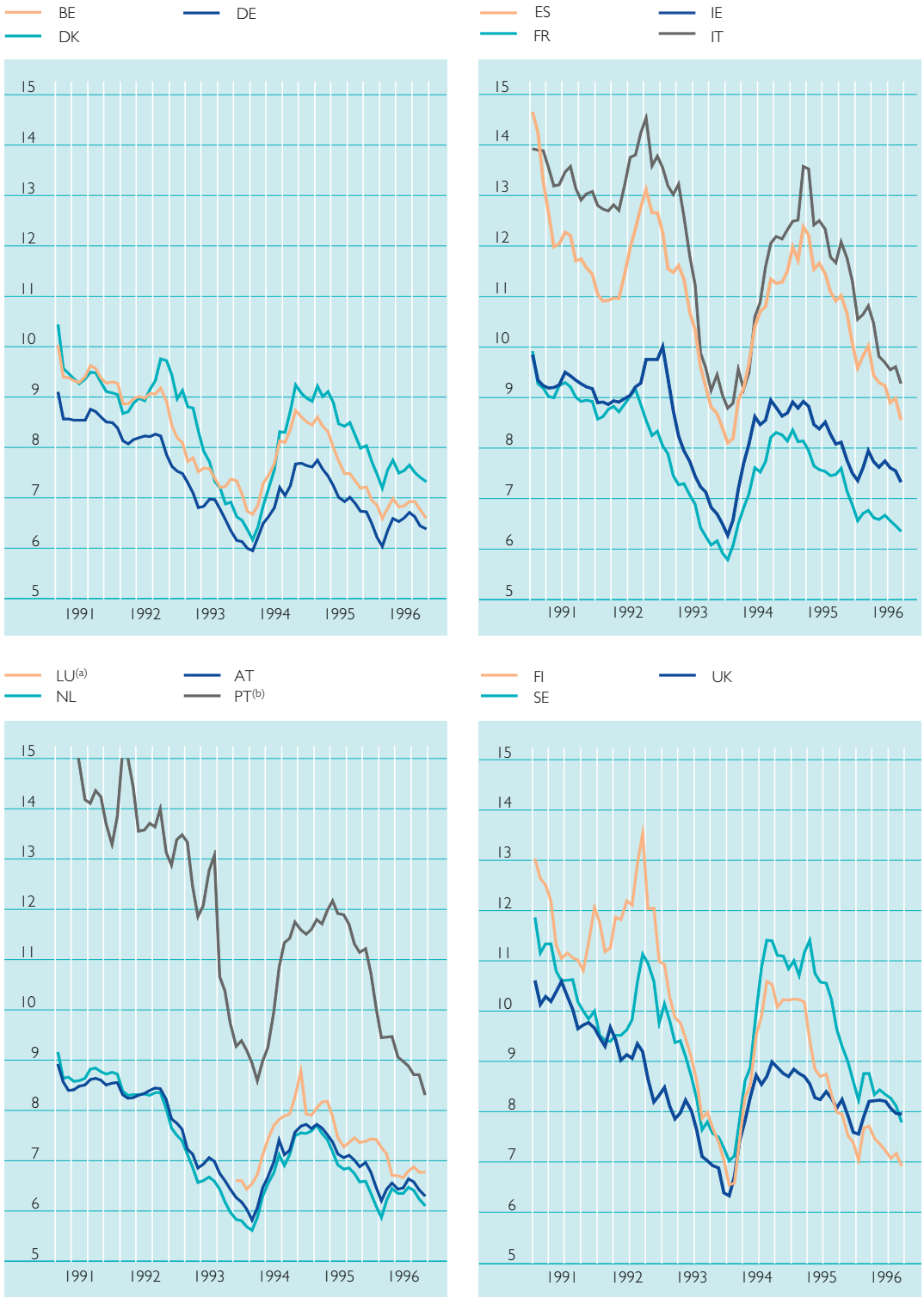
Yields in Belgium, Germany, France, Luxembourg, the Netherlands and Austria have consistently been the lowest in the Union, and differentials among these countries remained very narrow. In other countries, differentials against bond yields of the aforementioned countries have demonstrated volatility, although a general trend towards narrowing has been discernible. However, individual countries' experiences have differed over the reference period. As shown in Chart 5.3, some further narrowing has been seen in Denmark and Ireland, and significant declines in differentials have taken place in Spain, Italy, Portugal, Finland and Sweden. Against the general trend differentials between the United Kingdom and the countries with the lowest bond yields were broadly unchanged over the twelve months to September 1996.

This overall tendency towards convergence of long-term interest rates indicates that country-specific factors - such as inflation expectations and changing risk premia and thereby issues related to sustainability as well as expectations regarding prospects for EMU - played an important role (see Box 5.1). Looking at country-specific trends, the slope of the term structure of interest rates can provide useful information about domestic inflation expectations, although it may also be influenced by the position of the economy in the business cycle and expectations regarding Monetary Union. During the first few months of 1996, yield curve slopes in many EU countries (as measured by the one-year/ten-year yield spread) tended to steepen against a general background of weak economic activity. However, some turnaround was seen in later months. This indicates a decline in inflation expectations in many countries in line with the actual reductions.

Chart 5.2

Long-term interest rates*

(monthly averages; in percentages)



Source: National harmonised data.

* No Greek data are shown.

(a) Comparable data are only available from 22 October 1993.

(b) The Portuguese series is not continuous for reasons of scaling.

Recent developments also suggest that changing risk premia played an important role in the reduction in interest rate differentials. Two observations may support this view. First, since countries with higher bond yields also tend to have higher risk premia, their bond yields tend to be more sensitive to global bond market developments. As a consequence, when global bond yields are declining, their yields tend to decline by a larger margin than average and differentials tend to narrow during bond market rallies, as was the case in 1993 or the latter half of 1995. Likewise, when global bond yields are increasing, differentials tend to widen, as was the case during the bond market correction of 1994. A narrowing of differentials when global bond yields are stable or even rising, as was partly the case in 1996, may therefore be indicative of a decline in risk premia in some countries, such as Spain, Italy, Portugal, Finland and Sweden.

BOX 5.1

Long-term interest rates and sustainability of convergence

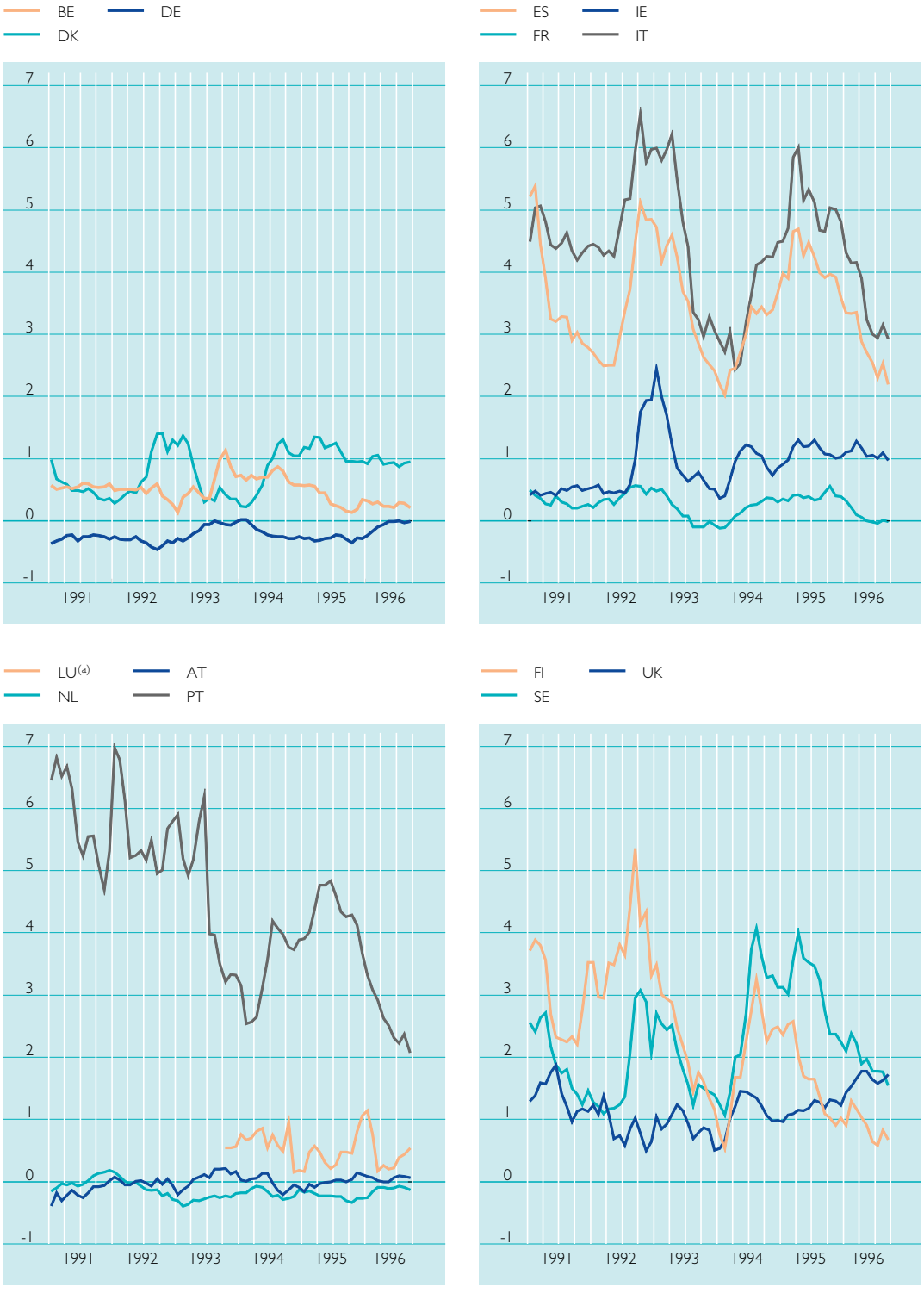
In principle, the level of domestic long-term interest rates reflects a combination of inflation expectations, the expected long-term real interest rate, and various risk premia required by investors to compensate for uncertainty with respect to factors such as default risk, exchange rate risk, market volatility and inflation variability. As to differentials between long-term interest rates, a distinction can therefore be made between nominal differences which predominantly reflect differences in inflation expectations, and differences in real rates.

As regards real interest rates, a high degree of mobility of goods and capital between countries should foster their equalisation across countries. As a consequence, expected real interest rates should in principle only differ across countries to the extent that risk premia differ. In the context of risk premia, uncertainty about future inflation and the monetary stance, creditworthiness and exchange rate considerations have become key to explaining differentials in long-term interest rates. Domestic and/or external imbalances which are regarded as unsustainable can lead to the incorporation of such risk premia into domestic bond yields. For example, a persistently high budget deficit and high levels of public debt may lead to an increase in domestic bond yields. Persistently high balance of payments deficits on current account or high net external debt positions may also contribute to expectations about future exchange rate risks and thereby increase risk premia. Finally, there is the influence of the inflation risk premia in long-term interest rates - which may be distinguished from inflation expectations per se as it often depends on a country's past inflation track record.

Overall, long-term interest rates can reflect a financial market assessment of the sustainability of macroeconomic trends, particularly with a view to inflation expectations and various risk premia. However, as Monetary Union approaches, for Member States which are perceived to qualify for forming the group of countries adopting the single currency, the focus is shifting away from the country perspective and towards a market assessment of the likely economic outlook for the single currency area as a whole, notwithstanding the fact that some country-specific risk premia may continue to exist. In this respect, a trend towards the convergence of long-term interest rates may therefore be seen as an indication that both inflation expectations and fundamentals reflected in risk premia are converging. This may reflect efforts at sustained convergence in individual countries, as well as convergence as a result of Monetary Union itself. However, long-term interest rate convergence must also be seen against a background of price stability, since two countries may have similar long-term interest rate levels with similar high levels of inflation.

Chart 5.3

Long-term interest rate differentials against countries with lowest long-term interest rates*
(monthly averages; in percentage points)



Source: National harmonised data.
* Weighted average of Belgium, Germany, France, the Netherlands and Austria. No Greek data are shown.
(a) Comparable data are only available from 22 October 1993.

A second factor is the behaviour of bond yield volatility. When the global bond market changed direction in the first half of 1996, the volatility of long-term interest rates declined on average in some Member States compared with 1995. Consistent with reduced risk premia, declining bond yield volatility tended to be observed in those countries where the largest narrowing of differentials occurred.

5.4 Assessment

Recent developments suggest that the process of convergence of long-term interest rates, which came to a halt in 1994 and the first half of 1995, resumed over the twelve-month period considered in this Report. A combination of factors appears to account for this trend. In some countries inflation expectations appear to have decreased, while an important role also seems to have been played by a reduction in risk premia. The decrease in risk premia may be attributed to a change in financial markets' perceptions of longer-term progress towards price stability, related factors such as ongoing efforts towards fiscal consolidation, the stability of exchange rates and a decrease in political uncertainty. Improved expectations regarding prospects for Monetary Union have also played a role. Looking at individual countries, the outturns may be interpreted as an indication that markets anticipate broadly similar macro-economic developments in those Member States showing no or only very small differences in long-term interest rates. This is particularly the case for Belgium, Germany, France, Luxembourg, the Netherlands and Austria. In countries whose rates remain above the reference value, namely Spain, Greece, Italy and Portugal, although a significant convergence of yields has occurred, differentials still remain wide, which indicates that progress towards overall convergence needs to be strengthened. However, more recently, a general acceleration of the convergence of long-term interest rates has been observed. This has been particularly the case in those countries whose long-term interest rates stand above the reference value during the twelve-month period considered.

6 Other factors in the assessment of convergence

6.1 Introduction

According to Article 109j (1) of the Treaty establishing the European Community, the assessment of convergence is also required to take into account a number of "other factors": the development of unit labour costs and other price indices, the situation and development of the balances of payments on current account, the results of the integration of markets, and the development of the ECU. As noted in the EMI's November 1995 report entitled "Progress Towards Convergence", reference to these factors in the Treaty is more general than for the convergence criteria, and while some of these bear a close relation to the latter, others (notably the integration of markets and the development of the ECU) may be considered as useful indicators in their own right. In assessing the information provided by these other factors, however, it is important to bear in mind that in some cases (particularly for labour market data and other price indices), the figures are less harmonised than the data used in earlier sections (see also Annex 1).

6.2 Development of unit labour costs and other price indices

Unit labour costs

Recent national data on unit labour costs, distinguishing between the two underlying components, increases in compensation per employee and productivity growth, are shown in Table 6.1.

Unit labour cost growth is expected to be higher in 1996 than in 1994 and 1995 for the EU as a whole, but still slightly lower than the level seen in 1993 and the average in 1991-92. Overall, compensation is expected to rise more slowly in 1996, but this is forecast to be more than offset by a slowdown in productivity growth. Unit labour costs are expected to fall in nominal terms in Ireland, to remain constant in Belgium and the Netherlands and to rise modestly in Germany, France, Austria, Finland and the United Kingdom. In other countries the rises in labour costs are expected to be more sizable.

Over the medium term, rises in unit labour costs in excess of consumer prices may indicate the presence of pent-up pressures on prices, signalling a possible upturn in inflation. An impression of the scale of such pressures may be obtained from a comparison of cumulative changes in unit labour costs and consumer prices. However, considering the period 1991-96, a comparison of cumulative unit labour cost growth and consumer prices does not indicate any major pressures on inflation from this source.

Table 6.1

Unit labour costs, wages and productivity

(annual percentage changes)

		1991	1992	1993	1994	1995	1996[a]
Belgium	Nominal unit labour costs	6.3	3.5	3.9	0.5	1.0	0.0
	Compensation per employee	8.1	5.9	4.3	4.0	2.6	1.2
	Productivity	1.8	2.4	0.4	3.5	1.6	1.2
Denmark	Nominal unit labour costs	1.9	3.1	-0.7	0.0	2.6	3.1
	Compensation per employee	4.3	3.8	1.6	3.6	3.6	3.7
	Productivity	2.4	0.7	2.3	3.6	1.0	0.6
Germany[b]	Nominal unit labour costs	3.3	6.2	3.7	-0.1	1.3	0.4
	Compensation per employee	5.9	10.6	4.3	3.4	3.6	2.6
	Productivity	2.5	4.4	0.6	3.5	2.3	2.2
Greece	Nominal unit labour costs	9.3	11.3	10.7	12.3	11.3	8.8
	Compensation per employee	15.4	10.2	8.6	11.9	12.5	10.0
	Productivity	6.1	-1.1	-2.1	-0.4	1.2	1.2
Spain	Nominal unit labour costs	7.4	6.8	3.3	1.0	2.0	3.3
	Compensation per employee	8.6	9.7	6.5	3.1	2.4	3.7
	Productivity	1.2	2.9	3.2	2.1	0.4	0.4
France	Nominal unit labour costs	4.0	2.8	2.9	0.2	1.2	1.6
	Compensation per employee	4.4	4.4	2.3	2.0	1.9	1.9
	Productivity	0.4	1.6	-0.6	1.8	0.7	0.3
Ireland	Nominal unit labour costs	1.6	-5.9	0.0	-6.1	-9.3	-6.2
	Compensation per employee	5.6	4.6	5.8	1.6	2.4	3.5
	Productivity	4.0	10.5	5.8	7.7	11.7	9.7
Italy	Nominal unit labour costs	9.0	4.3	2.0	-1.0	2.1	5.2
	Compensation per employee	8.8	6.4	4.1	2.9	6.0	5.7
	Productivity	-0.2	2.1	2.1	3.9	3.9	0.5
Luxembourg	Nominal unit labour costs	4.1	5.5	4.6	4.0	3.1	2.6
	Compensation per employee	4.5	4.9	5.4	4.2	3.0	2.9
	Productivity	0.4	-0.6	0.8	0.2	-0.1	0.3
Netherlands	Nominal unit labour costs	3.8	4.6	2.2	-5.6	1.2	0.0
	Compensation per employee	4.4	4.1	2.7	2.3	2.7	0.7
	Productivity	0.6	-0.5	0.5	7.9	1.5	0.7
Austria	Nominal unit labour costs	5.6	4.5	3.8	0.5	1.9	1.6
	Compensation per employee	6.5	5.6	4.2	3.1	3.8	2.8
	Productivity	0.9	1.1	0.4	2.6	1.9	1.2
Portugal	Nominal unit labour costs	15.1	12.9	6.5	3.9	1.7	3.6
	Compensation per employee	14.2	13.8	7.4	4.7	4.7	5.7
	Productivity	-0.9	0.9	0.9	0.8	3.0	2.1
Finland	Nominal unit labour costs	8.0	-2.1	-4.6	-2.1	2.3	1.9
	Compensation per employee	7.0	1.8	1.2	2.5	4.4	3.4
	Productivity	-1.0	3.9	5.8	4.6	2.1	1.5
Sweden	Nominal unit labour costs	3.9	-3.3	-4.1	2.2	3.5	4.5
	Compensation per employee	5.7	3.7	3.7	3.6	3.5	5.8
	Productivity	1.8	7.0	7.8	1.4	0.0	1.3
United Kingdom	Nominal unit labour costs	6.3	3.5	1.0	0.0	1.7	2.0
	Compensation per employee	8.0	6.1	3.6	3.8	3.4	3.7
	Productivity	1.7	2.6	2.6	3.8	1.7	1.7
EU-15	Nominal unit labour costs	5.7	4.5	2.6	-0.0	1.7	2.2
	Compensation per employee	7.0	7.2	4.0	3.2	3.7	3.4
	Productivity	1.3	2.7	1.4	3.2	2.0	1.2

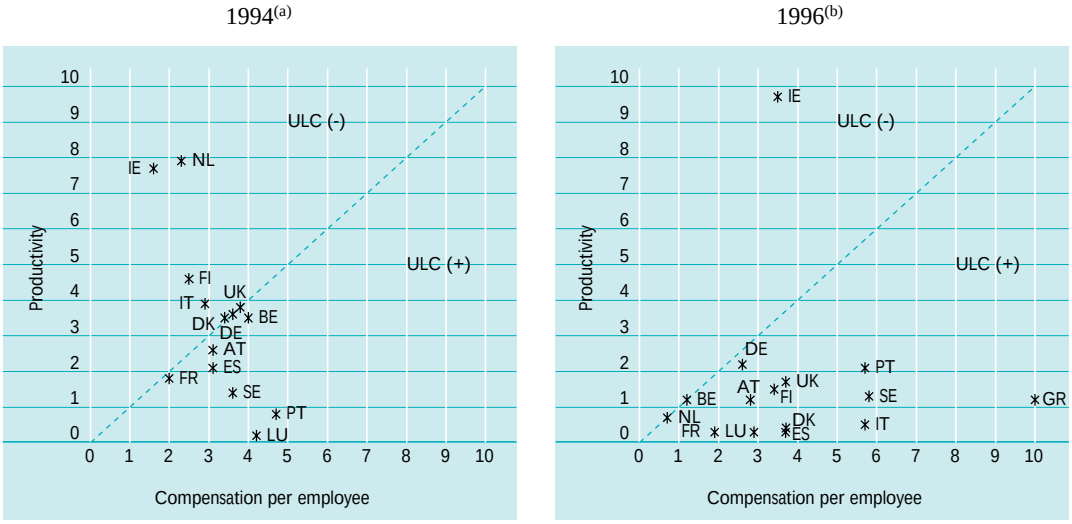
Source: National data.
(a) Forecasts.
(b) Western Germany up to end-1991, unified Germany thereafter.

Recent developments in compensation per employee and productivity may also provide some evidence as to the likely sustainability of price developments. Chart 6.1 compares the situation in Member States in two specific years: 1994 and 1996. As can be seen, there has been a turnaround in unit labour costs between 1994, when unit labour costs decelerated or even fell in a number of Member States, and 1996. In 1996, only in Ireland were unit labour costs expected to continue to fall, with productivity growth more than compensating for higher wage increases. On the whole, wage increases have become more disparate across countries, but with a general tendency for changes in compensation per employee to exceed productivity growth. In Belgium, Germany, Greece, Luxembourg, the Netherlands and Austria there has been moderation in wage growth between the years 1994 and 1996. Elsewhere there has been little change, or a rise in wage inflation. Also, a slowdown in productivity gains, which in most cases may largely be explained by cyclical developments, accounts for higher growth in unit labour costs. As economic activity strengthens, productivity growth can be expected to accelerate. But a key factor will be whether wage restraint is maintained and, where necessary, consolidated. Recent upward tendencies in a number of Member States warrant a note of caution.

Chart 6.1

Wage and productivity growth in 1994 and 1996

(annual percentage changes)



Source: National data.

(a) For reasons of scaling no 1994 data are shown for Greece; the annual percentage change of compensation per employee was 11.9% and the change in productivity was –0.4%
ULC = Nominal unit labour cost.

(b) Data for 1996 are forecasts.

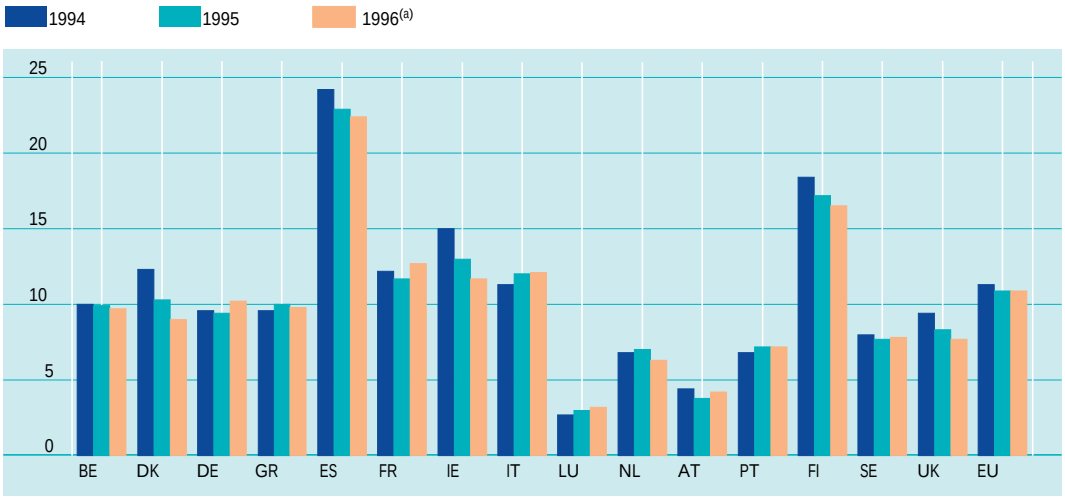
One factor which may have contributed to moderate wage claims in some countries, while at the same time leading to greater dispersion, is the trend in unemployment (see Chart 6.2). On the whole, unemployment rates rose substantially during the course of the last recession and, in most countries, have since remained at high levels. Only in five countries (Denmark, Spain, Ireland, Finland and the United Kingdom) has there been a significant decline since 1994, though in Spain and Finland

unemployment remains much higher than in the late 1980s. Thus, in most cases, it is unlikely that the tightness of labour markets will be the cause of significant upward wage pressures in the near future. On the other hand, the existence of sizable structural rigidities in most EU countries suggests that the prevailing high levels of unemployment may not accurately reflect the degree of slack in the economy. This underlines the crucial importance of structural reforms to eliminate rigidities and improve the functioning of labour markets.

Chart 6.2

Unemployment rates*

(as a percentage of the labour force)



Source: National data.

* Figures are not strictly comparable between countries owing to different national definitions.

(a) Data for 1996 are forecasts.

Producer prices

Some indication of the sustainability of price developments may be provided by increases in prices of intermediate, capital and consumption goods produced in the manufacturing sector. In particular, there is a risk that increases in the latter above the rate of general consumer price inflation, especially if these are persistent, will tend to squeeze margins and feed through to prices paid by the consumer. However, recent developments illustrate that, at least in the short term, differentials between the two may be offset by other factors, including changes in profit margins.

The latest data for consumer prices (CPIs) (for which longer time series are available than for IICPs) and producer prices (PPIs) or, where these are not available, wholesale prices, are shown in Table 6.2. The growth rate of PPIs rose between 1994 and 1995, and in 1995 exceeded that of CPIs in the majority of Member States. However, this was not inconsistent with the fact that the rate of consumer price inflation fell further in some of these countries. In 1996 available data for PPIs show that they have risen more slowly in general. Moreover, in the latest twelve-month period, PPIs have risen more slowly than CPIs in almost all countries, despite some upward pressure on oil prices. Thus, there are no general grounds to question the current sustainability of inflation rates arising from developments in PPIs.

Table 6.2

Producer prices* (PPIs) and consumer prices (CPIs)

(annual percentage changes)

		Annual					Monthly		
		Avg. 91-92	1993	1994	1995	1996[a]	Jul 96	Aug 96	Sep 96
Belgium	CPI	2.8	2.8	2.4	1.5	1.9	1.9	1.9	2.0
	PPI	-0.4	-1.0	1.4	2.2	0.8	0.1	0.1	-
Denmark	CPI	2.2	1.3	2.0	2.1	2.0	2.3	2.4	2.3
	PPI	-0.1	-0.5	1.3	2.9	1.1	1.1	1.2	1.0
Germany[b]	CPI	3.8	3.6	2.7	1.8	1.5	1.6	1.4	1.4
	PPI	1.9	-0.0	0.6	1.8	-0.4	-0.7	-0.7	-
Greece	CPI	17.7	14.4	10.9	9.3	8.8	8.6	8.5	8.5
	PPI	14.0	11.9	8.7	7.8	6.6	-	-	-
Spain	CPI	5.9	4.6	4.7	4.7	3.6	3.7	3.7	3.6
	PPI	1.4	2.4	4.3	6.4	1.8	0.9	0.8	-
France	CPI	2.8	2.1	1.7	1.7	2.1	2.3	1.6	1.6
	PPI	-	-	1.1	6.3	-2.6	-3.5	-3.6	-
Ireland	CPI	3.1	1.5	2.4	2.5	1.7	1.5	1.5	1.5
	PPI	1.2	4.6	1.1	2.5	0.9	0.8	0.1	-0.7
Italy	CPI	5.9	4.2	3.9	5.4	4.2	3.6	3.4	3.4
	PPI	2.7	3.6	3.6	7.3	2.6	0.8	0.5	-
Luxembourg	CPI	3.1	3.6	2.2	1.9	1.3	1.3	1.4	1.3
	PPI	-2.3	-1.7	0.5	3.7	-1.8	-	-	-
Netherlands	CPI	3.2	2.6	2.7	2.0	2.0	2.2	1.9	2.0
	PPI	0.9	-1.6	0.7	3.0	1.4	2.3	2.2	-
Austria	CPI	3.7	3.6	3.0	2.2	1.7	1.9	1.8	2.0
	PPI	0.3	-0.4	1.3	0.4	-0.4	-0.1	0.6	1.1
Finland	CPI	3.6	2.2	1.1	1.0	0.6	0.4	0.4	0.5
	PPI	1.5	4.7	1.6	0.2	0.5	0.5	0.3	0.5
Sweden	CPI	6.1	4.7	2.3	2.9	1.1	0.6	0.3	0.2
	PPI	0.1	4.9	4.9	9.8	-2.1	-4.3	-5.0	-
United Kingdom	CPI	5.7	3.0	2.4	2.8	2.9	2.8	2.8	2.9
	PPI	4.3	3.9	2.5	4.2	2.9	2.2	2.0	2.2

Source: National data. For further explanatory notes on consumer price indices see Table 2.1.

* For Denmark, Greece and Austria wholesale prices are used. For Portugal there are no data available.

(a) Based on latest available data.

(b) CPI and PPI data up to 1994 refer to western Germany only and to unified Germany thereafter.

Alternative price indices

Other price indices may also complement the analysis, in particular developments in consumer expenditure deflators (CED) and GDP deflators. Along with national consumer prices, the consumers' expenditure deflator is an alternative measure of consumer prices, while the GDP deflator covers a much broader range of goods and services (including exports but excluding imports).

In 1995 inflation measured by the CPI was lower than both the GDP deflator and the CED in three countries: Germany, Luxembourg and Portugal. In 1996 this was expected to be the case again in Germany

and Luxembourg, as well as in France, Ireland, Italy and Finland. Some caution may also be warranted in the light of the substantial differentials between increases in GDP deflators and CPIs in 1995 in a number of countries.

Assessment

Unit labour costs and other price indices do not provide grounds for reconsidering the judgements regarding the performance of Member States in terms of the price stability criterion (see Section 2). In most countries, unit labour costs are expected to rise rather slowly in 1996, albeit slightly faster than in 1995, as lower increases in compensation per employee largely offset a slowdown in productivity. Nevertheless, looking ahead, any tendency for wages to rise significantly, leading to further rises in unit labour costs, would constitute grounds for caution. Producer prices or, where these are not available, wholesale prices do not signal any major cause for concern; these indices have generally increased more slowly in 1996 and the growth rate in most cases is below that of consumer prices. Alternative price indices also suggest that current inflation rates are in general sustainable, although disparities between alternative deflators and CPI inflation rates do sound a cautionary note in the case of several Member States.

6.3 The situation and development of the balance of payments on current account

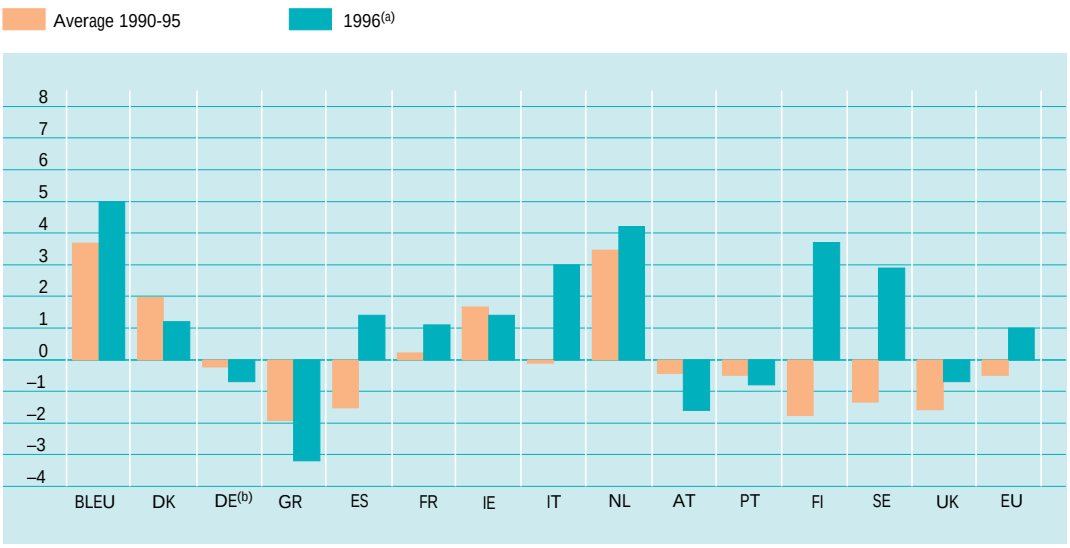
Current account balances may be seen as related to the criterion on the government budgetary position, exchange rate stability and inflationary pressures. As regards the link to fiscal policy, such an approach implies a need to evaluate fiscal positions within the context of an overall assessment of sectoral balances including the foreign and domestic private sectors. As far as exchange rates are concerned, real exchange rate disequilibria or misalignments have a bearing on many items of the current account. However, it is important to recognise in this context that the current account deficit or surplus is the obverse of capital flows. Clearly, the existence and scale of investment opportunities at home and abroad could play an important part in determining the current account balance. In this sense, a deficit, especially if it is the counterpart of investment inflows, may simply highlight the presence of relatively favourable rates of return on capital.

Current account balances on average over 1990-95 and as expected in 1996 are shown in Chart 6.3. Ten EU countries were expected to have a current account surplus in 1996: Belgium/Luxembourg, Denmark, Spain, France, Ireland, Italy, the Netherlands, Finland and Sweden. With the exceptions of Denmark and Ireland, the surpluses are expected to be larger (as a percentage of GDP) than the average over the previous five years. Deficits in 1996 are expected in Germany, Greece, Austria, Portugal and the United Kingdom. In the United Kingdom the deficit is forecast to be smaller than the average deficit over 1990-95; in Greece, the projected deficit exceeds 2% of GDP.

Information on the international investment position, i.e. on stocks of foreign assets and liabilities, is not available for all countries, but national, unharmonised data (see Tables 7.1-7.15) suggest that net foreign liability positions are held by Denmark, Greece, Spain, France, Italy, Austria, Finland and Sweden, and net foreign assets are held by Belgium, Germany, the Netherlands, Portugal and the United Kingdom. For other countries national data are not available.

Chart 6.3

Current account balances
(as a percentage of GDP)



Source: National data.
(a) Data for 1996 are forecasts.
(b) Western Germany up to June 1990, unified Germany thereafter.

6.4 The results of the integration of markets

An assessment of progress with respect to Economic and Monetary Union more generally, as well as the situation in individual Member States, may be derived from the results of the integration of markets.

According to figures prepared by the European Commission on the state of implementation of Single Market legislation (White Paper measures), as of September 1996 the average transposition rate in the Union is approximately 93%. In a breakdown by sector, the Commission has identified public procurement and special arrangements as the sectors with the most technical barriers.

Turning to data on trade flows, a significant proportion of trade for all EU countries is with other EU countries. Intra-EU exports as a proportion of total exports in 1994 (the latest available data for a whole year) ranges from 53% in the United Kingdom to nearly 80% in Portugal. The average for EU countries is around 62%.

Foreign direct investment (FDI) flows tend to be somewhat volatile, but may provide a useful supplementary indicator of market integration as an alternative to data on cross-border trade in goods and services. Preliminary figures for all fifteen EU Member States were released by EUROSTAT for the first time in 1996, for the year 1994. Considering intra-EU flows only, the three largest outward investors (i.e. to other EU countries) were the Netherlands, Germany and France. The three largest inward flows were recorded for France, Spain and Belgium/Luxembourg.

Turning to taxation issues, with regard to the integration of markets, indirect taxation and capital income taxation are of particular importance. There are considerable differences between Member States in respect of indirect taxation of goods and services. With respect to capital income

taxation, there are also substantial differences between systems in individual Member States, both in terms of rates and in terms of their precise application. For example, in some Member States with-holding taxes are levied on residents, while under other systems the paying agent must inform the tax authorities. Typically, residents and non-residents are treated differently under the individual systems. No comprehensive measures for harmonising capital income taxation with a view to the integration of financial markets have so far been taken in the EU.

6.5 The development of the ECU

The overall private ECU market contracted in 1995 for the third successive year, according to BIS data. The outstanding value of ECU claims (see Table 6.3) is estimated to have declined by 3.6% between end-1994 and end-1995, and lost further ground in the first quarter of 1996, to stand at ECU 159.5 billion at the end of March 1996. This is 17.5% below the peak of the market seen in September 1992.

Falls in bonds outstanding have been largely responsible for the overall contraction in the market. The period since the end of 1994 has seen a contraction of total ECU bonds outstanding from ECU 124 billion to ECU 111.2 billion at the end of March 1996, and ECU 110.6 billion at the end of June. Repayments of maturing bonds have been high, while issuance, notably in the private sector, remained weak - sovereign borrowers, which themselves reduced issuance, accounted for 88% of gross issues in 1995, up from 79% in 1994. Although overall international bond issuance was subdued in 1995, the decline in ECU issues went further as the share of international ECU bonds in the total outstanding fell from 4.1 to 3.6% between the end of 1994 and the end of 1995. In contrast to bonds, the estimated stock of bank lending (final bank lending and lending to banks outside the BIS reporting area), remained flat at ECU 55-56.0 billion throughout the period end-1994 to end-March 1996. The share of the ECU in total international bank assets, however, fell from 2.5 to 2.1%. For short-term instruments there was a slight rise in 1995 and early 1996, with medium-term notes being the main source of growth. Here again, however, the global volume of Euro-notes rose more rapidly than did that of ECU-denominated ones, implying a loss of market share.

The spread between the ECU market and theoretical or "basket" exchange rates has traditionally remained in a range of ±20 basis points, except during periods of currency turbulence. The spread widened markedly from April 1994 onwards, and broadened further in the first quarter of 1995 to reach over -3% at times in late 1995 and early 1996, the widest margin ever. At the same time, the short and long-term interest rate spread remained close to par throughout 1995. However, in the spring of 1996 there was some reversal of these trends, as the exchange rate spread eased to -1.5% and the long-term interest rate spread widened to -0.2%, and in the summer the exchange rate spread fell to as low as -0.25%.

Table 6.3

Indicators of the development of the ECU

(end-period; in billions of ECU)

	Dec 94	Dec 95	Mar 96	Jun 96	Sep 96
Bonds:	124.0	116.4	111.2	110.6	-
of which:					
international[a]	66.9	59.6	55.4	53.5	-
domestic[a]	57.1	56.7	55.7	57.1	-
Euro notes	6.6	8.9	9.3	8.8	-
Treasury bills	3.5	3.5	3.5	3.5	-
Estimated bank lending[b]	56.0	55.3	55.5	-	-
Estimated market size[c]	170.1	164.0	159.5	-	-
Total ECU lending[d]	167.3	152.3	153.0	-	-
Total ECU deposits[e]	168.1	144.1	147.8	-	-
Exchange rate spread[f]	-0.4	-2.1	-2.5	-1.5	-1.0
Short-term interest rate spread[f]	0.1	0.0	0.0	0.0	0.0
Long-term interest rate spread[f]	0.0	0.0	-0.1	-0.2	-0.2

Source: National data and BIS Quarterly Statistics on International Banking and Financial Market Developments.

(a) The distinction between domestic and international issues is made in the BIS Quarterly Statistics.

(b) Final bank lending and lending to banks outside the reporting area.

(c) ECU 20 billion is deducted for estimated double counting; there is an overlap between the securities and banking markets owing to the role of banks as issuers and holders of ECU securities. In the absence of comprehensive data, this overlap may only be estimated.

(d) Including interbank lending.

(e) Including interbank deposits.

(f) Quarterly averages, percentage points.

The persistent and large exchange rate spread in 1995 and early 1996, during a period when (with the exception of the first quarter of 1995) exchange rate tensions were not marked, is thought to reflect a number of factors, notably uncertainty regarding which countries will participate in the euro area and, to some extent, legal uncertainties about the continuity of ECU contracts. The decline in the exchange rate spread since the first quarter of 1996 suggests a decrease in tensions and uncertainties, reflected in very stable conditions within the EMS. The return to somewhat narrower exchange rate spreads may also reflect a lagged response to the conclusions of the Madrid summit and a more general increase in optimism in financial markets about the likelihood of EMU, as well as ongoing work to prepare the legal framework for the use of the euro.

7 Assessment of the performance of individual countries

This chapter brings together the various assessments made in the previous sections to give an overall view of the performance of individual countries. The data, reference values and other aspects related to the assessments are discussed in more detail in the respective sections of the Report, and are only briefly summarised here.

As in previous sections, the reference period for the assessment of price stability and long-term interest rates is the twelve-month period from October 1995 to September 1996. Regarding fiscal positions (as a percentage of GDP), data also include the autumn 1996 Commission projections of deficits and debts for 1996. Exchange rates are evaluated over the two-year period October 1994-September 1996. Each country section is supplemented by a table of convergence data and main economic indicators. The data, in particular the interim figures and projections for 1996, are explained in more detail in Box 7.1.

7.1 Belgium

The Belgian economy recovered rather rapidly from the recession in 1993, when *real GDP* fell by 1.4%, to reach a growth rate of 2.3% in 1994 (see Table 7.1). The slowdown in GDP growth to 1.9% in 1995 reflects the overall pause in growth in the EU, while several indicators point to a resumption of activity since the second quarter of 1996. The latest Commission forecast for GDP growth in 1996 is 1.4%. The conditions for a durable recovery in economic growth seem to be in place, with wage increases being moderate, and inflation and interest rates low. Structural adjustments of the social security and pension systems as well as measures directed at safeguarding the competitive position and employment growth in the context of the so-called "framework laws" should help both to support the process of fiscal consolidation and to improve the employment situation.[4] The unemployment rate stands at close to 10%.

Table 7.1

Belgium - Key indicators 1991-96*

	1991	1992	1993	1994	1995	1996
General economic indicators						
Real GDP growth, %	1.6	1.7	-1.4	2.3	1.9	1.4
Short-term interest rate, %	9.4	9.4	8.2	5.7	4.8	3.3
Unemployment rate, %	6.6	7.3	8.9	10.0	9.9	9.7
Convergence indicators[(a)]						
CPI inflation, %	3.2	2.4	2.8	2.4	1.5	1.9
IICP inflation, %	-	-	-	-	1.4	1.6
Reference value, %	4.4	3.8	3.1	3.1	2.7	2.6
General govt. surplus (+) or deficit (-), % of GDP	-6.5	-7.2	-7.5	-5.1	-4.1	-3.3
General government gross debt, % of GDP	129.4	130.6	137.0	135.0	133.7	130.6
Long-term interest rate, %	9.3	8.7	7.2	7.8	7.5	6.7
Reference value, %	10.7	10.7	9.3	10.0	9.7	8.7
Indicators of exchange rate performance						
Exchange rate against the DEM	20.59	20.59	20.90	20.61	20.57	20.57
Nominal effective exchange rate	99.8	101.9	102.8	104.5	108.9	107.2
Real effective exchange rate	98.6	99.2	99.7	101.1	104.3	102.5
Exchange rate volatility	0.04	0.04	0.33	0.09	0.07	0.02
Other factors						
Unit labour costs, % change	6.3	3.5	3.9	0.5	1.0	0.0
Current account, % of GDP	2.4	2.9	5.0	5.2	4.8	5.0
Net foreign assets (+) or liabilities (-), % of GDP	7.8	10.4	15.1	15.5	18.0	-
Exports, % of GDP[(b)]	74.2	75.6	78.1	83.3	85.8	87.4

* For data sources and explanations of the data see Box 7.1.

(a) Excluding the exchange rate criterion.
CPI Inflation data for 1996 are calculated over the first nine months, whereas IICP inflation data refer to the reference period October 1995-September 1996.

(b) In 1994 the share of intra-EU exports of total BLEU exports was 70.7% (EU average 61.7%).

[4] *These laws allow the Government to act in particular fields without the otherwise required intervention of Parliament, which confirms the measures taken ex post within a predetermined period.*

Over the reference period IICP inflation was 1.6%, and Belgium recorded one of the lowest inflation rates in the Union. Inflation was thus well below the reference value calculated for measuring the achievement of a high degree of *price stability*. Over the latest three-month period, IICP inflation was 2.0%. Over the medium term, and measured in terms of national consumer prices, inflation was reduced from 3.2% in 1991 to 1.5% in 1995. Developments in unit labour costs and other price indicators tend to support the view that there is no immediate threat to price stability in Belgium.

Since its recent peak of 7.5% of GDP in 1993, the *general government deficit* has continued to decline gradually, but at 4.1% of GDP in 1995 was well above the 3% reference value. Except for a slight deterioration in the early 1990s, the primary balance has tended to improve. In 1995 a substantial reduction in interest payments to 9.1% of GDP was the main factor contributing to the overall improvement. The fiscal deficit continues to stand substantially higher than general government investment, which, at 1.3% of GDP, is the lowest government investment ratio in the EU. The decline in the deficit ratio contributed to a lowering of the very high *debt-to-GDP ratio* (which peaked at 137.0% of GDP in 1993). In 1995 the reduction was partly due to the liquidation of government financial assets. The general government debt ratio was 133.7% of GDP in 1995, the highest in the EU and far above the 60% reference ratio. In 1996 the deficit-to-GDP ratio is forecast to continue its downward trend, falling to 3.3%, not far from the 3% reference value. At the same time, a further reduction in the debt-to-GDP ratio is expected to bring the debt ratio to 130.6% in 1996. Belgium is currently the subject of an EU Council decision that an excessive deficit exists.

As regards *exchange rate developments*, the Belgian franc participates in the exchange rate mechanism of the European Monetary System. Belgium has not devalued its currency's bilateral central rate over the reference period. The currency's exchange rate vis-à-vis the strongest ERM currencies was stable, with its volatility, measured on a comparable basis[5], being 0.0-0.1%. The nominal effective exchange rate has appreciated only marginally over the past two years. The Belgian short-term interest rate differential against the Deutsche Mark has fallen to zero.

Bond yields in Belgium have been on a declining trend since 1991 and over the reference period stood close to yields in Germany and the Netherlands (the countries with the lowest yields). Over the reference period, the long-term interest rate was 6.7%, remaining well below the reference value.

As regards *other factors*, over recent years the current account in Belgium has shown large and gradually growing surpluses. Belgium has a strong net external asset position.

To summarise, Belgium has shown good performance in the areas of price stability, convergence of long-term interest rates and exchange rate stability within the ERM. Progress is also being made in the field of public finances; the deficit ratio has remained on a declining trend and the very high debt ratio has been declining since reaching a peak in 1993. However, in the light of the still very high debt ratio, sustained and decisive action is required to bring fiscal developments under control on a permanent basis.

[5] *In the whole of this section volatility is measured against the Deutsche Mark, see Box 7.1.*

7.2 Denmark

The Danish economy grew slowly for a number of years in the early 1990s (see Table 7.2). However, in 1994 and early 1995 *real GDP* expanded strongly, led by private consumption and fuelled later by the pick-up of investment. According to the Commission, GDP growth for 1996 is forecast to be lower than in previous years, at 2.1%, reflecting the overall pause in growth in the EU. Nevertheless, the conditions for a durable recovery in economic growth appear to be in place. Overall confidence may also be supported by increased demand for labour and structural changes in labour markets, which have contributed to a reduction in unemployment from above 12% in 1993 to 9% in 1996.

Table 7.2

Denmark - Key indicators 1991-96*

	1991	1992	1993	1994	1995	1996
General economic indicators						
Real GDP growth, %	1.3	0.2	1.5	4.4	2.8	2.1
Short-term interest rate, %	9.8	11.5	10.9	6.2	6.1	4.0
Unemployment rate, %	10.6	11.3	12.4	12.3	10.3	9.0
Convergence indicators[(a)]						
CPI inflation, %	2.4	2.1	1.3	2.0	2.1	2.0
IICP inflation, %	-	-	-	-	2.3	2.2
Reference value, %	4.4	3.8	3.1	3.1	2.7	2.6
General govt. surplus (+) or deficit (-), % of GDP	-2.1	-2.9	-3.9	-3.5	-1.6	-1.4
General government gross debt, % of GDP	64.6	68.7	80.1	76.0	71.9	70.2
Long-term interest rate, %	9.3	9.0	7.3	7.8	8.3	7.4
Reference value, %	10.7	10.7	9.3	10.0	9.7	8.7
Indicators of exchange rate performance						
Exchange rate against the DEM	3.86	3.87	3.92	3.92	3.91	3.86
Nominal effective exchange rate	98.5	100.9	103.7	103.7	108.1	107.3
Real effective exchange rate	96.0	96.8	97.5	97.0	100.8	100.2
Exchange rate volatility	0.07	0.17	0.39	0.12	0.20	0.04
Other factors						
Unit labour costs, % change	1.9	3.1	-0.7	0.0	2.6	3.1
Current account, % of GDP	1.6	2.8	3.5	2.0	0.9	1.0
Net foreign assets (+) or liabilities (-), % of GDP	-40.2	-36.4	-33.3	-27.9	-27.4	-25.2
Exports, % of GDP[(b)]	37.7	38.1	37.0	38.2	38.6	38.9

* For data sources and explanations of the data see Box 7.1.

(a) Excluding the exchange rate criterion.
CPI Inflation data for 1996 are calculated over the first nine months, whereas IICP inflation data refer to the reference period October 1995-September 1996.

(b) In 1994 the share of intra-EU exports of total national exports was 63.2% (EU average 61.7%).

Over the reference period the Danish IICP inflation rate was 2.2%, i.e. below the reference value calculated for measuring the achievement of a high degree of *price stability*. Over the latest three-month period, IICP inflation was 2.5%. Measured in terms of national consumer prices, inflation in Denmark has remained at around 2% since 1991. Developments in unit labour costs and other price indicators tend to support

the view that there is no immediate threat to price stability in Denmark.

Following an easing of fiscal policy in 1993 and 1994, which caused the *deficit-to-GDP ratio* to reach 3.9% and 3.5% respectively, the deficit was reduced to 1.6% of GDP in 1995, i.e. well below the 3% reference value. The primary surplus increased significantly in 1995. In 1995 the general government deficit was lower than general government investment for the first time since 1991. The *general government debt-to-GDP ratio* reached a peak of 80.1% in 1993, but has since declined rather rapidly owing to the improved primary balance and also to the decumulation of financial assets by the Government. The debt ratio, standing at 71.9% of GDP in 1995, is still above the 60% reference value. In 1996 the deficit-to-GDP ratio is forecast to decline slightly to 1.4%. At the same time, a further reduction in the debt ratio is expected, so that this should reach 70.2% in 1996. Denmark is currently not the subject of an EU Council decision that an excessive deficit exists.

As regards *exchange rate developments*, the Danish krone participates in the exchange rate mechanism of the European Monetary System. Denmark has not devalued its currency's bilateral central rate over the reference period. The krone has remained broadly stable, but also experienced tensions in the first quarter of 1995. Its volatility, measured on a comparable basis, was 0.0-0.2%. Over the past two years the nominal effective exchange rate has shown a slight appreciation as a consequence of an appreciation vis-à-vis non-ERM and non-EU currencies. By end-September 1996 the Danish short-term interest rate differential against the Deutsche Mark had fallen to 0.6%.

Bond yields in Denmark in the 1990s have fluctuated relatively closely in line with bond yields in those EU countries with the lowest yields, but with a positive differential. Over the reference period, Danish yields, at an average level of 7.4%, remained below the reference value.

As regards *other factors*, the current account has been in surplus during recent years. Denmark has a net external liability position.

To summarise, Denmark has shown good performance in terms of price stability and the convergence of long-term interest rates. Furthermore, the krone has remained broadly stable within the ERM, although it has shown some volatility, and the general government deficit is expected to remain well below the reference value in 1996. Further improvements in the fiscal position are seen as warranted in order to sustain the substantial reductions in debt observed in recent years.

Denmark has given notification that it will not participate in Stage Three and as a consequence will not participate in the single currency at the start of Stage Three.

7.3 Germany

Following a strong recovery in 1994, when *real GDP* in Germany recorded an increase of 2.9%, output growth decelerated to 1.9% in 1995, mainly as a result of declining business investment and construction activity, as well as destocking, which has continued in 1996 (see Table 7.3). Several indicators point to a recovery after the first quarter of 1996, but GDP growth for the year as a whole is forecast by the Commission to be lower than in 1995 at 1.4%, and the unemployment rate, currently just above 10%, remains high. Comprehensive initiatives to consolidate public finances and diminish rigidities in product and labour markets are helping to improve the conditions for a durable recovery of economic growth.

Table 7.3

Germany - Key indicators 1991-96*

	1991	1992	1993	1994	1995	1996
General economic indicators						
Real GDP growth, %	5.0	2.2	-1.1	2.9	1.9	1.4
Short-term interest rate, %	9.2	9.5	7.2	5.3	4.5	3.3
Unemployment rate, %	5.7	7.8	8.9	9.6	9.4	10.2
Convergence indicators[(a)]						
CPI inflation, %	3.6	4.0	3.6	2.7	1.8	1.5
IICP inflation, %	-	-	-	-	1.5	1.3
Reference value, %	4.4	3.8	3.1	3.1	2.7	2.6
General govt. surplus (+) or deficit (-), % of GDP	-3.3	-2.8	-3.5	-2.4	-3.5	-4.0
General government gross debt, % of GDP	41.5	44.1	48.2	50.4	58.1	60.8
Long-term interest rate, %	8.5	7.8	6.5	6.9	6.9	6.3
Reference value, %	10.7	10.7	9.3	10.0	9.7	8.7
Indicators of exchange rate performance						
Exchange rate against the DEM	-	-	-	-	-	-
Nominal effective exchange rate	98.9	101.9	104.8	105.0	110.9	108.7
Real effective exchange rate	98.2	102.7	107.1	107.4	112.4	109.4
Exchange rate volatility	-	-	-	-	-	-
Other factors						
Unit labour costs, % change	3.3	6.2	3.7	-0.1	1.3	0.4
Current account, % of GDP	-1.1	-1.0	-0.7	-1.0	-0.7	-0.7
Net foreign assets (+) or liabilities (-), % of GDP	17.3	15.2	13.0	9.8	7.5	-
Exports, % of GDP[(b)]	26.1	25.5	24.5	25.7	26.7	27.3

* For data sources and explanations of the data see Box 7.1. GDP growth and unit labour cost data for 1991 and CPI data up to 1994 refer to western Germany only and to unified Germany thereafter.

(a) Excluding the exchange rate criterion.
CPI Inflation data for 1996 are calculated over the first nine months, whereas IICP inflation data refer to the reference period October 1995-September 1996.

(b) In 1994 the share of intra-EU exports of total national exports was 57.7% (EU average 61.7%).

Over the reference period, IICP inflation in Germany recorded a level of 1.3%, the third lowest in the EU, which is thus well below the reference value calculated for measuring the achievement of a high degree of *price stability*. Over the latest three-month period, IICP inflation was 1.3%. Germany has been successful in mastering the inflationary consequences of unification. In terms of national consumer prices, inflation reached a

high of 4.0% in 1992 and was subsequently reduced to below 2% from 1995 onwards. The subdued rise in unit labour costs was a factor underlying this development, and trends in other price indicators tend to support the view that there is no immediate threat to price stability.

The *general government deficit-to-GDP ratio*, which had declined in 1994 to below 3%, rose again in 1995 to 3.5%, i.e. above the 3% reference value. The deterioration reflected both slower growth in government revenues and faster-rising expenditure, while the primary surplus fell to stand broadly in balance in 1995. While the general government deficit and public investment were approximately of the same order of magnitude in 1994, the 1995 deficit substantially exceeded public investment. At the same time, the *debt ratio* increased sharply, from 50.4% of GDP in 1994 to 58.1% in 1995, to a large extent reflecting the unification-related assumption by the Government of the debt liabilities of the Treuhand agency, housing companies in the former GDR and the Deutsche Kreditbank. In 1996 the deficit is forecast to rise further to 4.0% of GDP, and thus to stand well above the 3% reference value. The rise in the fiscal deficit is expected to lead to a further increase in the debt-to-GDP ratio in 1996 to 60.8%, thus exceeding the 60% reference value. Germany is currently the subject of an EU Council decision that an excessive deficit exists.

As regards *exchange rate developments*, the Deutsche Mark participates in the exchange rate mechanism of the European Monetary System. Germany has not devalued its currency's bilateral central rate over the period under review. The Deutsche Mark's exchange rate vis-à-vis the strongest ERM currencies was stable. In terms of nominal effective exchange rates the marked appreciation seen in early 1995 was gradually corrected later in the year and in the first part of 1996. Germany, together with Belgium, France, the Netherlands and Austria, typically has had the lowest short-term interest rates in the Union.

After the significant rise in bond yields in 1994, *long-term interest rates* in Germany followed a declining trend in 1995. In early 1996 yields edged upwards and exhibited some degree of volatility. During the reference period, German long-term interest rates were among the lowest in the EU and, at 6.3%, remained well below the reference value.

As regards *other factors*, over recent years the current account has shown a small deficit. Germany has a net external asset position.

To summarise, Germany has shown good performance in terms of price stability and the convergence of long-term interest rates, and the Deutsche Mark participates as a stable currency in the ERM. As regards public finances, strong and sustained action is required. The deficit ratio rose to 3.5% in 1995 and is projected to rise further in 1996. The debt ratio is also expected to rise above 60% of GDP, which clearly underlines the importance of achieving a turnaround in fiscal trends.

7.4 Greece

After a protracted recession, *real GDP growth* in Greece resumed in 1994 and 1995, at 1.5-2.0% (see Table 7.4). For 1996, GDP growth is forecast by the Commission to be 2.4%. Efforts to improve the fiscal position and to reduce inflationary pressures are contributing to an improvement in the conditions for a further recovery of growth and increased confidence in the progress towards convergence, while the unemployment situation (with a rate of around 10%) is improving, albeit slightly.

Table 7.4

Greece - Key indicators 1991-96*

	1991	1992	1993	1994	1995	1996
General economic indicators						
Real GDP growth, %	3.1	0.4	-1.0	1.5	2.0	2.4
Short-term interest rate, %	20.2	19.8	19.1	26.9	16.4	14.0
Unemployment rate, %	7.7	8.7	9.7	9.6	10.0	9.8
Convergence indicators[(a)]						
CPI inflation, %	19.5	15.9	14.4	10.9	9.3	8.8
IICP inflation, %	-	-	-	-	9.0	8.4
Reference value, %	4.4	3.8	3.1	3.1	2.7	2.6
General govt. surplus (+) or deficit (-), % of GDP	-11.5	-12.3	-14.2	-12.1	-9.1	-7.9
General government gross debt, % of GDP	92.3	99.2	111.8	110.4	111.8	110.6
Long-term interest rate, %	-	24.1	23.3	20.8	17.4	15.1
Reference value, %	10.7	10.7	9.3	10.0	9.7	8.7
Indicators of exchange rate performance						
Exchange rate against the DEM	109.84	122.28	138.64	149.64	161.76	160.43
Nominal effective exchange rate	88.6	81.5	74.5	69.4	67.4	66.4
Real effective exchange rate	100.9	103.4	104.6	105.2	108.8	113.0
Exchange rate volatility	0.14	0.16	0.18	0.20	0.24	0.19
Other factors						
Unit labour costs, % change	9.3	11.3	10.7	12.3	11.3	8.8
Current account, % of GDP	-1.7	-2.1	-0.8	-0.1	-2.5	-3.2
Net foreign assets (+) or liabilities (-), % of GDP	-21.3	-23.2	-23.7	-20.4	-19.6	-
Exports, % of GDP[(b)]	16.9	18.3	18.6	19.7	19.7	20.0

* For data sources and explanations of the data see Box 7.1.

(a) Excluding the exchange rate criterion.
CPI Inflation data for 1996 are calculated over the first nine months, whereas IICP inflation data refer to the reference period October 1995-September 1996.

(b) In 1994 the share of intra-EU exports of total national exports was 58.3% (EU average 61.7%).

IICP inflation in Greece over the reference period was 8.4%, the highest rate in the EU, and stands considerably above the reference value calculated for measuring the achievement of a high degree of *price stability*. Over the latest three-month period, IICP inflation was 8.3%. Over the past few years, a significant reduction in inflation measured by national consumer prices has been achieved from 19.5% in 1991 to 9.3% in 1995. In 1996, however, the disinflation process lost some momentum. Significant further progress towards price stability is necessary. Developments in other price indices and unit labour costs underline this view.

The *deficit-to-GDP ratio* has declined considerably, from a peak of 14.2% in 1993 to 9.1% in 1995, as a result of higher government receipts. The primary balance recorded a surplus of 4.0% in 1995. The deficit ratio remains the highest in the Union, three times the level of general government investment, and far above the 3% reference value. Reflecting high deficits, the *debt-to-GDP ratio* has continued to increase, to stand at 111.8% in 1995, a level which is among the highest in the EU and far above the 60% reference value. In 1996 a further reduction in the deficit ratio is forecast, to 7.9% of GDP, i.e. still far above the reference value. The debt ratio is expected to decrease slightly to 110.6%. Greece is currently the subject of an EU Council decision that an excessive deficit exists.

As regards *exchange rate developments*, the Greek drachma does not participate in the ERM. It depreciated by some 2.5% against the strongest ERM currencies over the reference period, showing only slight volatility (0.2%, measured on a comparable basis). In effective terms the depreciation was 2.4%, in line with the announced target. Real effective exchange rate indicators all show that the drachma has appreciated, both over the reference period and in a medium-term perspective. The short-term interest rate differential against the Deutsche Mark narrowed by some 3 percentage points to stand at around 10 percentage points at the end of the reference period.

Long-term interest rates in Greece (which are indexed to the twelve-month Treasury bill rate) have declined rapidly over the past few years, falling from 24.1% in 1992 to 17.4% in 1995. Nevertheless, they were still far above the reference value over the reference period.

As regards *other factors*, over recent years Greece has been running current account deficits, which, after a marked reduction in 1993 and 1994, picked up again in 1995. Greece has a net external liability position.

To summarise, Greece has made progress in terms of reducing inflation, long-term interest rates and budget deficits. The drachma does not participate in the ERM. It has displayed a noteworthy degree of stability both vis-à-vis the strongest ERM currencies and in trade-weighted terms. Nevertheless, particularly strong and sustained action is still required, given that inflation and long-term interest rates are well above the reference values and both the deficit ratio and the debt ratio are very high.

7.5 Spain

Economic recovery in Spain began in early 1994 and growth accelerated until late 1995, when it began to decline in line with trends in activity in the EU more generally (see Table 7.5). The slowdown has, however, been less severe than in a number of other EU countries, and Spanish *real GDP growth* was 2.8% in 1995. The Commission forecast for GDP growth in 1996 is 2.1%. Declining inflation and efforts to consolidate the fiscal position, as well as labour market reforms in 1994 and the correction of the current account deficit are contributing to create favourable conditions for a durable recovery of economic growth. Nevertheless, the unemployment rate, which stands at around 22% in 1996, is still the highest in the EU.

Table 7.5

Spain - Key indicators 1991-96*

	1991	1992	1993	1994	1995	1996
General economic indicators						
Real GDP growth, %	2.3	0.7	-1.2	2.1	2.8	2.1
Short-term interest rate, %	13.2	13.3	11.7	8.0	9.4	7.8
Unemployment rate, %	16.3	18.4	22.7	24.2	22.9	22.4
Convergence indicators[(a)]						
CPI inflation, %	5.9	5.9	4.6	4.7	4.7	3.6
IICP inflation, %	-	-	-	-	4.7	3.8
Reference value, %	4.4	3.8	3.1	3.1	2.7	2.6
General govt. surplus (+) or deficit (-), % of GDP	-4.9	-3.6	-6.8	-6.3	-6.6	-4.4
General government gross debt, % of GDP	45.8	48.4	60.5	63.1	65.7	67.8
Long-term interest rate, %	12.4	11.7	10.2	10.0	11.3	9.5
Reference value, %	10.7	10.7	9.3	10.0	9.7	8.7
Indicators of exchange rate performance						
Exchange rate against the DEM	62.64	65.61	76.95	82.57	87.00	84.17
Nominal effective exchange rate	99.9	97.8	85.8	80.1	80.1	81.2
Real effective exchange rate	100.9	100.6	89.4	85.2	86.8	88.9
Exchange rate volatility	0.20	0.53	0.54	0.26	0.46	0.19
Other factors						
Unit labour costs, % change	7.4	6.8	3.3	1.0	2.0	3.3
Current account, % of GDP	-3.0	-3.0	-0.4	-0.7	1.4	1.4
Net foreign assets (+) or liabilities (-), % of GDP	-14.3	-16.6	-18.2	-19.2	-18.3	-
Exports, % of GDP[(b)]	18.0	19.2	21.1	24.0	25.2	26.9

* For data sources and explanations of the data see Box 7.1.

(a) Excluding the exchange rate criterion.
CPI Inflation data for 1996 are calculated over the first nine months, whereas IICP inflation data refer to the reference period October 1995-September 1996.

(b) In 1994 the share of intra-EU exports of total national exports was 71.0% (EU average 61.7%).

Over the reference period, IICP inflation in Spain was 3.8%, i.e. well above the reference value calculated for measuring the achievement of a high degree of *price stability*. Over the latest three-month period, IICP inflation was 3.7%. Over the medium term, and measured in terms of national consumer prices, inflation was broadly constant (at a rate of close to 6%) at the beginning of the 1990s, then declined to reach a level of 4.6% in 1993; more recently, further progress has been made in reducing

inflation, as is also indicated by other price indices. In the process of convergence towards price stability, further reductions in inflation are necessary. Developments in unit labour costs tend to support this view.

After a significant deterioration in the fiscal balance in 1993, when the *ratio of the general government deficit to GDP* reached 6.8%, the deficit ratio declined slightly, but rose again to 6.6% in 1995, thus remaining considerably above the 3% reference value. The deficit ratio increased because lower expenditure was more than offset by a fall in government revenues (reflecting a fall in social security contributions). The primary deficit increased to 1.3% in 1995. The budget deficit markedly exceeded the level of government investment in 1995. The *ratio of general government debt to GDP* has been increasing and exceeded the reference value of 60% for the first time in 1993; it rose further to 65.7% in 1995. In 1996 the deficit-to-GDP ratio is expected to fall to 4.4%, thus remaining well above the 3% reference value. It will be too high to prevent a further rise in the debt ratio to an anticipated level of 67.8% of GDP. Spain is currently the subject of an EU Council decision that an excessive deficit exists.

As regards *exchange rate developments*, the Spanish peseta participates in the exchange rate mechanism of the European Monetary System. It came under pressure early in 1995, and a decision was taken to devalue the central rate of the peseta by 7% on 6 March 1995. Since then, the bilateral and effective rates have recovered to the levels prevailing at the beginning of the reference period. The volatility of the exchange rate, measured on a comparable basis, was 0.2-0.5%. During the period of tension Spanish short-term interest rates rose to stand at around 5-5.5 percentage points above German rates, but the interest rate differential recently narrowed to slightly below 4 percentage points at end-September 1996.

Long-term interest rates in Spain were on a declining trend until early 1994, but thereafter rose sharply to reach a peak of 12.3% in March 1995. Since then, bond yields have fallen significantly, and the differential against those countries with the lowest yields has narrowed substantially. However, over the reference period, the average bond yield was 9.5%, which is above the reference value.

As regards *other factors*, the Spanish current account has improved considerably in recent years and is now in surplus. Spain has a net external liability position.

To summarise, Spain has made progress with regard to price stability and the convergence of long-term interest rates. Nevertheless, strong and sustained action is required as inflation and long-term interest rates remain above their respective reference values, the government deficit-to-GDP ratio, although falling in 1996, is still high and the debt-to-GDP ratio has continued to increase. The peseta, which participates in the ERM, was subject to a downward realignment of central rates in March 1995, but has since recovered and has remained stable, close to its central parity.

7.6 France

Following the recession in 1992-93, economic recovery began to gather pace in France in 1994 (see Table 7.6). However, in line with the overall growth pause in the EU, the recovery stalled in 1995, although *real GDP* grew by 2.2% for the year as a whole. Some pick-up in domestic demand was observed in early 1996, while the unemployment rate has continued to rise to around 12½%. The Commission forecast for GDP growth for 1996 is 1.0%. As significant structural efforts are under way to consolidate the fiscal position and inflationary pressures are subdued, there is a basis for a durable recovery of economic growth.

Table 7.6

France - Key indicators 1991-96*

	1991	1992	1993	1994	1995	1996
General economic indicators						
Real GDP growth, %	0.8	1.2	-1.3	2.8	2.2	1.0
Short-term interest rate, %	9.6	10.3	8.6	5.8	6.6	4.1
Unemployment rate, %	9.5	10.4	11.8	12.2	11.7	12.7
Convergence indicators[(a)]						
CPI inflation, %	3.2	2.4	2.1	1.7	1.7	2.1
IICP inflation, %	-	-	-	-	1.7	2.1
Reference value, %	4.4	3.8	3.1	3.1	2.7	2.6
General govt. surplus (+) or deficit (-), % of GDP	-2.2	-3.8	-5.6	-5.6	-4.8	-4.0
General government gross debt, % of GDP	35.8	39.6	45.6	48.4	52.8	56.4
Long-term interest rate, %	9.0	8.6	6.8	7.2	7.5	6.6
Reference value, %	10.7	10.7	9.3	10.0	9.7	8.7
Indicators of exchange rate performance						
Exchange rate against the DEM	3.40	3.39	3.43	3.42	3.48	3.40
Nominal effective exchange rate	97.9	101.2	103.5	104.3	108.1	108.5
Real effective exchange rate	96.3	97.8	98.7	98.3	100.9	101.0
Exchange rate volatility	0.07	0.12	0.25	0.10	0.32	0.12
Other factors						
Unit labour costs, % change	4.0	2.8	2.9	0.2	1.2	1.6
Current account, % of GDP	-0.5	0.3	0.7	0.5	1.1	1.1
Net foreign assets (+) or liabilities (-), % of GDP	-5.2	-3.2	-10.7	-7.3	-4.1	-
Exports, % of GDP[(b)]	23.3	24.2	24.4	25.1	26.1	26.3

* For data sources and explanations of the data see Box 7.1.

(a) Excluding the exchange rate criterion.
CPI Inflation data for 1996 are calculated over the first nine months, whereas IICP inflation data refer to the reference period October 1995-September 1996.

(b) In 1994 the share of intra-EU exports of total national exports was 62.0% (EU average 61.7%).

Over the reference period, IICP inflation in France was 2.1%, and thus stood below the reference value calculated for measuring the achievement of a high degree of *price stability*. Over the latest three-month period, IICP inflation was 1.9%. Over the medium term, and measured in terms of national consumer prices, inflation has been on a downward trend since 1990. Moreover, developments in unit labour costs and other

price indicators tend to support the view that there is no immediate threat to price stability.

The fiscal position deteriorated significantly in the early 1990s, with an increase in the *ratio of the general government deficit to GDP* to 5.6% in 1993. This development was primarily due to a significant increase in the structural component of the deficit. Fiscal consolidation measures have since 1994 been reflected in an improvement in the primary balance (although it has remained in deficit) and a decline in the deficit-to-GDP ratio to 4.8% in 1995, considerably above the 3% reference value. The deficit clearly exceeded general government investment. The *ratio of general government debt to GDP* rose to 52.8% in 1995, thus remaining below the 60% reference value. In 1996 a further reduction in the deficit ratio is envisaged, although at 4.0%, it will remain well above the reference value. The improvement in the fiscal deficit is not expected to be sufficient to stabilise the debt-to-GDP ratio, which is forecast to rise to 56.4%, i.e. still below the 60% reference value in 1996. France is currently the subject of an EU Council decision that an excessive deficit exists.

As regards *exchange rate developments*, the French franc participates in the exchange rate mechanism of the European Monetary System. France has not devalued its currency's bilateral central rate over the reference period. During the period of turbulence in the ERM in early 1995, the franc came under pressure and weakened, falling to about 6% below its central parity against the strongest currencies within the ERM. Since the second half of 1995 the franc has recovered and remained close to its central parity. Its nominal effective exchange rate has appreciated by around 2% since October 1994. Overall, its volatility was 0.1-0.3%, measured on a comparable basis. Over the reference period, the short-term interest rate differential against the Deutsche Mark has varied between 0.5 and 3 percentage points, and was 0.5 percentage point at end-September 1996.

In line with international developments, *long-term interest rates* in France have been on a declining trend since 1991. More recently, differentials against other low-yielding countries have narrowed considerably and have disappeared since early 1996. Over the reference period, the average bond yield was 6.6%, which is well below the reference value.

As regards *other factors*, the current account balance in France has been in surplus since 1992. France has a net external liability position.

To summarise, France has shown good performance in the areas of price stability and the convergence of long-term interest rates. The debt ratio remains below 60%. Although the exchange rate had weakened significantly in early 1995, the French franc has since recovered to stand close to its central parity within the ERM. Strong and sustained action is needed to improve the fiscal position against the background of a high deficit ratio in 1995 and the limited progress foreseen for 1996.

7.7 Ireland

In marked contrast to other EU economies the Irish economy has experienced rapid growth in recent years, at a rate well above average *real GDP growth* in the EU (see Table 7.7). Despite the general growth pause, the pace of growth accelerated further in the course of 1995, with a 10.7% increase in real GDP. The Commission forecast for GDP growth in 1996 is 7.8%. An improved fiscal situation, steadily improving competitiveness as a result of modest wage developments and low inflation supported by increased competition, as well as a steadily, although slowly, declining rate of unemployment, which stands at around 12%, signal good conditions for continued economic growth.

Table 7.7

Ireland - Key indicators 1991-96*

	1991	1992	1993	1994	1995	1996
General economic indicators						
Real GDP growth, %	2.6	4.6	3.7	7.3	10.7	7.8
Short-term interest rate, %	10.4	12.4	9.3	5.9	6.3	5.3
Unemployment rate, %	15.7	16.4	16.4	15.0	13.0	11.7
Convergence indicators[(a)]						
CPI inflation, %	3.2	3.1	1.5	2.4	2.5	1.7
IICP inflation, %	-	-	-	-	2.4	2.1
Reference value, %	4.4	3.8	3.1	3.1	2.7	2.6
General govt. surplus (+) or deficit (-), % of GDP	-2.3	-2.5	-2.4	-1.7	-2.0	-1.6
General government gross debt, % of GDP	95.0	92.0	94.5	87.9	81.6	74.7
Long-term interest rate, %	9.2	9.1	7.7	7.9	8.3	7.5
Reference value, %	10.7	10.7	9.3	10.0	9.7	8.7
Indicators of exchange rate performance						
Exchange rate against the DEM	2.67	2.66	2.42	2.43	2.30	2.38
Nominal effective exchange rate	98.4	101.6	95.6	95.8	96.8	98.4
Real effective exchange rate	96.8	99.4	92.4	92.4	93.1	94.1
Exchange rate volatility	0.05	0.16	0.52	0.34	0.50	0.26
Other factors						
Unit labour costs, % change	1.6	-5.9	0.0	-6.1	-9.3	-6.2
Current account, % of GDP	0.7	1.1	3.9	2.7	2.4	1.4
Net foreign assets (+) or liabilities (-), % of GDP	-	-	-	-	-	-
Exports, % of GDP[(b)]	60.1	65.3	69.0	73.0	77.2	78.7

* For data sources and explanations of the data see Box 7.1.

(a) Excluding the exchange rate criterion.
CPI Inflation data for 1996 are calculated over the first nine months, whereas IICP inflation data refer to the reference period October 1995-September 1996.

(b) In 1994 the share of intra-EU exports of total national exports was 70.7% (EU average 61.7%).

Over the reference period, IICP inflation in Ireland was 2.1%, and thus below the reference value calculated for measuring the achievement of a high degree of *price stability*. Over the latest three-month period, IICP inflation was 2.2%. Over the medium term, and measured in terms of national consumer prices, Irish inflation has trended downwards to reach a trough in 1993. Since then, it has risen to slightly above 2%,

before falling again according to the latest data. Developments in unit labour costs and other price indicators tend to support the view that there is no immediate threat to price stability.

Reflecting several years of significant fiscal consolidation, the fiscal position has continued to improve. In 1995, despite several expansionary measures, the *general government deficit-to-GDP ratio* rose by only 0.3 percentage point to 2.0% (which is below the general government investment ratio). It thus remained below the 3% reference value. The primary surplus declined to 3.0% in 1995. The *ratio of the general government debt to GDP* maintained the downward trend of the 1990s. Since the latest peak in 1993, the debt ratio declined by almost 13 percentage points to stand at 81.6% in 1995, which was still high and well above the 60% reference value. In 1996, the general government deficit ratio is expected to decrease to 1.6%. The debt ratio is expected to fall rapidly further to 74.7%. Ireland is currently not the subject of an EU Council decision that an excessive deficit exists.

As regards *exchange rate developments*, the Irish pound participates in the exchange rate mechanism of the European Monetary System. Ireland has not devalued its currency's bilateral central rate over the reference period. The Irish pound has demonstrated relatively high volatility (0.3-0.5%, measured on a comparable basis), and weakened during the turbulence in the ERM in early 1995, reaching a deviation from central rates vis-à-vis the strongest currencies of close to 8%. It remained at depressed levels for the remainder of the year. Since the beginning of 1996 the Irish pound has recovered against the strongest currencies in the ERM, reaching a level close to its central rate. The nominal effective exchange rate was broadly stable. Short-term interest rates have remained around 2 percentage points above German rates during most of the reference period; at end-September 1996 the differential was 2.6%.

Long-term interest rates in Ireland have been on a declining trend since 1991, and despite significant volatility in the period preceding the devaluation of 1993, long-term interest rate differentials against those countries with the lowest bond yields have narrowed. Over the reference period, the average bond yield was 7.5%, which is below the reference value.

As regards *other factors*, the current account balance in Ireland shows buoyant surpluses.

To summarise, Ireland has shown good performance in the areas of price stability and the convergence of long-term interest rates. As regards the fiscal position, the deficit is relatively low while the debt ratio has been on a rapidly declining path for a number of years, although it is still well above the reference value. Sustained efforts are nonetheless warranted in order to reduce the debt ratio further. The exchange rate weakened considerably in early 1995 but has subsequently recovered to a level, for September, close to its ERM central parity.

7.8 Italy

After experiencing a fall in GDP in 1993, the Italian economy recovered significantly until late 1995, when a slowdown took place in line with the rest of the EU (see Table 7.8). In 1995 *real GDP growth* reached 3.0% and the Commission forecast for 1996 is 0.8%. The unemployment rate has been rising slightly since 1993 (it stands at around 12% in 1996), and there have been significant differences in the recovery between sectors and regions. Lower inflation, further steps towards fiscal consolidation and structural changes in labour markets are seen as increasing confidence in progress towards convergence and as contributing to improving the conditions for a durable recovery of economic growth.

Table 7.8

Italy - Key indicators 1991-96*

	1991	1992	1993	1994	1995	1996
General economic indicators						
Real GDP growth, %	1.1	0.6	-1.2	2.1	3.0	0.8
Short-term interest rate, %	12.2	14.0	10.2	8.5	10.5	9.2
Unemployment rate, %	10.9	10.7	10.2	11.3	12.0	12.1
Convergence indicators[(a)]						
CPI inflation, %	6.5	5.4	4.2	3.9	5.4	4.2
IICP inflation, %	-	-	-	-	5.4	4.7
Reference value, %	4.4	3.8	3.1	3.1	2.7	2.6
General govt. surplus (+) or deficit (-), % of GDP	-10.2	-9.5	-9.6	-9.0	-7.1	-6.6
General government gross debt, % of GDP	101.4	108.5	119.3	125.5	124.9	123.4
Long-term interest rate, %	13.3	13.3	11.2	10.5	12.2	10.3
Reference value, %	10.7	10.7	9.3	10.0	9.7	8.7
Indicators of exchange rate performance						
Exchange rate against the DEM	747.66	790.02	950.38	994.66	1138.12	1032.22
Nominal effective exchange rate	98.3	95.3	79.7	76.0	68.8	74.8
Real effective exchange rate	100.1	98.5	83.1	80.4	75.0	82.9
Exchange rate volatility	0.11	0.63	0.56	0.37	0.88	0.41
Other factors						
Unit labour costs, % change	9.0	4.3	2.0	-1.0	2.1	5.2
Current account, % of GDP	-2.1	-2.3	1.2	1.6	2.5	3.0
Net foreign assets (+) or liabilities (-), % of GDP	-8.6	-10.9	-9.4	-7.2	-4.8	-3.5
Exports, % of GDP[(b)]	19.8	21.1	23.4	25.2	27.3	27.2

* For data sources and explanations of the data see Box 7.1.

(a) Excluding the exchange rate criterion.
CPI Inflation data for 1996 are calculated over the first nine months, whereas IICP inflation data refer to the reference period October 1995-September 1996.

(b) In 1994 the share of intra-EU exports of total national exports was 57.2% (EU average 61.7%).

Over the reference period, Italy's IICP inflation was 4.7%, i.e. well above the reference value for measuring the achievement of a high degree of *price stability*. Over the latest three-month period, IICP inflation was 3.5%. Over the medium term, and measured in terms of national consumer prices, inflation was reduced to stand slightly above 4% in 1993 and just below 4% in 1994. The process of

disinflation was interrupted in 1995, when inflation rose to 5.4%. Inflation fell rapidly in 1996, a tendency confirmed by other price indicators. In the process of convergence towards price stability further reductions in inflation are necessary. Developments in unit labour costs are crucial in this respect.

The *general government deficit*, which is among the highest in the EU, was reduced from the recent peak of 9.6% of GDP in 1993 to 7.1% in 1995, thus remaining far above the 3% reference value. The primary surplus increased significantly to 4.1% of GDP in 1995. However, government interest payments continued to increase, reaching 11.2% of GDP in 1995. The budget deficit exceeded government investment (2.3% of GDP in 1995) by a wide margin. The *general government debt-to-GDP ratio* reached its peak of 125.5% in 1994 and fell to 124.9% in 1995. The debt ratio is among the highest in the EU and stands far above the 60% reference value. Further improvements in public finances are also expected in 1996, bringing down the general government deficit to 6.6% of GDP, which is still far above the 3% reference value. The debt ratio is expected to fall to 123.4%. Italy is currently the subject of an EU Council decision that an excessive deficit exists.

As regards *exchange rate developments*, the lira does not participate in the exchange rate mechanism of the European Monetary System. It was severely affected by exchange rate turbulence at the beginning of 1995, reaching all-time lows between March and April. The volatility of the lira, measured on a comparable basis, was 0.4-0.9%. In the second half of 1995 and in 1996 the lira steadily appreciated, recovering significantly and returning to above the levels prevailing in October 1994 both vis-à-vis the strongest ERM currencies and in trade-weighted terms. From a peak in late 1995, the short-term interest rate differential against the Deutsche Mark declined significantly towards the end of the reference period; interest rates stood around 5 percentage points above German rates at end-September 1996.

Bond yields in Italy have been very volatile, with large spreads over the EU countries with the lowest yields due to shifts in financial markets' assessment of the country's economic prospects. Since mid-1995 bond yields have fallen significantly and the differential vis-à-vis countries with the lowest yields has narrowed substantially. Over the reference period, long-term interest rates in Italy stood at an average level of 10.3%, which is still well above the reference value.

As regards *other factors*, the current account has shown a remarkable turnaround to surplus since 1993. Italy has a net external liability position.

To summarise, Italy has made progress in reducing inflation and long-term interest rates, although they still remained well above their respective reference values over the reference period. The government deficit-to-GDP ratio has indeed been falling, but is still very high; the debt-to-GDP ratio also declined slowly in 1995 for the first time in fifteen years, but remains very high. Very strong and sustained action is required. The lira does not participate in the ERM. It was severely affected by exchange rate turbulence in spring 1995, but has since shown a marked recovery.

7.9 Luxembourg

In Luxembourg *real GDP growth* has been around 1 percentage point above the EU average in recent years (see Table 7.9). In 1995 growth was 3.4%, although activity slowed in the second half of the year. Indicators point to a recovery in GDP growth, and the Commission forecast for 1996 as a whole is 2.3%. Subdued inflation, low interest rates, and sound fiscal balances provide favourable conditions for continued robust growth and a sustainable economic performance. Employment growth has been strong, in particular in the services sector, and the unemployment rate, at around 3% in 1996, is the lowest in the EU.

Table 7.9

Luxembourg - Key indicators 1991-96*

	1991	1992	1993	1994	1995	1996
General economic indicators						
Real GDP growth, %	3.1	1.9	0.0	3.3	3.4	2.3
Short-term interest rate, %	-	-	-	-	-	-
Unemployment rate, %	1.4	1.6	2.1	2.7	3.0	3.2
Convergence indicators[(a)]						
CPI inflation, %	3.1	3.2	3.6	2.2	1.9	1.3
IICP inflation, %	-	-	-	-	1.9	1.3
Reference value, %	4.4	3.8	3.1	3.1	2.7	2.6
General govt. surplus (+) or deficit (-), % of GDP	1.9	0.8	1.7	2.6	1.5	0.9
General government gross debt, % of GDP	4.2	5.2	6.2	5.7	6.0	7.8
Long-term interest rate, %	-	-	6.5	7.7	7.6	7.0
Reference value, %	10.7	10.7	9.3	10.0	9.7	8.7
Indicators of exchange rate performance						
Exchange rate against the DEM	20.59	20.59	20.90	20.61	20.57	20.57
Nominal effective exchange rate	99.8	101.9	102.8	104.5	108.9	107.2
Real effective exchange rate	98.6	99.2	99.7	101.1	104.3	102.5
Exchange rate volatility	0.04	0.04	0.33	0.09	0.07	0.02
Other factors						
Unit labour costs, % change	4.1	5.5	4.6	4.0	3.1	2.6
Current account, % of GDP	14.5	16.5	13.7	14.1	15.0	-
Net foreign assets (+) or liabilities (-), % of GDP	-	-	-	-	-	-
Exports, % of GDP[(b)]	98.4	97.9	95.5	97.1	97.9	96.7

* For data sources and explanations of the data see Box 7.1.

(a) Excluding the exchange rate criterion.
CPI Inflation data for 1996 are calculated over the first nine months, whereas IICP inflation data refer to the reference period October 1995-September 1996.

(b) See Table 7.1.

Over the reference period, IICP inflation in Luxembourg was 1.3%, i.e. one of the lowest in the Union, and well below the reference value calculated for measuring the achievement of a high degree of *price stability*. Over the latest three-month period, IICP inflation was 1.4%. Over the medium term, and measured in terms of national consumer prices, inflation was reduced from 3.6% in 1993 to around 2% in both 1994 and 1995. Developments in unit labour costs and other price indicators tend to

support the view that there is no immediate threat to price stability.

The *general government fiscal balance* continued to record a surplus in 1995. In 1996 the fiscal balance is expected to remain in surplus (at 0.9% of GDP). At the same time, the *debt-to-GDP ratio* is by far the lowest in the Union, standing at 7.8% in 1996. The deficit and debt ratios thus clearly remain well below the reference values contained in the Treaty. Luxembourg is currently not the subject of an EU Council decision that an excessive deficit exists.

As regards *exchange rate developments*, the Luxembourg franc participates in the exchange rate mechanism of the European Monetary System. Luxembourg has not devalued its currency's bilateral central rate. The currency is in a monetary association with the Belgian franc and exhibits stability among the strongest ERM currencies.

Bond yields in Luxembourg are broadly similar to those in Belgium. They have been on a declining trend since 1990 and stood 0.7 percentage point above the long-term interest rates of the countries with the lowest yields in 1995. Over the reference period, the long-term interest rate attained an average level of 7.0%, thus remaining below the reference value.

As regards *other factors*, the annual current account surplus of Luxembourg has been around 15% of GDP, by far the largest in the EU.

To summarise, Luxembourg has shown very good performance in all the areas considered.

7.10 The Netherlands

During recent years, *real GDP growth* in the Netherlands has been around 0.5 percentage point higher than the EU average. In 1995 GDP growth stood at 2.1% (see Table 7.10), compared with 3.4% in 1994. The Commission forecast for GDP growth in 1996 is 2.5%. Structural changes in the labour market, subdued increases in unit labour costs and corporate restructuring as well as efforts towards fiscal consolidation have created a basis for a durable recovery of economic growth and there has been remarkable growth in employment, with the unemployment rate falling to a recent low of just below 6½%.

Table 7.10

The Netherlands - Key indicators 1991-96*

	1991	1992	1993	1994	1995	1996
General economic indicators						
Real GDP growth, %	2.3	2.0	0.8	3.4	2.1	2.5
Short-term interest rate, %	9.3	9.4	6.9	5.2	4.4	3.0
Unemployment rate, %	7.0	5.6	6.2	6.8	7.0	6.3
Convergence indicators[(a)]						
CPI inflation, %	3.1	3.2	2.6	2.7	2.0	2.0
IICP inflation, %	-	-	-	-	1.1	1.2
Reference value, %	4.4	3.8	3.1	3.1	2.7	2.6
General govt. surplus (+) or deficit (-), % of GDP	-2.9	-3.9	-3.2	-3.4	-4.0	-2.6
General government gross debt, % of GDP	78.8	79.6	80.8	77.4	79.7	78.7
Long-term interest rate, %	8.7	8.1	6.4	6.9	6.9	6.3
Reference value, %	10.7	10.7	9.3	10.0	9.7	8.7
Indicators of exchange rate performance						
Exchange rate against the DEM	1.13	1.13	1.12	1.12	1.12	1.12
Nominal effective exchange rate	99.2	101.5	104.3	104.6	109.0	107.5
Real effective exchange rate	97.8	99.4	101.5	102.0	105.7	104.0
Exchange rate volatility	0.02	0.03	0.04	0.03	0.02	0.03
Other factors						
Unit labour costs, % change	3.8	4.6	2.2	-5.6	1.2	0.0
Current account, % of GDP	2.7	2.3	3.9	4.4	4.3	4.2
Net foreign assets (+) or liabilities (-), % of GDP	20.6	17.7	20.2	18.5	-	-
Exports, % of GDP[(b)]	55.4	55.9	56.3	58.1	60.8	61.9

* For data sources and explanations of the data see Box 7.1.

(a) Excluding the exchange rate criterion.
CPI Inflation data for 1996 are calculated over the first nine months, whereas IICP inflation data refer to the reference period October 1995-September 1996.

(b) In 1994 the share of intra-EU exports of total national exports was 76.2% (EU average 61.7%).

Over the reference period, IICP inflation in the Netherlands was 1.2%, the second lowest in the EU, and well below the reference value calculated for measuring the achievement of a high degree of *price stability*. Over the latest three-month period, IICP inflation was 1.5%. Over the medium term, and measured in terms of national consumer prices, inflation was reduced from around 3% in 1991 and 1992 to 2.0% in 1995. Developments in unit labour costs and other price indicators tend to support

the view that there is no immediate threat to price stability.

The *ratio of the general government deficit to GDP* in the 1990s has fluctuated between 2.9% and 4.0% of GDP. The ratio of general government expenditure to GDP has declined since the peak observed in 1993. The deficit ratio rose in 1995 to 4.0%, thus reaching a peak during the 1990s and remaining well above the 3% reference value. The primary surplus (1.9% of GDP in 1995) declined somewhat, while interest payments (6.0% of GDP in 1995) remained broadly unchanged. The general government deficit exceeded government investment in 1995. The *general government debt ratio* in the Netherlands rose in the early 1990s to reach a peak of 80.8% in 1993. In 1995 it stood at 79.7%, well above the 60% reference value. In 1996 the deficit-to-GDP ratio is forecast to decline to 2.6%, thus falling below the 3% reference value. Against this background, the debt ratio is expected to decrease to 78.7% of GDP in 1996. The Netherlands is currently the subject of an EU Council decision that an excessive deficit exists.

As regards *exchange rate developments*, the Dutch guilder participates in the exchange rate mechanism of the European Monetary System and the Netherlands has not devalued its currency's bilateral central rate over the reference period. Exchange rate stability within the ERM has been firmly maintained, as the volatility of the guilder, measured on a comparable basis, was virtually zero. The nominal effective exchange rate was broadly stable over the reference period. The strength of the guilder was reflected in Dutch short-term interest rates, which have remained slightly below German rates in the last six quarters.

Bond yields in the Netherlands have been on a declining trend since 1990 and, in 1995, Dutch long-term interest rates were among the lowest in the EU. Over the twelve-month period to September 1996, Dutch long-term rates attained a level of 6.3%, thus remaining well below the reference value.

As regards *other factors*, the current account has continued to be in surplus. The Netherlands has a strong net external asset position.

To summarise, the Netherlands has shown good performance in respect of price and exchange rate stability within the ERM and the convergence of long-term interest rates. Further decisive action is required to improve the fiscal position, in particular with a view to a sustained reduction in the debt ratio.

7.11 Austria

After experiencing robust *real GDP growth* of 3.0% in 1994, the Austrian economy decelerated in the course of 1995, reflecting mainly the weaker growth of Austrian export markets, problems in the tourism sector, and a declining demand for construction (see Table 7.11). GDP growth was 1.8% in 1995. The Commission forecast for 1996 is 1.0%. Taking into account subdued inflationary pressures and the major consolidation programme aimed at redressing fiscal imbalances, the conditions are in place for a durable recovery of economic growth. The unemployment rate of around 4% still stands at a level well below that of other EU countries.

Table 7.11

Austria - Key indicators 1991-96*

	1991	1992	1993	1994	1995	1996
General economic indicators						
Real GDP growth, %	2.8	2.0	0.4	3.0	1.8	1.0
Short-term interest rate, %	9.5	9.5	7.0	5.1	4.6	3.4
Unemployment rate, %	3.4	3.6	4.2	4.4	3.8	4.2
Convergence indicators[(a)]						
CPI inflation, %	3.3	4.1	3.6	3.0	2.2	1.7
IICP inflation, %	-	-	-	-	2.0	1.7
Reference value, %	4.4	3.8	3.1	3.1	2.7	2.6
General govt. surplus (+) or deficit (-), % of GDP	-2.6	-1.9	-4.2	-4.4	-5.9	-4.3
General government gross debt, % of GDP	58.7	58.3	62.8	65.1	69.0	71.7
Long-term interest rate, %	8.6	8.2	6.7	7.0	7.1	6.5
Reference value, %	10.7	10.7	9.3	10.0	9.7	8.7
Indicators of exchange rate performance						
Exchange rate against the DEM	7.04	7.04	7.04	7.04	7.04	7.04
Nominal effective exchange rate	99.3	101.3	103.4	103.4	107.1	105.6
Real effective exchange rate	98.0	99.8	101.8	102.2	105.6	104.0
Exchange rate volatility	0.02	0.03	0.01	0.01	0.01	0.01
Other factors						
Unit labour costs, % change	5.6	4.5	3.8	0.5	1.9	1.6
Current account, % of GDP	0.0	-0.1	-0.4	-0.9	-2.0	-1.8
Net foreign assets (+) or liabilities (-), % of GDP	-6.3	-5.8	-6.6	-8.5	-11.5	-
Exports, % of GDP[(b)]	41.6	41.2	40.5	41.3	42.8	44.3

* For data sources and explanations of the data see Box 7.1.

(a) Excluding the exchange rate criterion.
CPI Inflation data for 1996 are calculated over the first nine months, whereas IICP inflation data refer to the reference period October 1995-September 1996.

(b) In 1994 the share of intra-EU exports of total national exports was 66.8% (EU average 61.7%).

Over the reference period, IICP inflation in Austria was 1.7%, i.e. well below the reference value calculated for measuring the achievement of a high degree of *price stability*. Over the latest three-month period, IICP inflation was 2.1%. Over the medium term, taking the national consumer price index as a basis, inflation was reduced steadily from 4.1% in 1992 to 2.2% in 1995. Developments in unit labour costs and other

price indicators tend to support the view that there is no immediate threat to price stability.

The fiscal position has deteriorated significantly compared with the early 1990s, when both the general government deficit and the debt ratio stood below the reference values of the Treaty. The *general government deficit* rose to 5.9% in 1995, considerably above the 3% reference value. This adverse development is mainly attributable to direct and indirect costs related to EU accession, tax reform, significant expenditure increases and moderate growth in economic activity. The primary deficit worsened to 1.5% in 1995. Furthermore, the fiscal deficit was almost twice as high as general government investment. This development has contributed to an increase in the *general government debt ratio*, which rose to above 60% of GDP in 1993 and has continued to rise, reaching 69.0% in 1995. In 1996 the deficit ratio is expected to fall to 4.3%, but will remain well above the 3% reference value. It is too high to prevent a further rise in the debt ratio, to an anticipated 71.7% of GDP in 1996. Austria is currently the subject of an EU Council decision that an excessive deficit exists.

As regards *exchange rate developments*, the Austrian schilling has participated in the exchange rate mechanism of the European Monetary System since January 1995 and Austria has not devalued its currency's bilateral central rate. The schilling firmly maintained its position as one of the strongest and most stable currencies in the ERM, reflecting in particular the close link to the Deutsche Mark. Exchange rate volatility as well as short-term interest rate differentials, measured on a comparable basis, are virtually zero. Measured in nominal effective terms, the schilling's appreciation by nearly 5% in the first quarter of 1995 was gradually corrected in the following months. By the end of the reference period the effective value of the currency had almost returned to its October 1994 level.

Austria has consistently been among the EU countries with the lowest *long-term government bond yields*. In the autumn of 1995 the spread of long-term yields vis-à-vis the Deutsche Mark and other low-yielding currencies in the ERM increased slightly but gradually fell again to normal levels. Over the reference period, the Austrian long-term interest rate attained an average of 6.5%, which is well below the reference value.

As regards *other factors*, the current account position has deteriorated recently. Austria has a net external liability position.

To summarise, Austria has shown good performance with respect to price stability, the convergence of long-term interest rates and exchange rate stability within the ERM. Nevertheless, strong and sustained action is required to redress the country's fiscal position, given that both the deficit ratio and the debt ratio are too high and the debt ratio is expected to rise further in 1996.

7.12 Portugal

From a trough in 1993, *real GDP* has continued to expand in Portugal (see Table 7.12). Growth, which was 2.3% in 1995, notwithstanding the deceleration in the second half of the year, is expected to be 2.5% in 1996 (Commission forecast). Expansion has become broadly based as domestic demand is underpinned by extensive public works. The unemployment rate has been around 7% since 1994. As efforts are under way to consolidate the fiscal position and inflationary pressures have become more subdued, conditions for durable economic growth appear to be in place.

Table 7.12

Portugal - Key indicators 1991-96*

	1991	1992	1993	1994	1995	1996
General economic indicators						
Real GDP growth, %	2.3	1.1	-1.2	0.8	2.3	2.5
Short-term interest rate, %	18.4	16.7	13.4	11.1	9.9	7.6
Unemployment rate, %	4.1	4.1	5.5	6.8	7.2	7.2
Convergence indicators[(a)]						
CPI inflation, %	11.3	8.9	6.5	5.2	4.1	3.1
IICP inflation, %	-	-	-	-	3.8	3.0
Reference value, %	4.4	3.8	3.1	3.1	2.7	2.6
General govt. surplus (+) or deficit (-), % of GDP	-6.7	-3.6	-6.9	-5.8	-5.1	-4.0
General government gross debt, % of GDP	71.1	63.3	68.2	69.6	71.7	71.1
Long-term interest rate, %	14.5	13.8	11.2	10.5	11.5	9.4
Reference value, %	10.7	10.7	9.3	10.0	9.7	8.7
Indicators of exchange rate performance						
Exchange rate against the DEM	87.12	86.47	97.21	102.31	104.68	102.83
Nominal effective exchange rate	100.7	104.2	97.8	93.8	95.7	95.2
Real effective exchange rate	107.1	115.9	112.2	110.2	113.8	114.1
Exchange rate volatility	0.27	0.42	0.43	0.23	0.23	0.11
Other factors						
Unit labour costs, % change	15.1	12.9	6.5	3.9	1.7	3.6
Current account, % of GDP	-0.9	-0.1	0.4	-1.7	-0.3	-0.8
Net foreign assets (+) or liabilities (-), % of GDP	-	-	15.6	10.2	4.1	1.0
Exports, % of GDP[(b)]	33.5	35.1	33.7	37.1	40.3	42.4

* For data sources and explanations of the data see Box 7.1. Unemployment data for 1996 refer to the average of available data to September 1996.

(a) Excluding the exchange rate criterion.
CPI Inflation data for 1996 are calculated over the first nine months, whereas IICP inflation data refer to the reference period October 1995-September 1996.

(b) In 1994 the share of intra-EU exports of total national exports was 79.9% (EU average 61.7%).

Over the reference period, IICP inflation in Portugal was 3.0%, i.e. above the reference value calculated for measuring the achievement of a high degree of *price stability*. Over the latest three-month period, IICP inflation was 3.4%. Over the medium term, and measured in terms of national consumer prices, inflation was reduced from 11.3% in 1991 to 4.1% in 1995. In the process of convergence towards price stability, further reductions in inflation are necessary; developments in other price

indicators and, in particular, unit labour costs, tend to support this view.

The *general government deficit-to-GDP ratio* has declined from the peak of 6.9% recorded in 1993 to 5.1% in 1995, which is considerably above the 3% reference value. The decline in 1995 was the result of a sharper rise in government receipts than in government expenditure. The primary balance improved slightly in 1995 to record a surplus position. The deficit ratio remained higher than the level of government investment in 1995. The *debt ratio* has been increasing from the low of 63.3% attained in 1992 to 71.7% of GDP in 1995, and thus stands above the 60% reference value. In 1996 the deficit ratio is expected to fall further to 4.0% of GDP, thus remaining well above the reference value of 3%. Against this background, the debt ratio is expected to decrease, albeit slightly, to 71.1%. The deficit is expected to be less than government investment expenditure in 1996. Portugal is currently the subject of an EU Council decision that an excessive deficit exists.

As regards *exchange rate developments*, the Portuguese escudo participates in the exchange rate mechanism of the European Monetary System. Following the decision to change the bilateral central rates of the peseta, a downward adjustment of 3.5% of the central rates of the Portuguese escudo against other currencies was also agreed in March 1995 in line with market rates prevailing since 1993. Since then, the escudo has recovered vis-à-vis the strongest currencies of the ERM (interrupted by some episodes of tension) to the level prevailing in October 1994. Its volatility over the reference period, measured on a comparable basis, remained low at 0.1-0.2%. The nominal effective rate was unchanged over the reference period. Over most of the reference period Portuguese short-term interest rates have stood at 5-6 percentage points above German rates; the short-term interest rate differential at end-September 1996 was narrower, standing at around 4 percentage points.

Bond yields in Portugal were on a declining trend from 1991 to 1994, but rose sharply thereafter to reach a peak of 12.2% in April 1995. Since then, bond yields have fallen significantly and the differential vis-à-vis those countries with the lowest yields has narrowed substantially. However, over the reference period the average bond yield was 9.4%, which is above the reference value.

As regards *other factors,* the current account has been slightly negative in recent years. Portugal has a net external asset position.

To summarise, Portugal has made progress in terms of price stability and the convergence of long-term interest rates has improved, but further efforts are still required, given the gap to be closed in relation to the reference values. Further strong and decisive action is also needed to improve the fiscal position, given the fact that the deficit ratio, while falling, is still high and the debt ratio, although declining in 1996, remains high. Within the ERM a downward adjustment of central rates took place following the decision to change the central rates of the peseta. However, in spite of the realignment, on balance, the escudo remained quite stable against the strongest ERM currencies.

7.13 Finland

The Finnish economy continues to recover from the deep recession of the early 1990s (see Table 7.13). Following a significant acceleration in activity in 1994-95, with growth rates of 4-4½%, the Commission forecast for *real GDP growth* in 1996 is 2.3%. Financial imbalances of firms and households have undergone considerable correction, while comprehensive efforts are under way to consolidate the fiscal position and inflationary pressures are subdued. These factors are seen as contributing to the conditions for durable economic growth and to confidence, which had suffered from the high level and only weak downward trend in unemployment, which currently stands at 16½%.

Table 7.13

Finland - Key indicators 1991-96*

	1991	1992	1993	1994	1995	1996
General economic indicators						
Real GDP growth, %	-7.1	-3.6	-1.2	4.4	4.2	2.3
Short-term interest rate, %	13.1	13.3	7.8	5.4	5.8	3.8
Unemployment rate, %	7.6	13.1	17.9	18.4	17.2	16.5
Convergence indicators[(a)]						
CPI inflation, %	4.3	2.9	2.2	1.1	1.0	0.6
IICP inflation, %	-	-	-	-	1.0	0.9
Reference value, %	4.4	3.8	3.1	3.1	2.7	2.6
General govt. surplus (+) or deficit (-), % of GDP	-1.5	-5.9	-8.0	-6.2	-5.2	-3.3
General government gross debt, % of GDP	23.0	41.5	57.3	59.5	59.2	61.3
Long-term interest rate, %	11.7	12.0	8.8	9.0	8.8	7.4
Reference value, %	10.7	10.7	9.3	10.0	9.7	8.7
Indicators of exchange rate performance						
Exchange rate against the DEM	2.44	2.88	3.46	3.22	3.05	3.06
Nominal effective exchange rate	96.0	83.6	72.0	77.6	85.8	83.2
Real effective exchange rate	95.3	82.4	70.1	74.5	81.1	77.7
Exchange rate volatility	0.57	0.99	0.50	0.40	0.35	0.28
Other factors						
Unit labour costs, % change	8.0	-2.1	-4.6	-2.1	2.3	1.9
Current account, % of GDP	-5.4	-4.6	-1.3	1.3	4.5	3.7
Net foreign assets (+) or liabilities (-), % of GDP	-35.3	-47.8	-54.1	-51.7	-42.7	-
Exports, % of GDP[(b)]	23.2	26.4	31.2	33.9	35.2	34.9

* For data sources and explanations of the data see Box 7.1.

(a) Excluding the exchange rate criterion.
CPI Inflation data for 1996 are calculated over the first nine months, whereas IICP inflation data refer to the reference period October 1995-September 1996.

(b) In 1994 the share of intra-EU exports of total national exports was 58.5% (EU average 61.7%).

Over the reference period, IICP inflation was 0.9%, and Finland thus recorded the lowest inflation rate in the Union, being well below the reference value calculated for measuring the achievement of a high degree of *price stability*. Over the latest three-month period, IICP inflation was 1.1%. Over the medium term, and measured in terms of national consumer prices, inflation was reduced from 4.3% in 1991 to around 1% in

both 1994 and 1995. Although the decline in inflation reflects the deep recession of 1990-93, it is also partly due to Finland's accession to the EU, which has also accelerated structural changes in the economy. Developments in unit labour costs and other price indicators tend to support the view that there is no immediate threat to price stability.

Fiscal surpluses turned into deficits in 1991, and the *ratio of the general government deficit to GDP* reached a peak of 8.0% in 1993. Thereafter it improved gradually to stand at 5.2% in 1995, thus remaining considerably above the 3% reference value. Similarly, the ratio of government expenditure to GDP has fallen since the peak recorded in 1993. The primary balance recorded a small surplus in 1995. The general government deficit significantly exceeded government investment in 1995. The general government *debt ratio* rose rapidly from 23.0% in 1991 to 59.5% in 1994, and stood at 59.2% in 1995, just below 60% of GDP. In 1996 the deficit ratio is forecast to improve to 3.3% of GDP, not far from the 3% reference value. This will not be sufficient to prevent the debt ratio from rising to a level of 61.3% in 1996, thus exceeding the 60% reference value. Finland is currently subject to an EU Council decision that an excessive deficit exists.

As regards *exchange rate developments*, over the reference period the Finnish markka did not participate in the exchange rate mechanism of the European Monetary System.[6] It has been among the strongest non-ERM currencies and was only modestly affected by the turbulence of early 1995. Both vis-à-vis the strongest ERM currencies and in effective terms the markka is currently slightly above the level prevailing at the beginning of the reference period. The volatility of the Finnish markka, measured on a comparable basis, was 0.3-0.4%. The data suggest that in real effective terms the markka has depreciated since 1987. During the first half of 1995 the short-term interest rate differential against the Deutsche Mark rose to 1.7 percentage points, but has since narrowed, to be virtually zero at end-September 1996.

Bond yields in Finland have been on a declining trend since 1991 and stood at around 1½ percentage points above the lowest yields in the EU in 1995. Over the reference period, bond yields declined further (albeit with some volatility) to attain an average level of 7.4%, thus remaining below the reference value for the interest rate criterion.

As regards *other factors*, the current account has shown increasing surpluses during recent years. Finland has a net external liability position.

To summarise, Finland has shown good performance in terms of price stability and the convergence of long-term interest rates. Over the reference period the markka remained outside the ERM. It was among the most stable non-ERM currencies and, indeed, has been as stable as several ERM currencies. Decisive action is needed to improve the fiscal position further given that both the deficit and debt ratios exceed the reference values in 1996.

[6] *The Finnish markka joined the exchange rate mechanism of the European Monetary System, effective from 14 October 1996.*

7.14 Sweden

The Swedish economy continues to recover from the recession of the early 1990s (see Table 7.14). *Real GDP growth* was 2½-3% in 1994-95. Reflecting the overall pause in growth in the EU, the rate of growth decelerated towards the end of 1995 and was relatively moderate in early 1996. The Commission forecast for GDP growth in 1996 is 1.7%. Policy initiatives have been taken to help to improve the conditions for a durable recovery of economic growth. In particular, structural efforts are under way to improve the adverse fiscal position and to improve the functioning of labour markets. Inflationary pressures have become subdued. Unemployment stands at just below 8% in 1996.

Table 7.14

Sweden - Key indicators 1991-96*

	1991	1992	1993	1994	1995	1996
General economic indicators						
Real GDP growth, %	-1.1	-1.4	-2.2	2.6	3.0	1.7
Short-term interest rate, %	11.6	12.9	8.4	7.4	8.7	6.3
Unemployment rate, %	3.0	5.4	8.2	8.0	7.7	7.8
Convergence indicators[(a)]						
CPI inflation, %	9.7	2.6	4.7	2.3	2.9	1.1
IICP inflation, %	-	-	-	-	2.9	1.6
Reference value, %	4.4	3.8	3.1	3.1	2.7	2.6
General govt. surplus (+) or deficit (-), % of GDP	-1.1	-7.8	-12.3	-10.8	-8.1	-3.9
General government gross debt, % of GDP	53.0	67.1	76.0	79.3	78.7	78.1
Long-term interest rate, %	10.7	10.0	8.5	9.7	10.2	8.5
Reference value, %	10.7	10.7	9.3	10.0	9.7	8.7
Indicators of exchange rate performance						
Exchange rate against the DEM	3.65	3.73	4.71	4.76	4.98	4.47
Nominal effective exchange rate	99.5	100.9	81.5	80.4	80.3	87.9
Real effective exchange rate	104.1	104.1	85.4	84.1	83.9	90.7
Exchange rate volatility	0.17	0.73	0.62	0.51	0.71	0.46
Other factors						
Unit labour costs, % change	3.9	-3.3	-4.1	2.2	3.5	4.5
Current account, % of GDP	-2.0	-3.5	-2.0	0.4	2.0	2.9
Net foreign assets (+) or liabilities (-), % of GDP	-27.5	-37.4	-46.3	-46.4	-39.4	-40.8
Exports, % of GDP[(b)]	29.5	30.7	33.7	37.5	40.6	41.9

* For data sources and explanations of the data see Box 7.1.

(a) Excluding the exchange rate criterion.
CPI Inflation data for 1996 are calculated over the first nine months, whereas IICP inflation data refer to the reference period October 1995-September 1996.

(b) In 1994 the share of intra-EU exports of total national exports was 59.3% (EU average 61.7%).

Over the reference period, IICP inflation in Sweden was 1.6%, i.e. well below the reference value calculated for measuring the achievement of a high degree of *price stability*. Over the latest three-month period, IICP inflation was 0.8%. Over the medium term, and measured in terms of national consumer prices, inflation was volatile but was reduced from 9.7% in 1991 to 2.3% in 1994. Inflation stood at 2.9% in 1995; there

has been an improvement since then. The long-term reduction in inflation partly reflects the recession of 1990-93, but it is also considered to reflect structural changes. Although other price indicators tend to support the view that there is no immediate threat to price stability, unit labour costs, which declined in 1992-93, have recently shown upward tendencies - a development which warrants a note of caution.

After a period of sharply deteriorating fiscal balances in the early 1990s, the *general government deficit-to-GDP ratio* fell gradually from 12.3% in 1993 to 8.1% in 1995. It thus remained among the highest in the EU and stood far above the 3% reference value. The primary balance improved significantly in 1995, while remaining in deficit. In 1995 the general government deficit substantially exceeded government investment. The *general government debt ratio* deteriorated sharply from below 60% in 1991 to reach 79.3% in 1994, and stood at 78.7% of GDP in 1995, well above the reference value of the Treaty. In 1996 the deficit-to-GDP ratio is forecast to continue to decline, to reach 3.9%, thus remaining well above the reference value. The debt ratio is expected to decline to 78.1% of GDP. Sweden is currently the subject of an EU Council decision that an excessive deficit exists.

As regards *exchange rate developments*, the Swedish krona does not participate in the exchange rate mechanism of the European Monetary System. It has gradually appreciated in effective terms since mid-1995, and currently stands around 10% higher than at the beginning of the reference period. The volatility of the krona, measured on a comparable basis, has occasionally been rather high, ranging from 0.5-0.7%, although it has been more stable since spring 1996. In the longer term, the real exchange rate of the Swedish krona is not far from the levels prevailing in 1987. The short-term interest rate differential against the Deutsche Mark widened in the first half of the reference period but has since gradually narrowed; the Swedish short-term interest rate stood at 1.6 percentage points above the German rate at end-September 1996.

Swedish *bond yields* have shown a relatively high degree of volatility. Over the reference period yields in Sweden, although returning to a declining trend in early 1996, stood at 8.5% on average, just below the reference value.

As regards *other factors*, the current account shows growing surpluses. Sweden has a net external liability position.

To summarise, Sweden has shown good performance in respect of price stability and the convergence of long-term interest rates. Firm and decisive action is needed to improve the Swedish fiscal position, given that the deficit ratio is still too high and the debt ratio remains well above the reference value. The krona does not participate in the ERM. Although it was subject to turbulence in spring 1995, it has appreciated vis-à-vis the strongest currencies of the ERM and has tended to stabilise since spring 1996.

7.15 United Kingdom

Following the deep and protracted recession of the early 1990s, the UK economy has expanded rather steadily since 1993 (see Table 7.15). *Real GDP growth* accelerated to 3.8% in 1994 but slowed during the course of 1995 to stand at 2.4% for the year as a whole. GDP growth is forecast by the Commission to be 2.3% in 1996. Fiscal consolidation and a steadily falling unemployment rate, which currently stands at around 7.5%, together with relatively low wage pressures are among the main factors creating a favourable basis for continued economic growth.

Table 7.15

United Kingdom - Key indicators 1991-96*

	1991	1992	1993	1994	1995	1996
General economic indicators						
Real GDP growth, %	-2.0	-0.5	2.2	3.8	2.4	2.3
Short-term interest rate, %	11.5	9.6	5.9	5.5	6.7	6.0
Unemployment rate, %	8.0	9.8	10.4	9.4	8.3	7.7
Convergence indicators[a]						
CPI inflation, %	6.8	4.7	3.0	2.4	2.8	2.9
IICP inflation, %	-	-	-	-	3.1	3.0
Reference value, %	4.4	3.8	3.1	3.1	2.7	2.6
General govt. surplus (+) or deficit (-), % of GDP	-2.6	-6.3	-7.8	-6.8	-5.8	-4.6
General government gross debt, % of GDP	35.7	41.9	48.5	50.4	54.1	56.3
Long-term interest rate, %	10.1	9.1	7.5	8.2	8.3	8.0
Reference value, %	10.7	10.7	9.3	10.0	9.7	8.7
Indicators of exchange rate performance						
Exchange rate against the DEM	2.93	2.75	2.48	2.48	2.26	2.31
Nominal effective exchange rate	100.8	97.1	88.4	88.5	84.5	84.5
Real effective exchange rate	102.0	98.3	88.1	88.0	84.7	84.9
Exchange rate volatility	0.24	0.60	0.45	0.36	0.57	0.33
Other factors						
Unit labour costs, % change	6.3	3.5	1.0	0.0	1.7	2.0
Current account, % of GDP	-1.4	-1.7	-1.7	-0.4	-0.4	-0.7
Net foreign assets (+) or liabilities (-), % of GDP	1.9	3.7	5.9	5.1	7.1	-
Exports, % of GDP[b]	24.7	25.8	26.1	27.2	28.5	29.6

* For data sources and explanations of the data see Box 7.1.

(a) Excluding the exchange rate criterion.
CPI Inflation data for 1996 are calculated over the first nine months, whereas IICP inflation data refer to the reference period October 1995-September 1996.

(b) In 1994 the share of intra-EU exports of total national exports was 53.3% (EU average 61.7%).

Over the reference period, IICP inflation in the United Kingdom was 3.0%, hence above the reference value calculated for measuring the achievement of a high degree of *price stability*. Over the latest three-month period, IICP inflation was 2.9%. Over the medium term, and measured in terms of national consumer prices (the retail price index excluding mortgage interest payments, RPIX), inflation fell from 6.8% in 1991 to 2.4% in 1994. Since then it has risen slightly, partly reflecting the rise in import prices following the depreciation of sterling in the first half of 1995, to stand at 2.8% in 1995.

In the process of convergence towards price stability further reductions in inflation are necessary.

There was a sizable deterioration in the fiscal position during the last recession, with the *general government deficit-to-GDP ratio* reaching 7.8% in 1993. The deficit fell to 5.8% in 1995, thus remaining considerably above the 3% reference value. The fiscal deficit considerably exceeded general government investment. A primary deficit, in combination with a slowdown in economic activity, led to a further accumulation of public debt, with the *general government debt-to-GDP ratio* rising to 54.1% in 1995, thus remaining below the 60% reference value. In 1996 the fiscal deficit is forecast to fall to 4.6% of GDP, remaining well above the 3% reference value. This improvement is not expected to be sufficient to stabilise the debt ratio, which is forecast to rise to 56.3% in 1996, still below the 60% reference value. The United Kingdom is currently subject to an EU Council decision that an excessive deficit exists.

As regards *exchange rate developments*, the pound sterling does not participate in the exchange rate mechanism of the European Monetary System. At the beginning of 1995 it depreciated by around 10% against the strongest ERM currencies and by 5% in nominal effective terms. For most of 1995 sterling remained broadly unchanged at this lower level, but has staged a gradual recovery from late 1995 onwards, rising towards its early-1995 levels. The volatility of the exchange rate, measured on a comparable basis, was 0.3-0.6%. In a longer-term view the real exchange rate of the pound sterling is currently not far from the levels prevailing in 1987. The short-term interest rate differential against German rates widened gradually during the first part of the reference period, reflecting the different cyclical positions of the two economies. Since then the short-term interest rate has remained less than 3 percentage points above German rates.

Long-term interest rates in the United Kingdom have fallen gradually since autumn 1994 to average around 8.3% in 1995. Over the reference period bond yields have remained relatively stable, attaining an average level of 8.0%, which is below the reference value. Bond yield differentials vis-à-vis the countries with the lowest yields have remained around 1.5 percentage points over the reference period.

As regards *other factors*, over recent years the current account has been slightly in deficit. The United Kingdom has a net external asset position.

To summarise, the United Kingdom has shown good performance in respect of long-term interest rates. The debt ratio remains below 60%. Performance in terms of price stability needs improvement. Strong and sustained action is needed to improve the fiscal position, given that the deficit ratio is still too high. Sterling does not participate in the ERM. Over the reference period, it showed some volatility and depreciated vis-à-vis the strongest ERM currencies in early 1995, but has subsequently recovered.

The United Kingdom has notified the Council of the EU, in accordance with the terms of Protocol No. 11, that it does not intend to move to the third stage in 1997: this notification is without prejudice to its subsequent decision regarding entry in 1999.

BOX 7.1

Explanatory notes to Tables 7.1-7.15 (Key economic indicators)

General economic indicators

Real GDP growth; data and forecast from European Commission (autumn 1996).

Short-term interest rate = three-month interbank rate; national data, for 1996 average of available data (first nine months).

Unemployment rate, % of labour force; national data and forecast.

Convergence indicators (excluding the exchange rate criterion)

CPI inflation; national data; figure for 1996 is an average of the first nine months; see Chart 2.2 for further explanation of the data used.

IICP inflation, annual average change; data from EUROSTAT; for 1996 a twelve-month average of the IICP index up to September as a percentage of the previous twelve-month average.

Reference value for price stability; average inflation rate of the three best-performing EU Member States plus 1½ percentage points; for 1991-94 based on CPI (national data), for 1995-96 based on IICP, see above.

General government surplus (+) or deficit (-), % of GDP; data and forecast from European Commission (autumn 1996 European Commission forecast).

General government gross debt, % of GDP; data and forecast from European Commission (autumn 1996 European Commission forecast).

Long-term interest rate, %; harmonised national data on bond yields; annual average; for 1996 the twelve-month average up to September.

Reference value for the interest rate criterion; average of long-term interest rates of the three Member States with lowest inflation rates plus 2 percentage points.

Indicators of exchange rate performance

Exchange rate against the Deutsche Mark; national data; 1996: average of data available up to end-September.

Nominal effective exchange rate; against twenty-six trading partners, monthly index (1990: 100); source: BIS; 1996: average of available data up to end-September.

Real effective exchange rate = nominal effective exchange rate as above, deflated by consumer prices, monthly index (1990: 100); source: BIS; 1996: average of data available up to September.

Exchange rate volatility of bilateral rates against the DEM; standard deviation of daily observations (logarithmic first differences) multiplied by 100, calculated over each calendar year; national data; 1996: volatility over the nine months ending in September.

Other factors

Unit labour cost, % change; national data and forecast.

Current account, % of GDP; national data and forecast.

Net foreign assets (+) or liabilities (-), % of GDP; international investment position (IIP), as defined by the IMF (see Balance of Payments Yearbook, Part 1, 1994), or the closest possible substitute; national data and forecast.

Exports, % of GDP; data and forecast: European Commission (autumn 1996); share of intra-EU exports in 1994 is based on Trade Statistics Yearbook 1994, IMF.

Annex 1

Data issues and progress in harmonisation of statistics on convergence indicators

Data issues and progress in harmonisation of statistics on convergence indicators

The data used in this Report are specified in the individual sections. The data extend up to September 1996. This applies to the assessment of inflation and long-term interest rates, which is based on the twelve-month period from October 1995 to September 1996, and to that of exchange rates, which are evaluated over the two-year period from October 1994 to September 1996. Data used for fiscal positions (as a percentage of GDP) include the latest projections of deficits and debts for 1996 from the European Commission. It should be noted that these projections could undergo substantial change and that judgements based on these data can only be preliminary.

Not all data are yet fully harmonised. This Annex therefore provides details of the progress achieved in the harmonisation of statistics on convergence indicators.

Consumer prices

The Protocol (No. 6) on the convergence criteria referred to in Article 109j (1) of the Treaty establishing the European Community requires price convergence to be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions. Although current consumer price statistics in the Member States are largely based on similar principles, there are considerable differences of detail and these affect the comparability of the national results.

The conceptual work on the harmonisation of consumer price indices is carried out by the European Commission (EUROSTAT) in close liaison with the National Statistical Institutes. As a key user, the EMI is closely involved in this work. In October 1995 the EU Council adopted a Regulation concerning Harmonised Indices of Consumer Prices which serves as the framework for further detailed harmonisation measures. It sets out a step-by-step approach for harmonising consumer price indices to provide both the necessary data for the analysis of convergence and for the conduct of a single monetary policy in Stage Three.

A first step towards harmonised indices of consumer prices was taken in 1996 with the publication of the Interim Indices of Consumer Prices (IICPs) by EUROSTAT. IICPs are compiled to facilitate comparisons across the European Union until indices based on more harmonised methods can be produced. They are available from January 1994. The interim indices are entirely based on existing national indices, adjusted only by excluding major items for which national coverage or methods differ significantly (mainly owner-occupiers' housing costs, expenditures for education, health and insurance) and by including certain items which are not covered in all countries (alcoholic beverages and tobacco). IICPs cover between 75% and 90% of the total weight of the national indices. They are not fully comparable since considerable differences in concepts and practices remain. However, the indices are more comparable than current national indices and thus provide a better basis for assessing convergence. They are therefore used for measuring consumer price convergence in this Report, although the exclusion of major items from the indices is an important drawback.

Harmonised Indices of Consumer Prices (HICPs) will be calculated in a second step, beginning in January 1997. They will form the basis for the report on convergence

covering 1997. Work on these indices is under way. At this juncture, the European Commission has prepared two comprehensive Regulations to define HICPs from 1997. They concern - inter alia - the initial coverage of HICPs in 1997 (which excludes major parts of consumers' expenditures on health and education and the costs of owner-occupied housing), initial standards for the procedures of quality adjustment and common rules for the treatment of new goods and services. Moreover, a detailed harmonised classification for HICP sub-indices has been agreed.

Although these Commission Regulations are a substantial step towards fully comparable HICPs, it has not proved possible to solve all the conceptual questions in time for 1997. Difficult areas remain to be resolved, such as, for example, the extension of coverage of HICPs and the appropriate frequency for updating the index weights, which will make further harmonisation measures necessary. The EMI has emphasised the need to limit the number of stages and the delays in the harmonisation process to a strict minimum in order to ensure high comparability and sufficient consistency and stability in consumer price statistics.

Public finances

The Protocol (No. 5) on the excessive deficit procedure annexed to the Treaty together with a Council Regulation of November 1993 define "government", "deficit", "interest expenditure", "debt", "investment" and "gross domestic product (GDP)" by reference to the European System of Integrated Economic Accounts (ESA), second edition. The ESA is a coherent and detailed set of national accounts tables agreed for the European Community in order to facilitate comparative analyses between Member States. According to a Council Regulation of June 1996, the ESA, second edition, will be applied for the excessive deficit procedure up to and including the year 1999 and will be replaced by the ESA 95 thereafter.

"Government" comprises central government, regional or local government and social security funds. It does not include public enterprises and is therefore to be distinguished from a more broadly defined public sector.

"Government deficit" is mainly the difference between government gross saving and the sum of government investment (defined as gross fixed capital formation) and net capital transfers payable by government. Furthermore, "government debt" is the sum of the gross liabilities of government at nominal value outstanding as classified in the ESA, second edition, in the categories currency and deposits, bills and bonds, and other loans. Government debt does not cover trade credits and other liabilities which are not represented by a financial document such as overpaid tax advances; it also does not include contingent liabilities such as government guarantees and pension commitments. The definitions of government deficit and government debt imply that the change in government debt outstanding at the end of two consecutive years may differ substantially from the size of government deficit for the year under consideration. For example, government debt may be reduced by using the receipts from privatising public enterprises or by selling other financial assets without any immediate impact on the government deficit. Conversely, government deficit may be reduced by substituting loans provided by the government for transfers without any immediate impact on government debt.

With government deficits in mind, further work is in progress on the detailed definition and accounting rules of interest expenditures and debt assumption. In addition, the question has been raised of whether the statistical recording of certain transactions, such as taxes on income and

social contributions, receive equal treatment in the various Member States - in particular whether the amounts recorded as government receipts are the amounts actually paid or the amounts assessed to be paid (some of which are never paid).

The "Gross domestic product (GDP)" used for the compilation of the Communities' own resources is also used in connection with the excessive deficit procedure. The GDP compilation procedures are monitored by a Committee established by a Council Directive of February 1989.

As from the beginning of 1994, Member States report data related to the government deficit and government debt to the European Commission at least twice a year. The Treaty gives responsibility for providing the statistical data to be used for the excessive deficit procedure to the European Commission.

Exchange rates

Exchange rates vis-à-vis the ECU of the currencies of the Member States are quoted daily (so-called 2.15 p.m. concertation) and are published in the Official Journal of the European Communities; European cross-rates used throughout this Report are derived from these ECU exchange rates. For information purposes, reference is also made in this Report to nominal and real effective exchange rates on the basis of series calculated by the BIS.

Long-term interest rates

The Protocol (No. 6) on the convergence criteria referred to in Article 109j of the Treaty establishing the European Community requires interest rate convergence to be assessed on the basis of long-term government bonds, or comparable securities, observed over a period of one year before the assessment, taking into account differences in national definitions. The Treaty provisions imply that the representative long-term interest rates should in statistical terms reflect as accurately as possible any changes in market sentiment with regard to the durability of the convergence and the participation in the ERM of the Member State concerned. The possible distorting effects of other determinants should be as limited as possible.

While Article 5 of the Protocol on the convergence criteria assigns the responsibility for providing the statistical data for the application of the Protocol to the Commission, conceptual assistance has been provided by the EMI with regard to defining representative long-term interest rate statistics, given its expertise in the area.

Although the methodology for calculating the yields of bonds is similar across Member States, considerable differences existed in the context of defining representative long-term interest rate statistics regarding the choice of securities, yield formulae used, maturities chosen, treatment of taxation and adjustment for coupon effects. The object of the harmonisation exercise was to make recommendations, in particular with regard to these choices, which are general enough to allow for differences in national markets, and flexible enough to allow for the evolution of those markets, without impairing the comparability of data.

The harmonisation principles were that the issuer of bonds should be the central government, with securities of close to ten years to maturity, and that yields should be measured gross of tax. To ensure that the depth of the market is taken into account, and that no liquidity premium is carried into the yield, the representative securities should be chosen on the basis of their high liquidity. The responsibility for this choice is a matter for the Member States. Countries may choose either a benchmark or a sample

of bonds, using the liquidity of the market at the ten-year point as the determining factor. "Special feature" bonds (e.g. embedded option, zero coupon) are excluded from the assessment. The selection of highly liquid bonds is also seen as an effective indirect means to minimise the effects of different coupon values. Finally, a uniform formula was chosen using existing international standards, namely formula 6.3, "Formulae for Yield and other Calculations", of the International Securities Market Association. Where there is more than one bond in the sample, the liquidity of the selected bonds warrants the use of a simple average of the yields to produce the representative rate. The production of the harmonised representative long-term interest rates defined above has been implemented by the central banks, and fully harmonised data are now available and used in this Report.

Other factors

The last paragraph of Article 109j (1) of the Treaty states that the reports of the Commission and the EMI shall, besides the four main criteria, 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.

Whereas for the four main criteria Protocol No. 6 describes the data to be used in more detail, and stipulates that the Commission shall provide the data to be used for the assessment of compliance with these criteria, there is no reference to these "other factors" in the Protocol. Whilst the development of the ECU and the integration of markets relate to the progress towards Economic and Monetary Union in more general terms, the analysis of the other factors requires - in the context of the assessment of convergence - the definition of statistical concepts to ensure sufficient comparability between the national data.

Regarding the balance of payments on current account, the Commission (EUROSTAT), in co-operation with the EMI, has taken the lead in the harmonisation of concepts. The IMF Balance of Payments Manual (5th edition) serves as the yardstick. Specific European guidelines have been drawn up where necessary. Member States have started to implement these harmonisation proposals and it is desirable that they should compile fully harmonised national current account data as early as possible in 1998. However, since the introduction of the Intrastat system in January 1993, the compilation of trade statistics in Member States has been delayed and reliance on provisional data has had to be increased. The Commission (EUROSTAT) and the Member States are working towards improving this situation.

The available data on unit labour costs, derived from data on wage costs, employment and output, are not fully comparable between countries. They differ in terms of coverage and methods; the same is true for producer price indices, the main indicator used in this Report for the "other price indices". They are, in addition, not yet calculated for all Member States.

These reservations have to be taken into account when drawing conclusions from the "other factors". Against this background, the EMI strongly supports the current initiatives taken by the Commission (EUROSTAT) to implement Regulations covering several of these indicators, aimed at ensuring a more harmonised statistical basis across the EU, and finds it desirable that first results are achieved as soon as possible. Moreover, so as to have a reliable statistical basis for a future single monetary policy in Stage Three, the EMI underlines the importance of the timely provision of these data in accordance with the timetable for Monetary Union set out in the Treaty.

Chapter II

Statutory requirements to be fulfilled for NCBs to become an integral part of the ESCB

1 Introduction

Article 7 of the EMI's Statute requires that the reports to the Council on the state of preparations for the third stage shall include an assessment of "the statutory requirements to be fulfilled for national central banks to become an integral part of the ESCB". Article 109j (1) of the Treaty[1] requires the EMI (and the Commission) to report, by the end of 1996 at the latest, inter alia on "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".[1] Article 108 of the Treaty, as reproduced in Article 14.1 of the Statute, states in this connection that Member States shall ensure, at the latest at the date of the establishment of the ESCB, that their national legislation, including the statutes of their national central banks (NCBs), are compatible with the Treaty and the Statute.

The present Report assesses progress made by Member States towards the fulfilment of their aforementioned obligations under Article 108, i.e. legal convergence. Its emphasis lies on the achievement of the requirements with respect to central bank independence. Central bank independence is an important, but not the sole, requirement to be fulfilled for the NCBs to become an integral part of the ESCB. Central bank statutes are also likely to need adaptation in other respects, in addition to which there may be a need to adapt legislation other than central bank statutes. While this Report pays attention to the latter two areas, further work needs to be done. This Report is therefore not exhaustive and does not prejudge subsequent assessments of progress made by Member States towards the fulfilment of their obligations under Article 108 of the Treaty. The EMI will pro-actively continue to act as a forum for an exchange of views between NCBs in this field and will refer to this issue in future reports which it is required to submit under Article 109j of the Treaty and 7 of its Statute.

The EMI's report on "Progress towards convergence" published in November 1995 (the "1995 Convergence Report")[2] contains several basic assumptions with regard to the statutory requirements to be fulfilled by NCBs with a view to their integration in the ESCB in Stage Three of EMU.

- The Treaty establishing the European Community[3] and the Statute of the ESCB/ECB[4] (the "Treaty" and the "Statute") do not require the harmonisation of NCBs' statutes; national peculiarities may continue to exist. However, the Treaty and the Statute do imply that national legislation and the statutes of NCBs need to be adjusted in order to eliminate inconsistencies with the Treaty and the Statute and to ensure the necessary degree of integration of NCBs in the ESCB. The supremacy of the Treaty and the Statute over national legislation does not discharge Member States from this obligation to adapt their legislation.

- Timely adaptation requires the legislative process to be initiated during Stage Two.[5] This also enables the EMI and other Community institutions to assess, pursuant to their reporting obligations under the Treaty, progress made

[1] *References to the Treaty and the Statute are references to the Treaty establishing the European Community and the Statute of the ESCB/ECB, unless indicated otherwise.*

[2] *In particular pages 88 - 97.*
[3] *In particular Articles 107 and 108.*
[4] *In particular Articles 7 and 14.*
[5] *See also Article 109e (5) of the Treaty.*

towards the fulfilment of the legal requirements for Stage Three.[6]

- Adaptations of statutes in the field of central bank independence need to be fully effective at the latest by the date of the establishment of the ESCB, whilst adaptations aimed at the integration of NCBs in the ESCB would need to become effective at the start of Stage Three for Member States without a derogation and at the start of their full participation in Monetary Union for Member States with a derogation or with a special status.[5]

[6] *In relation to the application of Article 107 of the Treaty on central bank independence and Article 108 of the Treaty on the adaptation of national legislation and the statutes of NCBs, the Treaty and the Statute do not make a distinction between Member States with and without a derogation. A derogation implies that the respective NCB retains its powers in the field of monetary policy and participates in the ESCB on a restrictive basis until the date at which the Member State joins Monetary Union. 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 Stage Three before the Council makes its assessment under Article 109j (2) of the Treaty. Denmark has already given notification that it will not participate in Stage Three and, in accordance with Article 2 of Protocol No. 12, Denmark will therefore be treated as a country with a derogation. The implications thereof were elaborated in a Decision taken by the Heads of State or Government at their Edinburgh Summit meeting on 11 and 12 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 the powers of Danmarks Nationalbank in the field of monetary policy. In the event that the United Kingdom does not participate in Stage Three, Article 2 of Protocol No. 11 will exempt the United Kingdom from the impact of, inter alia, Articles 107 and 108 of the Treaty and Articles 7 and 14 of the Statute.*

2 Central bank independence

Building further on the EMI's 1995 Convergence Report, the EMI has established a list of features of central bank independence, distinguishing between features of an institutional, personal, functional and financial nature. In doing so, the EMI made several basic assumptions:

- Central bank independence is required when exercising the powers and carrying out the tasks and duties conferred upon the ECB and the NCBs by the Treaty and the Statute and features of central bank independence should therefore be considered from that perspective.

- Such features should not be seen as a kind of secondary Community legislation, going beyond the scope of the Treaty and the Statute, but as tools to facilitate an assessment of the independence of NCBs.

- Central bank independence is not a matter which can be expressed in arithmetical formulae or applied in a mechanical manner and the independence of individual NCBs should therefore be assessed on a case-by-case basis given that the institutional context in which NCBs operate differs from country to country.

- Whereas some provisions of the statutes of NCBs are clearly incompatible with the Treaty and the Statute, others may require further analysis before a final assessment can be made.

2.1 Institutional independence

The requirement of institutional independence is laid down in Article 107 of the Treaty as reproduced in Article 7 of the Statute. These Articles prohibit the ECB, the NCBs and members of their decision-making bodies from seeking or taking instructions from Community institutions or bodies, from any government of a Member State or from any other body. In addition, they also prohibit Community institutions and bodies and the governments of the Member States from seeking to influence the members of the decision-making bodies of the ECB or of those decision-making bodies of the NCBs whose decisions may have an impact on the fulfilment by the NCBs of their ESCB-related tasks. Against this background, the EMI is of the opinion that the following rights of third parties (e.g. government, parliament)[7] are incompatible with the Treaty and/or the Statute and therefore require adaptation.

A right to give instructions

Rights of third parties to give instructions to NCBs or their decision-making bodies are incompatible with the Treaty and the Statute as far as ESCB-related tasks are concerned.

A right to approve, suspend, annul or defer decisions

Rights of third parties to approve, suspend, annul or defer decisions of NCBs are incompatible with the Treaty and the Statute as far as ESCB-related tasks are concerned.

A right to censor decisions on legal grounds

A right to censor, on legal grounds, decisions relating to the performance of ESCB-related tasks is incompatible with the Treaty and the Statute as the performance of these tasks may not be obstructed at a

[7] *The prohibition on instructions and attempts to influence covers all sources of external influence on the NCBs in relation to ESCB matters which prevent them from complying with the Treaty and the Statute.*

national level. This is not only an expression of central bank independence but also of the more general requirement of the integration of NCBs in the ESCB (see Section 4 below). Also, the statutes of several NCBs provide for a right of the Governor to censor decisions on legal grounds and subsequently submit them to political authorities for final decision. Although a Governor is not a "third party", this would be equivalent to seeking instructions from political bodies, which is incompatible with Article 107 of the Treaty.

A right to participate in decision-making bodies of an NCB with a right to vote

The participation of representatives of other bodies (e.g. government or parliament) in decision-making bodies of an NCB with a right to vote on matters concerning the exercise by the NCB of ESCB-related tasks, even if this vote is not decisive, is incompatible with the Treaty and the Statute.

A right to be consulted (ex ante) on an NCB's decisions

The prohibition on external influence should not be interpreted in such an extensive way that it would preclude a dialogue between NCBs on the one hand and government and other state bodies (parliament, etc.) on the other. The crucial issue is whether a national institution has any formal mechanism at its disposal to ensure that its views influence the final decision. An explicit statutory obligation for an NCB to consult political authorities provides for such a mechanism and is therefore incompatible with the Treaty and the Statute.

A dialogue between NCBs and their respective political authorities, even when based on statutory obligations to provide information and exchange views, is not incompatible with the Treaty and the Statute, provided that:

- this does not result in interference with the independence of the members of decision-making bodies of NCBs;
- the ECB's competences and accountability at the Community level as well as the special status of a Governor in his/her capacity as a member of its decision-making bodies are respected; and
- confidentiality requirements resulting from Statute provisions are observed.

2.2 Personal independence

The EMI is of the opinion that the statutes of NCBs have to respect the following features of personal independence:

A) The statutes of NCBs must, in accordance with Article 14.2 of the Statute, contain a minimum term of office for a Governor of five years. This, of course, does not preclude longer terms of office, whilst an indefinite term of office does not require the adaptation of statutes if the grounds for the dismissal of a Governor are in line with those of Article 14.2 of the Statute (see point B below).

B) NCBs' statutes must ensure that Governors may not be dismissed for reasons other than those mentioned in Article 14.2 of the Statute (i.e. no longer fulfilling the conditions required for the performance of his/her duties or being guilty of serious misconduct). The purpose of this requirement is to prevent the dismissal of a Governor from being at the discretion of the authorities involved in his/her appointment, particularly the government or parliament. As from the date of the establishment of the ESCB, statutes of NCBs should contain grounds for dismissal which are compatible with

those laid down in Article 14.2 of the Statute or should not mention any grounds for dismissal since Article 14.2 is directly applicable. This issue requires further study as far as its implementation is concerned.

C) Personal independence could be jeopardised if the same rules for the security of tenure of office of Governors were not also applied to other members of the decision-making bodies of NCBs involved in the performance of ESCB-related tasks. A requirement to confer comparable security of tenure follows from various Treaty and Statute Articles. Article 14.2 of the Statute does not restrict the security of tenure of office to Governors, whilst Article 107 of the Treaty and Article 7 of the Statute refer to "any members of decision-making bodies of NCBs" rather than "Governors". This applies in particular where a Governor is "primus inter pares" between colleagues with equivalent voting rights or where, in the case referred to in Article 10.2 of the Statute, such other members may have to deputise for the Governor within the Governing Council. This general principle would not exclude a differentiation in terms of office and in grounds for dismissal in those cases where members of decision-making bodies and/or such bodies themselves are not involved in the performance of ESCB-related tasks.

D) Personal independence also entails ensuring that no conflicts of interest arise between the duties of members of decision-making bodies of NCBs vis-à-vis their respective NCB (and of Governors, additionally, vis-à-vis the ECB) and any other functions which such members of decision-making bodies involved in the performance of ESCB-related tasks may have and which may jeopardise their personal independence. As a matter of principle, membership of a decision-making body involved in the performance of ESCB-related tasks is incompatible with the exercise of other functions which might create a conflict of interest. The EMI will look further into the implementation of this general principle.

2.3 Functional independence

NCBs in Stage Three operate in a framework whose objectives are determined by Article 105 (1) of the Treaty and Article 2 of the Statute (the core element of which is the primacy of maintaining price stability) and statutes of NCBs should unambiguously reflect this situation. This aspect of functional independence is also closely related to the integration of NCBs in the ESCB in general (see Section 4 below).[8]

In addition, under Article 14.4 of the Statute, an NCB may perform tasks and functions other than those related to the ESCB, unless these are deemed, by the Governing Council of the ECB, to interfere with the objectives and tasks of the ESCB. This should also be regarded as a feature of functional independence protecting the integrity of the system.

2.4 Financial independence

If an NCB is fully independent from an institutional and functional point of view, but at the same time unable to avail itself autonomously of the appropriate economic means to fulfil its mandate, its overall independence would nevertheless be undermined. In the EMI's opinion, NCBs should be in a position to avail themselves of the appropriate means to ensure that their ESCB-related tasks can be properly

[8] *Pursuant to Article 109k (3) of the Treaty, Article 105 (1) thereof does not apply to Member States with a derogation. Pursuant to Article 5 of Protocol No. 11 of the Treaty, Article 105 (1) of the Treaty does not apply to the United Kingdom.*

fulfilled. An ex post review of an NCB's financial accounts may be regarded as a reflection of an NCB's accountability towards its owners provided that the NCB's statute contains adequate safeguards that such a review will not infringe its independence. Ex ante influence on an NCB's financial means may infringe an NCB's independence. In those countries where third parties and, particularly, the government and/or parliament are in a position, directly or indirectly, to exercise influence on the determination of an NCB's budget or the distribution of profit, the relevant statutory provisions should contain a safeguard clause to ensure that this does not impede the proper performance of the NCB's ESCB-related tasks.

3 Inconsistencies between the Treaty and the statutes of NCBs in the area of central bank independence

The specification of features of central bank independence in Section 2 above allows an assessment to be made of those provisions in the statutes of NCBs which, in the EMI's opinion, are incompatible with the Treaty and the Statute and which therefore require adaptation. Annex 1 to this Chapter, which contains a description of the institutional features of NCBs, identifies provisions in their respective statutes which, having regard to the foregoing, are deemed to be incompatible with the Treaty and the Statute. Such provisions are identified without an assessment of their impact on the actual degree of independence. Conversely, the identification of such provisions should be without prejudice to the potential wish of national legislators not only to remove inconsistencies but also to include provisions in the statute of an NCB aimed at strengthening its independence. Indeed, national legislators may for reasons of legal clarity wish, for example, to include the text of Article 107 of the Treaty in the statutes of their NCBs (although this would not be formally necessary as this Article is directly applicable) or elaborate on the implications of an NCB becoming an integral part of the ESCB. The description in Annex 1 to this Chapter is therefore restricted to provisions which, in the EMI's view, at a minimum need to be adapted, whilst envisaged adaptations are also addressed. As stated in the introduction to this Chapter, the observations do not constitute a final assessment of legal convergence in the area of central bank independence.

4 Other statutory requirements to be fulfilled for NCBs to become an integral part of the ESCB

The full integration of NCBs in the ESCB will necessitate measures in addition to those designed to ensure independence. In particular, such measures may be necessary to enable NCBs to execute tasks as members of the ESCB and in accordance with decisions by the ECB. The main areas of attention are those where statutory provisions may form an obstacle to an NCB complying with the requirements of the ESCB or to a Governor fulfilling his/her duties as a member of the Governing Council of the ECB, or where statutory provisions do not respect the prerogatives of the ECB. For example, there should be no statutory obstacles to a Governor in his/her capacity as a member of a decision-making body of a Community organ taking whatever stance in the decision-making process within the ECB he/she deems fit. Structures or rules of decision-making bodies of NCBs binding a Governor in his/her voting behaviour in the Governing Council of the ECB are not compatible with integration requirements under the Treaty and the Statute. Also, as a further example, some NCBs' statutes provide for a regime for the issuance of banknotes which will differ from the situation arising from the application of Article 105a (1) of the Treaty and Article 16 of the Statute, either by establishing competences or by creating compulsory steps in the process of issuing banknotes. Avoidance of inconsistencies with the Treaty and the Statute would require appropriate amendments. As far as the fulfilment of the statutory requirements for the integration of NCBs in the ESCB is concerned, this is an area where NCBs have more leeway to maintain national peculiarities than in the area of central bank independence. At the same time, however, it would be desirable to avoid the statutes of different NCBs containing different provisions on the same issues, particularly when this concerns matters where the primary competence lies at a central level rather than at the level of individual NCBs. Whilst recognising that the harmonisation of the statutes of NCBs is not required under the Treaty and the Statute, the EMI will pro-actively continue to act as a forum for an exchange of views between NCBs in this field, acknowledging that the adaptation of legislation generally requires long lead times and needs to be accomplished before the establishment of the ESCB. The EMI will refer to this issue in future reports which it is required to submit under Article 109j of the Treaty and Article 7 of its Statute.

5 Changes in legislation

In the period between publication of the 1995 Convergence Report and the present Report considerable attention has been paid in the Member States to the need to adapt the statutes of their respective NCBs in order to comply with Treaty and Statute requirements. This has in several cases resulted in the submission of adapted statutes to parliaments on which the EMI has been consulted under Article 109f (6) of the Treaty and Article 5.3 of its Statute.

Some of the proposed adaptations were designed to make national legislation consistent with Article 104 of the Treaty, which prohibits the provision of central bank credit to the public sector, as well as with Article 104a, which prohibits the granting of privileged access by governmental or public bodies to financial institutions. To this effect, legislation was enacted in Luxembourg and proposed in both Ireland and Finland within the context of further adaptations of the statutes of their respective NCBs (see below). In addition to statutory amendments, operational practices were changed in several countries to ensure compliance with Articles 104 and 104a of the Treaty.

Further adaptations of central bank legislation have been proposed in Belgium, Ireland, Luxembourg and Finland. The EMI has been consulted on these adaptations under Article 109f (6) of the Treaty and Article 5.3 of its Statute. In Belgium a reform of the National Bank of Belgium's Organic Law will be submitted to Parliament very shortly. The Bank's proposed new statute aims to fulfil all Treaty and Statute requirements for Stage Three of Economic and Monetary Union. The proposed statute covers a wide range of issues, such as the National Bank of Belgium's independence and its integration in the ESCB as well as its tasks and organisational structure. The draft law was submitted to the EMI for consultation on 1 August 1996 and the EMI delivered its opinion on 9 September 1996 (CON/96/10). In Luxembourg a draft Law on the Institut Monétaire Luxembourgeois and the monetary status of the Grand Duchy of Luxembourg was submitted to Parliament in December 1993, the enactment of which is still pending. The draft law contains various provisions on the IML's objectives and tasks as well as on the monetary association between Luxembourg and Belgium. The draft law was submitted to the EMI for consultation on 18 February 1994 and the EMI delivered its opinion on 12 March 1994 (CON/94/1). In Ireland draft legislation on the Central Bank of Ireland has been published which covers issues such as payment systems, the collection of statistics, prudential supervision and aspects relating to the position of the Bank's Governor and Directors. The draft legislation was submitted to the EMI for consultation on 25 March 1996 and the EMI delivered its opinion on 28 May 1996 (CON/96/4). Finally, in Finland draft legislation is pending before Parliament which addresses Suomen Pankki's independence and particularly the status of its Parliamentary Supervisory Council. The draft legislation was submitted to the EMI for consultation on 10 April 1996 and the EMI delivered its opinion on 17 May 1996 (CON/96/5). The above adaptations are addressed in more detail on a country-by-country basis in Sections 5 of Annex 1 to this Chapter.

To varying degrees, the changes to the statutes of NCBs currently under consideration do not preclude the necessity for further adaptations with a view to ensuring their compatibility with the Treaty and the Statute by the date of the establishment of the ESCB and NCBs' integration in the ESCB by the start of Stage Three of EMU. The only exception may be Belgium, as far as the National Bank of Belgium's proposed new statute is concerned. Prospective changes to the statutes of NCBs have also

been highlighted on a country-by-country basis in Section 5 of Annex I to this Chapter. In this connection, the obligation under Article 108 of the Treaty to remove inconsistencies with the Treaty and the Statute also applies to legislation other than the statutes of NCBs if such other legislation has an effect on central bank independence. For example, this would be the case of the Swedish Constitution, which contains provisions on the status of Sveriges Riksbank and the members of its Governing Board which might have to be adapted to the requirements of the Treaty, or otherwise developed in ordinary legislation in a manner compatible with it. It may also be the case of general laws on governmental entities, budgetary laws or company laws, if these have an impact on the legal status of the national central banks.

Furthermore, Article 108 of the Treaty requires adaptation of national legislation addressing not only the status of national central banks, but also containing other provisions which are incompatible with the Treaty. In this respect, and as an example, Finland changed its Currency Act (358/93) in order to allow Finland to participate in the Exchange Rate Mechanism of the European Monetary System in anticipation of Finland's participation in Monetary Union. Draft legislation to this effect was submitted to the EMI for consultation on 9 November 1995 and the EMI delivered its opinion on 11 December 1995 (CON/95/16). The constitutional provision in Finland establishing the markka as the lawful currency of Finland will also need to be reviewed in the light of the introduction of the euro in that Member State.

Annex 1

Institutional features of the national central banks of the Member States of the European Union with particular emphasis on central bank independence

This Annex contains, inter alia, descriptions of inconsistencies in the area of central bank independence between the statutes of the individual NCBs, on the one hand, and the Treaty and the Statute, on the other, which require adaptation under Article 108 of the Treaty. Such descriptions concentrate on major inconsistencies and are not necessarily exhaustive. Furthermore, they do not prejudge the wishes of national legislators to incorporate features of central bank independence in the statutes of their respective NCBs even if there are no inconsistencies in the present statutes of such NCBs. In addition, the descriptions prejudge neither future assessments of the independence of individual NCBs nor of legal convergence in a more general sense in the Member States of the European Union as they will be elaborated in future reports which the EMI is required to submit under Article 109j of the Treaty and Article 7 of its Statute. For reasons of brevity, descriptions of inconsistencies are deliberately condensed and should be read in conjunction with the relevant parts of this Report for further clarification.

National Bank of Belgium

1. Legal basis

The statute of the National Bank of Belgium is currently contained in the Organic Law on the National Bank of Belgium of 24 August 1939 as amended and the Statutes of the National Bank of Belgium of 23 September 1939 as amended. The Bank is a limited liability company ("société anonyme"), in which the Belgian State owns a controlling stake with 50% of the shares. General company law is explicitly recognised as a supplementary statutory source.

2. Organisational structure

The Bank is directed by the Governor and administered by the Board of Directors, assisted by the Council of Regency. It is supervised by the Board of Censors. There is, in addition, the General Council.

The Governor is appointed by the King on a nomination from Government for a renewable term of five years. The Governor can be suspended or dismissed by the King. The grounds for such suspension or dismissal have not been laid down in statutory provisions.

The Board of Directors includes, in addition to the Governor, three to six members appointed by the King on a proposal of the Council of Regency for a term of six years. No specific provisions regarding their dismissal from office are included in the statute of the Bank. The Board manages the Bank and is in charge of the orientation of policy under the control of the Council of Regency.

The Council of Regency includes the Governor, the Directors and ten Regents. Regents are appointed for three years by the general meeting of shareholders. Five are appointed on a proposal of the Minister of Finance, three on a proposal from the most representative organisations of industry, commerce and agriculture, and two on a proposal of the most representative labour organisations. The Council of Regency has general powers to set the rates and terms of discount, advances and loans and approves the Annual Report on the Bank's operations.

The Board of Censors includes eight to ten Censors elected for three years by the general meeting of shareholders. Besides controlling the operations of the Bank, it votes on the budget and approves the annual accounts as proposed by the Council of Regency.

The General Council includes the Governor, the Directors, the Regents and the Censors. It has important administrative functions, and decides on the distribution of profits in accordance with the criteria laid down in the Organic Law.

Membership of the above governing bodies is subject to several rules on incompatibilities of functions, the most important being that members of Parliament or Government may not hold the office of Governor, Vice-Governor, Director, Regent or Censor and that the Governor, Vice-Governor and the Directors may not exercise any function on the boards of commercial companies, whilst Regents may not perform high-ranking functions in banks.

While there is no right of instruction from political authorities, there is a Government Commissioner in the Bank who is entitled to participate without voting rights in meetings of decision-making bodies of the Bank. A power of suspension and a right to oppose decisions can in general terms be exercised by the Government Commissioner and the Minister of Finance respectively against any

decision of the Bank contrary to the law, to the Statutes of the Bank or to the interests of the State. However, by virtue of the Law of 22 March 1993, this power no longer exists with regard to the basic tasks of the Bank - namely the definition and implementation of monetary policy, the conduct of foreign exchange operations consistent with the exchange arrangements applicable to the franc, the holding and management of the official foreign reserves and the promotion of the smooth operation of payment systems - insofar as the decisions are in conformity with the law and the Statutes of the Bank. In this respect, the autonomy of the Bank has thus been enhanced.

3. Objectives and tasks

No explicit statutory objectives are laid down in the Bank's Organic Law or its Statutes. The Bank's main tasks are: the determination of monetary and exchange rate policy; management of foreign reserves; European and international monetary co-operation; and safeguarding the smooth functioning of payment systems. Other tasks, which do not include banking supervision, are conferred on the Bank under specific legislative provisions.

The Bank is responsible for the formulation and implementation of monetary policy. It conducts monetary policy in the context of the exchange rate regime which is determined by the Government. In particular, exchange rate arrangements are adopted by the King (the Government) after consultation with the Bank. The Bank can use a wide range of monetary policy instruments. However, the introduction of reserve requirements requires the approval of the Government.

4. Relations with political bodies

There are no institutional statutory relations between Parliament and the Bank and, indeed, the Governor has rarely appeared before Parliament. Regarding relations with the Government, the Governor has only rarely attended meetings of the Council of Ministers. The Bank publishes an Annual Report. The Minister of Finance has to approve the form of the weekly financial statements of the Bank.

5. Inconsistencies with Treaty and Statute requirements and prospective changes to the Bank's statute

The statute of the Bank contains several inconsistencies with Treaty and Statute requirements for central bank independence which require adaptation.

As far as institutional independence is concerned, after the reform of 1993, the Government Commissioner still retains a power of suspension and a right to oppose decisions adopted by the decision-making bodies of the Bank, which are limited to the control of legality. In addition, the need for governmental approval to introduce reserve requirements is inconsistent with the necessary degree of autonomy in monetary policy matters.

As far personal independence is concerned, provisions referring to security of tenure of office of the Governor and the members of the Board of Directors require adaptation. Also, the role of the Council of Regency should be revisited, given its composition.

As far as functional independence is concerned, the statute of the Bank does not unambiguously reflect the primacy of maintaining price stability.

The Belgian Government and the Bank have acknowledged in the past that the above structure requires the adaptation of the Bank's statute in the light of the Treaty and Statute requirements for Stage Three. This resulted in a draft law on the reform of the Organic Law on the National Bank of Belgium, which was submitted to the EMI for consultation on 1 August 1996 and on which the EMI delivered an opinion (CON/96/10) on 9 September 1996. The EMI welcomed the draft law as a comprehensive piece of legislation, both on central bank independence as well as on the integration of the Bank in the ESCB. The draft law recognises that:

- central bank independence would need to be achieved at the latest at the date of establishment of the ECB/ESCB;
- integration provisions would need to become effective at the start of Stage Three; and
- certain provisions would need to reflect the practicalities of the transition from Stage Two to Stage Three, such as the envisaged date for the introduction of euro banknotes.

The proposed new statute of the Bank aims at fulfilling all Treaty and Statute requirements for Stage Three through, inter alia, the following provisions:

- the prohibition of external influence laid down in Article 107 of the Treaty and Article 7 of the Statute is incorporated in draft legislation;
- the role of the Council of Regency is restricted to advisory tasks without an ex ante right of consultation on ESCB-related tasks;
- the right of the Government Commissioner to review the legality of the Bank's activities on ESCB-related tasks is abolished;
- the private shareholders of the Bank will not be able to influence the performance of ESCB-related tasks;
- the grounds for dismissal of the Governor which are derived from Article 14.2 of the Statute have been extended to other members of the Board of Directors;
- the incompatibilities of the functions of the Governor and other members of the Board of Directors are broad enough to prevent the risk of conflicts of interest;
- the draft legislation unambiguously reflects the statutory objective of the ESCB and the Bank's role as an integral part of the ESCB in the achievement thereof;
- the draft legislation acknowledges that the performance of non-ESCB-related tasks is, in accordance with Article 14.4 of the Statute, subject to the views of the Governing Council of the ECB on their compatibility with ESCB-related tasks.

Danmarks Nationalbank

1. Legal basis

The statute of Danmarks Nationalbank is contained in the National Bank of Denmark Act (Act No. 116) of 7 April 1936. The Bank is a self-governing institution, its profits after allocations falling to the State.

2. Organisational structure

The governing bodies of the Bank are the Board of Governors, the Board of Directors and the Committee of Directors.

The Board of Governors consists of three members. The Chairman is appointed by the Crown. The other Governors are appointed by the Board of Directors. According to the National Bank of Denmark Act, the term of office is indefinite, with a retirement age of seventy. The Board of Governors has full and sole responsibility for monetary policy. Governors are prevented from active involvement in the management of commercial organisations and companies and may not carry out or take part in private business activities.

The Board of Directors consists of twenty-five members, of which two are appointed by the Royal Bank Commissioner, i.e. the Minister of Economic Affairs. Eight members are appointed by Parliament from among its members, while the remaining fifteen are appointed by the Board of Directors to ensure a broad representation of business and other sectors. The term of office is five years with the possibility of re-election. The Board is competent in administrative and organisational fields.

The Committee of Directors consists of the two members of the Board of Directors appointed by the Royal Bank Commissioner together with five members elected by the Board of Directors from among its members. The term of office is one year with a possibility of re-election. The Committee of Directors has - as does the Board of Directors - administrative and organisational competence.

In his/her capacity as Royal Bank Commissioner, the Minister of Economic Affairs supervises the Bank's fulfilment of its obligations under the National Bank of Denmark Act, and under the ordinances and provisions made pursuant to the Act. The Royal Bank Commissioner may participate in the meetings of the Committee of Directors, although to date never has. For certain decisions at least one of the two members of the Committee appointed by the Royal Bank Commissioner has to be present in order to form a quorum. The Royal Bank Commissioner presides over - but has no voting right at - the meetings of the Board of Directors.

According to the Bank's by-laws, the Chairman of the Board of Governors may be dismissed by the Crown, the other two members by the Board of Directors. In the latter case, a majority of two-thirds of the members of the Board of Directors is required. No grounds for dismissal have been laid down. For the members of the Board of Directors and the Committee of Directors there are no rules relating to dismissal.

3. Objectives and tasks

The National Bank of Denmark Act states that the Bank has the objective of maintaining a safe and secure currency system and of facilitating and regulating payment flows and the extension of credit. This is generally interpreted as implying the objective of maintaining price stability.

Authority for monetary policy rests with the Board of Governors, including setting interest rates and deciding on other monetary policy instruments. This includes the tasks of fixing the discount rate and rates on advances, folio account and current account, the issuing of bank promissory notes and the purchase and sale of securities. The Board of Governors has full freedom in formulating and implementing monetary policy.

The Bank also manages official reserves and serves as fiscal agent for the Danish Government.

4. Relations with political bodies

With regard to relations with Parliament, eight of the twenty-five members of the Board of Directors are appointed by Parliament from among its members. There are no reporting requirements to Parliament.

With regard to relations with the Government, the Minister of Economic Affairs in his/her capacity as Royal Bank Commissioner supervises the Bank's fulfilment of its obligations under the National Bank of Denmark Act, and under the ordinances and provisions made pursuant to the Act. The Royal Bank Commissioner and the Minister of Finance are entitled to participate in deliberations on changes in the official discount rate, but without voting rights.

The Bank is statutorily obliged to publish its annual accounts once they have been approved by the Board of Directors and endorsed by the Royal Bank Commissioner, together with an Annual Report.

5. Inconsistencies with Treaty and Statute requirements and prospective changes to the Bank's statute

The statute of the Bank does not unambiguously reflect the primacy of maintaining price stability. Since Denmark has opted out of participation in Monetary Union, there is no need to adapt the Bank's statute in this respect.

Deutsche Bundesbank

1. Legal basis

The legal basis for the establishment of the Deutsche Bundesbank is contained in the Bundesbank Act of 26 July 1957 as amended. Further provisions can be found in the Bundesbank Statute of 27 November 1958, which is based on Section 34 of the Bundesbank Act. The Bank is a Federal corporation under public law. Its capital is held by the Federal Government.

2. Organisational structure

The decision-making bodies of the Bank are the Central Bank Council, the Directorate and the Managing Boards of the Land Central Banks.

The Central Bank Council consists of the President and the Deputy President of the Bundesbank, the other members of the Directorate and the Presidents of the Land Central Banks.

The Directorate comprises the President, the Deputy President and up to six further members. All members of the Directorate are appointed by the President of the Federal Republic on a proposal of the Federal Government, after consultation with the Central Bank Council.

The Managing Boards of the nine Land Central Banks consist of the President, the Vice-President and in six cases one further member. The Presidents of the Land Central Banks are appointed by the President of the Federal Republic on a proposal of the Bundesrat (the Upper Chamber of Parliament), following the submission of a proposal from the authority designated under the laws of the Land or Länder concerned and after consultation with the Central Bank Council.

Members of the governing bodies are appointed for a period of eight years. In exceptional cases, however, appointments may be for a shorter period, but with a two-year minimum. Generally, appointments are renewable. The members of the governing bodies can be dismissed by the President of the Federal Republic. The grounds for such dismissal are defined in the individual contracts with the Bank. Dismissal would, moreover, have to follow general principles of German civil service law, under which the grounds for dismissal must be well founded (e.g. inability to perform the duties).

3. Objectives and tasks

The Bundesbank Act defines the main function of the Bank as the safeguarding of the currency and the execution of domestic and external payments. Safeguarding of the currency implies the objective of price stability. Without prejudice to the performance of its functions, the Bank is required to support the general economic policy of the Federal Government.

Monetary and credit policy is determined by the Central Bank Council on its own authority, based on the instruments of monetary policy determined by the Bundesbank Act. In exercising the powers conferred on it by the Bundesbank Act, the Bank is independent of instructions from the Federal Government. The monetary powers conferred on the Bank are the issuing and recalling of banknotes; discount, credit, open market and minimum reserve policies and the right to order and collect statistics from credit institutions. Within this statutory framework the Bank may employ, develop and refine the monetary policy instruments at its discretion.

4. Relations with political bodies

There are no institutional statutory relations between Parliament and the Bank.

With regard to relations with the Government, the members of the Federal Government are entitled to attend the meetings of the Central Bank Council. They have no right to vote, but may propose motions. At the request of a member of the Federal Government, a decision of the Central Bank Council can be deferred for up to two weeks. This right has not been used to date. In addition, the Government is involved in the appointment procedure as described above.

Finally, the Bank publishes Monthly and Annual Reports. Its annual accounts are verified by auditors and by the Federal Court of Auditors.

5. Inconsistencies with Treaty and Statute requirements and prospective changes to the Bank's statute

The Bank's statute contains a few inconsistencies with Treaty and Statute requirements for central bank independence which require adaptation:

- as far as institutional independence is concerned, the Government's right to defer a decision of the Central Bank Council;
- as far as personal independence is concerned, the fact that there is no guaranteed minimum five-year term of office for members of the Bank's decision-making bodies; and
- as far as functional independence is concerned, the fact that the Bank's statute does not unambiguously reflect the primacy of maintaining price stability.

Furthermore, the grounds for dismissal of the members of the governing bodies, which are defined in individual contracts, need to be reviewed in the light of Article 14.2 of the Statute.

For the time being, no prospective changes to the Bank's statute have been notified to the EMI.

Bank of Greece

1. Legal basis

The formation, powers and functions of the Bank of Greece are contained in the Statute of the Bank of Greece of 1928 as amended. The Bank is established as a corporation ("société anonyme"). The Greek State and State undertakings are limited to holding, directly or indirectly, shares which in aggregate amount to no more than one-tenth of the issued share capital of the Bank. Otherwise limits are not placed on who may become a shareholder.

2. Organisational structure

The governing body of the Bank is the General Council. The General Council is entrusted with the general operational, administrative and financial affairs of the Bank. On issues relating to monetary and exchange rate policies, authority rests with the Governor, who consults an internal committee on monetary and credit affairs.

The General Council is accountable to the General Meeting of shareholders. The General Meeting has certain specific powers reserved to it. In particular, the General Meeting has the power, inter alia, to approve the Annual Report and the accounts of the Bank, to appoint members of the General Council and to propose amendments to the Statute, which, subsequently, must be ratified by Parliament as a Law. Every person registered as holding twenty-five or more shares in the share capital of the Bank is entitled to attend and vote at the General Meeting.

The General Council consists of the Governor, the Deputy Governors and nine non-executive Councillors. The Governor and the Deputy Governors are appointed by the President of the Republic of Greece, following a proposal by the General Council which is endorsed by the Government, for renewable four-year terms. The nine Councillors are elected by the General Meeting for renewable three-year terms.

The Governor and Deputy Governors are required to devote exclusive service to the Bank except in cases where they are on the Board of Directors of Legal Entities of Public Law, of State Undertakings, or of State Advisory Bodies. No such requirement for exclusive service applies to the non-executive Councillors.

The Governor or, in his/her absence, a Deputy Governor presides over the General Council, legally represents the Bank and, on behalf of the General Council, decides on matters which are not specifically reserved to the General Council or the General Meeting.

A non-voting Government Commissioner may be nominated by the Minister of Finance. He/she attends the General Meeting and the meetings of the General Council and can veto decisions if he/she considers them to be contrary to the Statute or any other laws of the State. However, the final arbiter of any such veto challenge initiated by the Government Commissioner is a Commission of three persons appointed to rule on such matters. One member of this Commission is chosen by the Government, one by the Bank and the third is agreed upon between the Government and the Bank or, failing such agreement, by the President of the Supreme Court.

3. Objectives and tasks

The statutory objective of the Bank is to control the currency in circulation and

credit. This is considered to imply that monetary stability is the ultimate objective of the Bank.

The main tasks are the implementation of monetary and exchange rate policies.

The Bank formulates monetary policy in accordance with the Government's macro-economic objectives, particularly those relating to inflation, output and exchange rate policy. Interest rates applying to government paper are, however, set by the Government, albeit in consultation with the Bank.

Exchange rate policy is formulated by the Government in consultation with the Bank, which is responsible for its implementation.

The Bank has the exclusive right to issue banknotes. It also manages official reserves. In addition, the Bank is the banking supervisory authority and plays a key role in the country's payment system.

4. Relations with political bodies

In addition to the Government Commissioner, there is a competent parliamentary committee which expresses an opinion regarding the suitability of candidates for appointment as Governor. Accountability is ensured by the publication of the Bank's Annual Report and certain financial statements.

5. Inconsistencies with Treaty and Statute requirements and prospective changes to the Bank's statute

The statute of the Bank contains several inconsistencies with Treaty and Statute requirements for central bank independence which require adaptation.

As far as institutional independence is concerned, the Government Commissioner's power to veto the Bank's decisions on grounds of legality is incompatible with Treaty and Statute requirements for central bank independence as far as ESCB-related tasks are concerned. In addition, the subordination of the Bank's monetary policy decisions to the Government's macro-economic objectives is incompatible with Treaty and Statute requirements for central bank independence.

As far as personal independence is concerned, a minimum five-year term of office should be ensured for the Bank's Governor and the other members of the General Council. In addition, it should be ensured that no conflicts of interest could arise between the duties of non-executive Councillors vis-à-vis the Bank and other functions they may perform. Finally, incompatibilities of functions laid down in the Bank's statute may need to be reviewed in terms of their effectiveness in practice as they do not necessarily exclude the possibility of conflicts of interest.

As far as functional independence is concerned, the statute of the Bank does not unambiguously reflect the primacy of maintaining price stability.

Banco de España

1. Legal basis

The statute of the Banco de España is contained in Law 13/1994 dated 1 June 1994 on the "Autonomy of the Banco de España". This Law was enacted with the purpose of adapting the statute of the Bank to the provisions of the Treaty on European Union. The Bank is statutorily defined as a "public law entity with separate legal personality and full legal capacity". The capital of the Bank belongs to the State.

2. Organisational structure

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

The Governor is appointed by the Crown following a proposal by the President of the Government. The term of office is for a non-renewable period of six years. The Governor manages the Bank and presides over the Governing Council and the Executive Commission.

The Deputy Governor is appointed by the Government following a proposal by the Governor. The term of office is for a non-renewable period of six years. The Deputy Governor is assigned powers under internal Bank rules which are delegated to him by the Governor.

The Governing Council is composed of the Governor, the Deputy Governor, six elected Council members and two ex officio members: the Director-General of the Treasury and Financial Policy and the Vice-President of the National Stock Market Commission - with the latter two not having voting rights when monetary policy matters are under discussion. The six elected Council members are appointed by the Government following a proposal by the Economy and Finance Minister, after consultation with the Governor. Elected Council members serve a four-year term and may be reappointed once. The main functions of the Governing Council are to approve general guidelines for action by the Bank to fulfil its assigned functions and to supervise the implementation of monetary policy by the Executive Commission.

The Executive Commission is made up of the Governor, the Deputy Governor and two elected Council members. The Directors General of the Bank attend the meetings in a participatory but non-voting capacity. The Executive Commission is in particular responsible for implementing monetary policy subject to the guidelines of the Governing Council.

The two elected members of the Executive Commission are appointed by the Governing Council from the Council's elected members, on a proposal by the Governor.

Members of the Governing Council are subject to a strict regime of professional exclusivity.

3. Objectives and tasks

The primary objective of the Bank, as stated in Law 13/1994, is achieving price stability. Furthermore, without prejudice to the objective of price stability, monetary policy shall support the general economic policy of the Government.

The Bank's main tasks are to define and implement monetary policy; hold and manage reserves; implement exchange rate policy; promote the smooth operation and

the stability of the financial system and, in particular, of the payment system; issue banknotes and put coins into circulation; act as fiscal agent for the Government and supervise credit institutions. The Bank may require credit institutions to immobilise funds by setting a reserve requirement. However, the use of monetary policy instruments imposing obligations on entities other than credit institutions requires clearance by the Government.

The Banco de España is fully independent in the formulation and implementation of monetary policy. Article 1 of Law 13/1994 states that "the Bank shall pursue its activities and fulfil its objectives with autonomy from the Administration". Furthermore, Article 10 establishes that "neither the Government nor any other public authority may give instructions to the Bank regarding either the objectives or the implementation of monetary policy".

With regard to the formulation of exchange rate policy, Article 11 provides that "following consultation with the Banco de España, the Government shall adopt the exchange rate system and the parity for the peseta against other currencies, which must be compatible with the objective of price stability". It is also statutorily provided that the Bank is responsible for implementing exchange rate policy and, to that end, the Bank may conduct the operations it deems suitable.

4. Relations with political bodies

The Bank is obliged to report to both Parliament and the Government on the objectives and implementation of monetary policy. It is explicitly provided that neither of these constitutional organs may give instructions to the Bank on monetary policy. Moreover, every year the Bank is under the obligation to publish the objectives of monetary policy for the year and the implementation methods to attain these objectives.

The Governor may be required to attend the meetings of the Fiscal and Financial Policy Council, a co-ordination body on which all regional autonomous governments and the central government are represented, the purpose of which is to set the rules for the financial discipline of the regional governments, although without any competence in monetary policy-related issues.

The budget of the Bank is submitted to Parliament for approval. It is estimative in nature (i.e. non-binding) and cannot be consolidated with the General State Budget nor is it subject to Government approval. The yearly balance sheet and profit and loss accounts are submitted to the Government for approval, and are subject to an audit by the Court of Auditors. The estimative nature of the budget submitted to Parliament for approval and the fact that the Bank's budget is not subject to Government approval are to be understood as avoiding any political interference in the Bank's autonomous performance of its tasks and as implying that the General Budget Law does not contain provisions binding upon the Bank.

5. Inconsistencies with Treaty and Statute requirements and prospective changes to the Bank's statute

The statute of the Bank contains a few inconsistencies with Treaty and Statute requirements for central bank independence which require adaptation.

As far as institutional independence is concerned, it should be ensured that the absence of voting rights for the Director-General of the Treasury and Financial Policy and the Vice-President of the National Stock

Market Commission not only extends to monetary policy matters but to all ESCB-related tasks.

As far as personal independence is concerned, in accordance with Article 14.2 of the Statute, the four-year term of office foreseen for the elected members of the Governing Council of the Bank should be increased to five.

For the time being, no prospective changes to the Bank's statute have been notified to the EMI.

Banque de France

1. Legal basis

The statute of the Banque de France is contained in Law 93-980 of 4 August 1993 "Relative au statut de la Banque de France et à l'activité et au contrôle des établissements de crédit" as amended. The capital of the institution is fully owned by the State.

2. Organisational structure

The Bank is directed by the Governor. Responsibility for monetary policy functions is vested in the Monetary Policy Council. A General Council administers the Bank and decides in any matter beyond the competence of the Monetary Policy Council.

The Governor and the two Vice-Governors are appointed for a renewable term of six years by the Government and cannot be dismissed before the expiry of their term except for reasons of incapacity or serious misconduct. The Governor chairs the Bank's decision-making bodies.

The Monetary Policy Council includes the Governor, two Vice-Governors and six other members appointed by Government. The six other members have a non-renewable term of nine years. Members of the Monetary Policy Council cannot be dismissed before the expiry of their term except for reasons of incapacity or serious misconduct and they are subject to a strict regime of professional exclusivity. The Monetary Policy Council is responsible for formulating and implementing monetary policy. It can neither seek nor accept instructions from the Government or any other person in the performance of its duties.

The Bank's activities other than monetary policy are governed by the General Council. The General Council includes the members of the Monetary Policy Council plus one member elected by the employees of the Bank. A censor or his/her alternate, appointed by the Minister of Economic Affairs and Finance, attends General Council meetings. He/she may submit proposals for the approval of the Council and oppose any decision taken by it.

3. Objectives and tasks

The Bank has the objective of formulating and implementing monetary policy with the aim of ensuring price stability within the framework of the general economic policy of the Government. Its main tasks are the conduct of monetary and exchange rate policy; the management of official reserves; European and international monetary co-operation; and the safeguarding of the smooth functioning of the payment systems. Other tasks are conferred on the Bank under specific legislative provisions, which include balance of payments statistics, and prudential supervision is entrusted to a Banking Commission chaired by the Governor of the Bank to which the Bank provides administrative support.

The Bank conducts monetary policy in the context of the exchange rate regime which is determined by the Government.

The Bank can use a wide range of monetary policy instruments, including the establishment of minimum reserves.

4. Relations with political bodies

The Governor must present an Annual Report, which includes a description of monetary policy operations and perspectives, to the President of the Republic and to Parliament. The Governor may ask to be heard by the Finance Committees of the two Chambers of Parliament, and he may also be asked by these Committees to appear. Financial accounts are submitted yearly to the Finance Committees of the two Chambers of Parliament.

The Prime Minister and the Minister for Economy and Finance (or a representative) may attend meetings of the Monetary Policy Council. They may present proposals but have no voting rights.

5. Inconsistencies with Treaty and Statute requirements and prospective changes to the Bank's statute

The statute of the Bank contains a few inconsistencies with Treaty and Statute requirements for central bank independence which require adaptation.

As far as institutional independence is concerned, it should be ensured that the independence of the decision-making bodies of the Bank extends to all ESCB-related tasks and not only to monetary policy matters. Furthermore, the Governor's reporting obligation to the Finance Committees of the two Chambers of Parliament should respect the principles set out in Section 2.1 of Chapter II of this Report.

For the time being, no prospective changes to the Bank's statute have been notified to the EMI.

Central Bank of Ireland

1. Legal basis

The formation, powers and functions of the Central Bank of Ireland are set out in the Central Bank Acts, 1942-1989. The Bank is an institution established by statute whose capital is wholly owned by the State.

2. Organisational structure

The Bank is governed by the Board of Directors, which consists of the Governor and up to nine non-executive Directors.

The Governor is appointed by the President of Ireland on the advice of the Government and the appointment is for a renewable term of seven years. He/she may be removed from office by the President on the advice of the Government because of incapacity due to ill-health, or following a unanimous vote of the Board of Directors requesting that the President remove the Governor from office "for cause stated".

Members of the Board of Directors other than the Governor and "service directors" are appointed by the Minister for Finance for a term of five years. Up to a maximum of two Directors can be appointed from among civil servants by the Minister for Finance, one of whom is usually the Secretary of the Department of Finance; such service directors have full voting powers and the length of their term of office is set at the discretion of the Minister for Finance.

While responsibility for policy formulation and implementation rests with the Board of Directors, the latter has, in practice, delegated the day-to-day exercise and performance of this function to the Governor.

3. Objectives and tasks

The primary statutory objective of the Bank is to safeguard the integrity of the currency, which is interpreted as being the maintenance of price stability. Safeguarding of the currency implies the objective of price stability. The main tasks of the Bank are the formulation and implementation of monetary policy; the implementation of foreign exchange rate policy; the holding and managing of the official external reserves; managing the financial markets and overseeing the payment system; issuing currency; and acting as fiscal agent for the Government and as registrar of Government securities. The Bank is responsible for licensing and supervising credit institutions. Its supervisory responsibilities also cover a range of securities-related activities, including the Stock Exchange, financial futures and options exchanges, money brokers, collective investment schemes and certain investment intermediaries.

The Bank has full autonomy to formulate and implement monetary policy and exercises full discretion in its choice and use of monetary policy instruments. The Minister for Finance can request that the Governor, on behalf of the Board, or the Board itself consult and advise with him in relation to the execution and performance by the Bank of its objectives and tasks in relation to monetary policy. This power has never been used.

While the determination of exchange rate policy is ultimately a matter for the Government, the Minister for Finance is obliged, by statute, to consult the Bank before making any alteration in the general exchange rate arrangements or any specific exchange rate adjustments.

4. Relations with political bodies

The Bank is required to prepare an Annual Report and send it to the Minister for Finance, who, in turn, has the duty to present it to both Houses of the Oireachtas (Parliament). Similarly, the Bank's annual Statement of Accounts is submitted to the Comptroller and Auditor General, who, in turn, after audit and certification, is obliged to send it to the Minister for Finance, who presents it to Members of the Houses of the Oireachtas. The Bank's freedom to publish reports on money and credit issues and on the economic situation, outlook and policies provides a vehicle for communicating its views to the wider public. The Annual Report on its activities and the annual Statement of Accounts are published by the Bank. Moreover, the Governor attends meetings of a Select Committee of Dáil Eireann (House of Representatives).

5. Inconsistencies with Treaty and Statute requirements and prospective changes to the Bank's statute

The Bank's statute contains several inconsistencies with Treaty and Statute requirements for central bank independence which require adaptation.

As far as institutional independence is concerned, the right of service directors to participate in meetings of the Board of Directors with a right to vote is incompatible with the requirement of central bank independence. Furthermore, the obligation of the Governor or the Board of Directors to consult with the Minister for Finance if requested is an explicit statutory mechanism which may be used to influence the decision-making process within the Bank and is, therefore, considered to be incompatible with the requirement of central bank independence. Finally, the attendance of the Governor at meetings of a Select Committee of the House of Representatives should respect the principles set out in Section 2.1 of Chapter II of this Report.

With regard to personal independence, the grounds for dismissal of the Governor and members of the Board of Directors should be brought into line with those mentioned in Article 14.2 of the Statute, and this applies in particular to the grounds for dismissal of the Governor who may currently be dismissed "for cause stated". In addition, it should be ensured that no conflicts of interest arise between the duties of non-executive members of the Board of Directors vis-à-vis the Bank and any other functions they may perform.

As far as functional independence is concerned, the statute of the Bank does not unambiguously reflect the primacy of maintaining price stability.

As far as financial independence is concerned, the power of the Minister for Finance to regulate the periodical determination and distribution of surplus income should be adapted with a safeguard clause that this may not impede the proper performance of ESCB-related tasks.

A draft law on the Central Bank of Ireland has been published. It provides for rules on the Bank's involvement in payment systems (e.g. oversight, realisation of collateral, netting, finality of payments), the collection of statistics and prudential supervision. It also introduces in effect the prohibition on public financing as contained in Article 104 of the Treaty in the Bank's statute. Furthermore, it provides for an obligation for the Bank's Governor to appear before a Select Committee of Dáil Eireann, prohibits the Governor from being a director of or holding shares in credit and financial institutions, and also fixes the term of office of directors at a standard period of five years. The draft legislation was submitted to the EMI for consultation on 25 March 1996

and the EMI delivered its opinion (CON/96/4) on 28 May 1996. In its opinion, the EMI took note of the fact that the above legislation is a step towards fulfilling the Treaty and Statute requirements for Stage Three and that further adaptations are under consideration.

Banca d'Italia

1. Legal basis

The statute of the Banca d'Italia is contained in Royal Decree No. 1067 of 11 June 1936 as amended. Other important provisions are the 1910 codified law on the Banks of Issue (Royal Decree No. 204 of 28 April 1910 as amended) and Title III of the 1936 Banking Law (Royal Decree Law No. 375 of 12 March 1936 as amended). The Bank is an institution ("istituto di diritto publico") the capital of which can only be owned by certain specific categories of credit institutions, social security institutions and insurance institutions. The Bank's structure reflects its original status as a joint stock company.

2. Organisational structure

The Bank is directed by the Governor, assisted by the General Manager and two Deputy General Managers, and administered by the Board of Directors and the Committee of the Board of Directors. Financial supervision is exercised by the Board of Auditors. A government inspector must take part in the meetings of the General Assembly and those of the Board of Directors.

The Governor is appointed by the Board of Directors acting by a qualified majority for an unlimited period of time; the appointment must then be approved by decree of the President of the Republic on a proposal by the President of the Council of Ministers and in agreement with the Minister of the Treasury, the Council of Ministers having been heard. The Governor can be dismissed by the Board of Directors following the same procedure and with the same majority. The statute of the Bank does not contain any grounds for dismissal. The Governor presents monetary policy objectives to be included in the Government's annual policy planning. The Governor is in charge of the conduct of monetary policy.

The General Manager is responsible for the ordinary administration of the Bank and for implementing the resolutions of the Board; in the performance of these tasks he/she is assisted by two Deputy General Managers. The General Manager and the two Deputy General Managers assist the Governor and act in his/her place when absent or prevented from performing his/her functions. They are appointed for an unlimited period of time and can be dismissed by the Board following the same procedure as in the case of the Governor.

The Board of Directors is composed of the Governor and thirteen independent members, one of whom is elected for each of the main branches of the Bank; they must neither be members of the Chambers, nor hold a political office, nor be administrators, agents, auditors, managers or employees of credit institutions. The members of the Board are elected for a renewable term of three years. No specific provision regarding their dismissal from office is included in the Bank's statute. The task of the Board is to administer the Bank; the Board does not have any powers with respect to monetary policy measures. The General Manager and the two Deputy General Managers also attend the meetings of the Board of Directors.

The Committee of the Board of Directors is composed of the Governor and four members of the Board, elected for a term of one year, renewable by the Board itself. It assists the Board in the administration of the Bank.

The Board of Auditors includes five auditors and two substitutes, nominated by the

General Assembly for a renewable term of three years. Besides controlling the administration of the Bank with regard to compatibility with laws, regulations and the statute, it votes on the budget as proposed by the Board of Directors and expresses its opinion on the distribution of the annual dividend.

3. Objectives and tasks

The Italian Constitution states that the Republic has a duty to protect savings, and this constitutional principle is understood, and applied by the Bank, as entailing the objective of price stability. No explicit reference to the objective of price stability is contained in the statutory provisions concerning the Banca d'Italia.

The main tasks of the Bank are the issue of banknotes (in agreement with the Government, insofar as their production is concerned); the conduct of monetary policy; the fixing of discount rates and compulsory reserves; the oversight of payment systems; the supervision of banks and other financial institutions; acting as fiscal agent for the Government; and managing official reserves jointly with the Ufficio italiano dei cambi.

4. Relations with political bodies

The Governor may be invited to appear before parliamentary commissions. With regard to relations with the Government, each year, within the framework of the adoption of the economic and financial programme, the Governor presents the objectives of monetary policy to be incorporated in the annual economic plan to the Government. Monetary policy actions are taken by the Bank with full autonomy. The Governor may be invited to meetings of the inter-ministerial committee for economic planning (CIPE).

The Treasury has supervisory powers over the issue of banknotes, and the administration and accounting of the Bank. The Minister of the Treasury has the power to suspend and annul only the deliberations of the General Assembly and of the Board which are contrary to laws, regulations or the statute of the Bank.

An Annual Report and other documents are published on a regular basis.

5. Inconsistencies with Treaty and Statute requirements and prospective changes to the Bank's statute

The statute and other provisions concerning the Bank contain a few inconsistencies with the Treaty and Statute requirements for central bank independence which require adaptation.

As far as institutional independence is concerned, the statutory power of the Minister of the Treasury to fix interest rates on certain interest-bearing current account deposits with the Bank (with the exception of those on compulsory reserves) requires adaptation. Also, the Governor's appearance before parliamentary commissions and attendance at meetings of the inter-ministerial committee for economic planning would need to respect the principles set out in Section 2.1 of Chapter II of this Report.

As far as functional independence is concerned, the statutory objective of the Bank does not unambiguously reflect the primacy of maintaining price stability.

Institut Monétaire Luxembourgeois

1. Legal basis

The statute of the Institut Monétaire Luxembourgeois (IML) is contained in the Law of 25 May 1983 establishing the Institut Monétaire Luxembourgeois as amended. The IML is a legal entity organised under public law whose capital is wholly owned by the State.

2. Organisational structure

The governing bodies of the IML are the Management and the Council.

The Management is a collegiate body, comprising the Director General and two Directors. They are appointed by the Grand-Duke on a proposal by the Council of Ministers for a renewable six-year term. The Management is the executive body of the IML, responsible for the fulfilment of the IML's objectives. If there is a fundamental disagreement between the Government and the Management on the IML's policy and the execution of its tasks, the Government, with the consent of the Council of the IML, may propose to the Grand-Duke the collective, and only the collective, dismissal of the Management. Without prejudice to this provision, members of the Management are not subject to instructions from political authorities.

The Council has seven members appointed by the Council of Ministers for renewable four-year terms. The Council provides guidelines and gives opinions on specified activities of the IML, and approves its annual accounts and yearly budget, but has no competence in the field of prudential supervision. The members of the Council are not subject to instructions from political authorities.

3. Objectives and tasks

Luxembourg is linked to Belgium in an economic union comprising a monetary association dating back to 1922. The IML, created in 1983, does not at this stage exercise all the attributes of a fully-fledged central bank, as the National Bank of Belgium currently performs a series of tasks for both members of the association.

The tasks of the IML are to issue banknotes and coins; promote the stability of the currency and, to that effect, oversee the proper functioning of financial markets; execute obligations and exercise rights resulting from international agreements in the monetary and financial field; and exercise the prudential supervision of the financial sector.

The "last word" in monetary and exchange rate policy decisions belongs to the Government, and the IML only avails itself of a limited number of monetary policy instruments. Although the IML has the authority to regulate the use of the banking system's franc-denominated liabilities, it has never used this facility.

4. Relations with political bodies

The Management of the IML has a statutory obligation to submit an Annual Report, financial accounts and a budget for the approval of the Government. These documents are forwarded to Parliament. The Government-appointed auditor of the IML also draws up an annual report which is submitted to the Council of the IML, the Government and Parliament. In addition, the Director General of the IML traditionally meets for a twice-yearly exchange of views with the Parliamentary Committee for Budgetary and Financial Matters.

5. Inconsistencies with Treaty and Statute requirements and prospective changes to the IML's statute

There are various inconsistencies in the statute of the IML with regard to the Treaty and Statute requirements for central bank independence which require adaptation.

As far as institutional independence is concerned, competence for monetary policy is vested in the Government rather than in the IML. This is incompatible with the Treaty and the Statute. Adaptations should acknowledge that competence for monetary policy in Stage Three is exclusively vested in the Governing Council of the ECB and that the IML will be an integral part of the ESCB. Furthermore, the status of the Management and the Council would need to be defined.

If the Council of the IML were to become the decision-making body with regard to ESCB-related tasks, the personal independence of its members would have to comply with the requirements of the Treaty and the Statute. In particular, the security of tenure of its members would need to be brought into line with Article 14.2 of the Statute, i.e. a five-year minimum period of office and no grounds for dismissal other than those mentioned in Article 14.2. In addition, it would need to be ensured that no conflicts of interest could arise between the duties of members of the Council vis-à-vis the IML and other functions they may perform. Moreover, the power of the Government to dismiss collectively the Management of the IML in the event of fundamental disagreement between the Government and the Management is incompatible with the grounds for dismissal listed in Article 14.2 of the Statute.

As far as functional independence is concerned, the statute of the IML does not unambiguously reflect the primacy of maintaining price stability.

As far as financial independence is concerned, the Government's power to discharge governing bodies of the IML from their responsibilities would need to be adapted with a safeguard clause in order to ensure that this power does not impede the proper performance of ESCB-related tasks. Furthermore, the appropriateness of the IML's financial means would have to be assessed in the light of the proper performance of ESCB-related tasks and the fulfilment of the IML's financial obligations towards the ECB.

Moving to the final stage of EMU will entail the dissolution of the monetary association with Belgium, with the Institut Monétaire Luxembourgeois taking over the full functions of the central bank of Luxembourg. A draft law on the Institut Monétaire Luxembourgeois and the Monetary Status of the Grand Duchy of Luxembourg was submitted to Parliament in December 1993, the enactment of which is still pending. The draft states in its "Exposé des Motifs" that its purpose is to implement all Treaty provisions concerning Stage Two and also to introduce some features of NCBs which are to be put in place before Stage Three. In accordance with the draft law, the principal objective of the IML will be to ensure price stability, while supporting the economic policy of the Luxembourg Government. A clear definition of the basic tasks of the IML is also given. These include the definition and implementation of monetary policy. The IML is to conduct its affairs in accordance with the principle of a market economy. However, the monetary association between Belgium and Luxembourg will remain unchanged during Stage Two. The draft declares that additional legislation will be required in due time for Stage Three. The draft law was submitted to the EMI for consultation on 18 February 1994 and the EMI delivered its opinion (CON/94/1) on 12 March 1994. An act aimed at the implementation of Article 104 of the Treaty, on which the EMI was consulted on 31 August 1995 and on which the EMI delivered its opinion on 5 October 1995 (CON/95/14), came into force on 1 January 1996.

De Nederlandsche Bank

1. Legal basis

The statute of De Nederlandsche Bank is contained in the Bank Act 1948 and its Articles of Association as amended. The Bank is a limited liability company ("Naamloze Vennootschap") organised under private law and is therefore also subject to general rules of company law, insofar as the application of such rules has not been explicitly excluded or would be incompatible with the Bank's special status, while at the same time certain laws governing public entities are also applicable to the Bank, which reflects the public nature of its main activities. The State is the only shareholder.

2. Organisational structure

The Governing Board and the Supervisory Board are the governing bodies of the Bank and the Bank Council is an advisory body.

The Governing Board consists of the President and the Secretary, as well as no less than two (the current number) and no more than five Executive Directors. They are nominated by a joint meeting of the Governing Board and the Supervisory Board, which presents nominations for appointments to the Crown. The latter takes a decision after the Cabinet has discussed the matter. All appointments are for a renewable seven-year term. Non-compliance with directions from the Minister of Finance (see Section 3) is a ground for dismissal, with no other grounds being explicitly mentioned in the statute of the Bank. All policy decisions of the Bank are made by the Governing Board, which is also fully responsible for the management of the Bank.

The Supervisory Board consists of twelve members, appointed by the Minister of Finance for a renewable term of four years. It supervises the Bank's business affairs and adopts the annual balance sheet and profit and loss account. A Royal Commissioner supervises the affairs of the Bank on behalf of the Government. The Royal Commissioner has the right to attend all meetings of the Bank's shareholders (i.e. the State), the Supervisory Board and all joint meetings of the Governing Board and the Supervisory Board (but not of the Governing Board itself) in an advisory capacity.

The Bank Council consists of sixteen members and the Royal Commissioner. Its role is to offer advice to the Bank and the Minister of Finance on matters of the Bank's policy. Four members are appointed by and from the members of the Supervisory Board. The other twelve are appointed by the Crown, and include financial experts and representatives of industry and labour.

3. Objectives and tasks

The statutory objective of the Bank is to safeguard the value of the currency. This is generally interpreted as implying the objective of maintaining price stability.

The Bank's main tasks are to issue banknotes; facilitate domestic and external money transfers; manage official reserves; and supervise banks and other financial institutions. The Bank was entrusted with the supervision of exchange offices by an Act of 15 December 1994. A draft of this Act was submitted to the EMI for consultation under Article 109f (6) of the Treaty and Article 5.3 of the EMI's Statute on 16 February 1994 and the EMI delivered its opinion (CON/94/2) on 16 March 1994.

The Bank has full freedom regarding the formulation and implementation of domestic monetary policy. As the Minister of Finance is responsible to Parliament for the conduct of monetary policy, regular consultation takes place between the Bank and the Minister.

In the event of major disagreement, the Minister of Finance has the authority to give such directions to the Governing Board as he/she deems necessary for the Bank's policy to be properly co-ordinated with the Government's monetary and financial policies. The Governing Board, however, can state its objections to these directions and appeal to the Crown. The Crown's decision can only be taken by the Council of Ministers meeting in plenary session. If it is decided that the Governing Board has to comply with the directions, the reasoned decision of the Crown, as well as the Bank's objections, are published in the official gazette. However, until now the Minister of Finance has never exercised this statutory right to give directions; this was intended by the legislator, and has continued to be considered by policy-makers, as an ultimate remedy only.

Participation in exchange rate arrangements as well as the acceptance of changes in central rates is determined by the Government, after consultation with the Bank. Within the constraints imposed by the EMS arrangement and with due respect to the bilateral agreement between the Netherlands and Germany on the fluctuation margins between the guilder and the Deutsche Mark, the Bank has full freedom in the formulation of the strategy with respect to exchange rate policy and in the use of instruments (interest rates, intervention, the fluctuation margin).

4. Relations with political bodies

There are no institutional statutory relations between the Bank and Parliament. The Minister of Finance is accountable to Parliament for the conduct of monetary policy. As required by the Bank Act, the Governing Board publishes a weekly summary balance sheet of the Bank. Furthermore, the Bank publishes an Annual Report (including the annual accounts) on its activities.

5. Inconsistencies with Treaty and Statute requirements and prospective changes to the Bank's statute

The statute of the Bank contains several inconsistencies with Treaty and Statute requirements for central bank independence which require adaptation.

As far as institutional independence is concerned, the right of the Minister of Finance to give instructions to the Bank is incompatible with the Treaty and Statute requirements for central bank independence. Abolition of this right may also necessitate a review of the supervisory role of the Royal Commissioner, which would seem to have become obsolete.

As far as personal independence is concerned, non-compliance with instructions from the Minister of Finance as a ground for dismissal is incompatible with the grounds for dismissal listed in Article 14.2 of the Statute.

As far as functional independence is concerned, the statute of the Bank does not unambiguously reflect the primacy of maintaining price stability.

In order to comply with the requirements of Article 108 of the Treaty, the Bank has initiated preparatory discussions with the Netherlands Ministry of Finance aimed at modernising the Bank Act 1948 and bringing it into line with the requirements for Stage Three of EMU, at the latest before the establishment of the ESCB. These discussions are currently at an advanced stage.

Oesterreichische Nationalbank

1. Legal basis

The statute of the Oesterreichische Nationalbank is contained in the National Bank Act 1984 of 20 January 1984 as amended. The Bank is a joint stock company with special status. Among the shareholders half of the capital is subscribed by the Republic.

2. Organisational structure

As a consequence of the Bank's legal form as a joint stock company with special status, the governing bodies of the Bank include the General Meeting of shareholders, the General Council and the Board of Executive Directors.

The General Meeting discharges the General Council and the Board of Executive Directors from responsibility for its administration during the preceding year, approves the annual statement of account, decides on the allocation of profits and elects six members of the General Council and four auditors. Only Austrian citizens or legal persons and enterprises having their seat in Austria may be shareholders. Half of the capital was subscribed initially (and is still held) by the Federal Republic, which then also decided on those persons and enterprises to be permitted to subscribe the remaining capital of the Bank.

The General Council decides on the general guidelines for monetary and credit policy, is charged with the supreme direction and supervision of the conduct of all the Bank's business, and gives its opinion on draft legislation. It consists of the President, two Vice Presidents and eleven other members, the latter performing this duty as an honorary office. The President is appointed by the President of the Republic on nomination by the Federal Government. The Vice Presidents, as well as the five other members not elected by the General Meeting, are appointed by the Federal Government. The term of office in all cases is a five-year period which can be renewed.

The Board of Executive Directors is responsible for the overall administration of the Bank and conducts the business of the Bank in accordance with the National Bank Act and the general guidelines set by the General Council. The Board of Executive Directors appoints the Bank's staff and represents the Bank both in courts of law and extrajudicially. It is composed of the Chief Executive Director, his/her deputy and up to four Executive Directors appointed by the General Council for a term of not more than five years.

The President can be dismissed by the President of the Republic if he/she ceases to meet the requirements set for his/her appointment or if he/she is prevented from performing his/her duties for more than a year.

3. Objectives and tasks

The Bank Act states that the Bank "shall ensure ... that the value of the Austrian currency is maintained with regard both to its domestic purchasing power and to its relationship with stable foreign currencies". This is interpreted as implying the objective of maintaining price stability. With regard to the credit policy of the Bank, due regard has to be given to the country's economic needs. Furthermore, the Bank Act states that "in determining the general lines of monetary and credit policy" to be followed by the Bank in this field, "due regard shall be paid to the economic policy of the Federal Government".

The Bank's monetary policy instruments comprise discount and lending transactions, open market operations, minimum reserve requirements, transactions in foreign bills and foreign exchange.

4. Relations with political bodies

The Bank has no reporting requirements to Parliament or other entities. With regard to relations with the Government, according to the Bank Act, the "Federal Minister of Finance shall see to it that the Bank acts in accordance with the law and shall appoint a State Commissioner and a deputy for the purpose of exercising this right of supervision". The State Commissioner is entitled to attend General Meetings and meetings of the General Council in an advisory capacity and to examine the conduct of the Bank's business. Finally, he/she has the right to raise objections against decisions of the General Council if he/she considers any such decision to be in conflict with existing legislation. Such an objection has suspensive effect and is examined by an Arbitration Tribunal regarding its substance if the objection is not revoked by the Federal Minister of Finance within seven days.

No person who is in the active service of the Republic, or of a Land, or who is a member of the Nationalrat, the Federal Council, a Parliament of a Land, the Federal Government or the Government of a Land may be a member of the General Council. Apart from the participation of the State Commissioner as described above, no right is foreseen for members of the Government to attend meetings of the decision-making bodies.

Finally, the Bank publishes an Annual Report and an annual statement of account as well as a weekly return.

5. Inconsistencies with Treaty and Statute requirements and prospective changes to the Bank's statute

The statute of the Bank contains several inconsistencies with Treaty and Statute requirements for central bank independence which require adaptation.

As far as institutional independence is concerned, the right of the State Commissioner to examine the legality of the Bank's acts - with the possibility of suspension and subsequent decision by the Federal Ministry of Finance or an Arbitration Tribunal - is not compatible with the Treaty and Statute requirements for central bank independence as far as ESCB-related tasks are concerned. Furthermore, the role or the composition of the General Council needs to be reviewed. The General Council is currently a decision-making body in monetary policy matters, whilst it is, at the same time, largely composed of representatives of various branches of industry who fulfil their duties towards the Bank on a non-exclusive basis. This combination of responsibility for monetary policy, on the one hand, and the representation of the interests of third parties, on the other, creates a potential for conflicts of interest and is, therefore, incompatible with Treaty and Statute requirements for central bank independence.

As far as personal independence is concerned, the statute of the Bank should be adapted in order to provide for a minimum five-year term of office for the members of the Board of Executive Directors.

As far as functional independence is concerned, the statute of the Bank does not unambiguously reflect the primacy of maintaining price stability.

For the time being, no prospective changes to the statute of the Bank have been notified to the EMI.

Banco de Portugal

1. Legal basis

The statute of the Banco de Portugal is contained in the Organic Law approved by Decree-Law No. 337/90 of 30 October 1990 amended by Decree-Law 231/95 of 12 September 1995 and by Law 3/96 of 5 February 1996. Article 105 of the Constitution refers to the Banco de Portugal.

2. Organisational structure

The Bank is managed by the Governor and the Board of Directors. It is supervised by the Board of Auditors and assisted by an Advisory Board.

The Governor is appointed for a renewable term of five years by the Government on a proposal by the Ministry of Finance. The Board of Directors includes the Governor, one or two Deputy Governors, and three to five members, all appointed by the Government on a proposal by the Ministry of Finance for a renewable term of five years. The Board manages the Bank. The Governor has a casting vote and the right to suspend Board decisions and submit them to the Government. Directors are subject to a strict regime of professional exclusivity. The statute of the Bank does not contain any provisions regarding the dismissal for the Governor or other members of the Board of Directors.

The Board of Auditors includes four members, three appointed by the Minister of Finance and one appointed by the Bank's employees, all for three-year renewable terms. The Board of Auditors monitors all the activities of the Bank, and one of its members must attend, without voting or vetoing rights, all meetings of the Board of Directors.

The Advisory Board includes representatives from the financial and economic sector and regions and has advisory functions.

3. Objectives and tasks

The primary objective of the Bank is to maintain price stability taking into account the general economic policy of the Government. Its main tasks are to conduct monetary policy; co-operate with the Government in the definition of the exchange rate policy and implement the latter; hold and manage the official reserves; act as intermediary in the State's international monetary relations; regulate, promote and supervise the payment systems; regulate and implement the regime for monetary, financial, foreign exchange and balance of payments statistics; and oversee the stability of the national financial system. In this latter respect the Bank has responsibility for banking supervision.

To implement monetary policy the Bank has full freedom in setting policy instruments. However, "Avisos" relating to some of the features of the reserve requirements framework and the discount rate (the latter not currently being in use for monetary policy purposes) are signed by the Minister of Finance and published in the Official Journal ("Diario de Republica").

The definition of the central exchange rate of the currency is the responsibility of the Government in co-operation with the Bank. The Bank is responsible for the management of the exchange rate within the fluctuation bands of the ERM.

4. Relations with public bodies

The annual budget of the Bank is forwarded to the Minister of Finance. The annual accounts are submitted, together with the opinion of the auditors, to the Minister of Finance for approval. The Bank is subject to the obligation to publish its accounts periodically. Recent legislation also introduced an obligation for the Governor to inform Parliament (through one of its Committees) about monetary policy matters following the publication of the Annual Report by the Bank.

5. Inconsistencies with Treaty and Statute requirements and prospective changes to the Bank's statute

The statute of the Bank contains a few inconsistencies with the Treaty and Statute requirements for central bank independence which require adaptation.

Notwithstanding the fact that its statute empowers the Bank to conduct monetary policy, the Minister of Finance signs the Bank's "Avisos" relating to some features of the reserve requirements framework and the discount rate. This is incompatible with the Treaty and Statute requirements for central bank independence. Furthermore, the need to submit to the Government the vetoes of the Governor suspending decisions of the Board of Directors may be seen as a form of seeking instructions which is incompatible with the Treaty and the Statute. Finally, an obligation for the Governor to inform Parliament about monetary policy issues should respect the principles set out in Section 2.1 of Chapter II of this Report. Adaptation of the Bank's competences may also necessitate a review of the supervisory role of the Board of Auditors in the light of independence and confidentiality requirements.

For the time being, no prospective changes to the Bank's statute have been notified to the EMI.

Suomen Pankki

1. Legal basis

The statute of the Bank is contained in the Constitution and in the Act on Suomen Pankki of 21 December 1925 as amended. The Bank is an institution organised under public law. The part of the Bank's profit which is not employed to increase the Bank's own funds may be transferred to the State following a decision of Parliament to that effect.

2. Organisational structure

The governing bodies are the Parliamentary Supervisory Council and the Board.

According to the Constitution, the Bank operates under the guarantee and the care of Parliament and is supervised by the Parliamentary Supervisory Council. The nine members of the Council are appointed for the entire parliamentary term by Parliament from among members of Parliament, although the law does not prevent persons other than members of Parliament from being appointed. The Council has a dual role: it is a supervisory authority and also a decision-making body which fixes the rates of interest applied by the Bank or their limits. In practice, these limits have been set sufficiently wide to allow the Board to decide on necessary monetary policy operations.

The Board of Suomen Pankki comprises the Governor, who is the Chairman, and a maximum of five members; all are appointed by the President of the Republic on a proposal by the Parliamentary Supervisory Council. The President is not bound to follow the proposal of the Council. The term of office of Board members is indefinite. There are no statutory provisions on dismissal. The Board has general decision-making powers; it decides on all matters which have not been expressly entrusted to the Council.

3. Objectives and tasks

The statutory objectives of the Bank are to maintain a stable and secure monetary system and to assist and facilitate the circulation of money in Finland. Thus, the Act on Suomen Pankki gives the Bank responsibility for pursuing the goal of monetary stability.

The Bank's main tasks include formulating and implementing monetary policy; holding and managing foreign currency reserves; and participating in the oversight of payment and financial systems. The Bank has the sole right to issue legal tender. The Bank is not fiscal agent for the Government. Other tasks are conferred on the Bank under specific legislative provisions.

The Financial Supervisory Authority functions administratively in connection with the Bank, but acts independently in its decision-making.

Monetary policy is determined independently by the Bank. The Act does not impose any requirement on the Bank to negotiate monetary policy decisions beforehand with the Government. The Minister of Finance may not attend meetings of the Board nor veto any monetary policy decisions taken by the Bank.

The Bank is independent in the use of its monetary policy instruments (open market operations, credit operations, minimum reserves).

The decision-making procedure regarding changes in the external value of the markka is defined in the Currency Act. Under the Currency Act, the Council of State (Government) takes decisions on the external value of the markka on a proposal by the Bank. The Parliamentary Supervisory Council decides whether to make such a

proposal on the basis of a proposal by the Board. The Government can then either approve the proposal as it stands or reject it.

If the fluctuation range has been determined for the Finnish markka, the Bank ensures that its external value remains within that range. Within that framework, the Bank has full freedom regarding its operations in the foreign exchange market. If a serious disturbance occurs in the foreign exchange market, the Bank is entitled to temporarily disregard the limits on the fluctuation range.

4. Relations with political bodies

The Parliamentary Supervisory Council supervises the administration and management of the Bank. The Council submits an annual report to the Parliamentary Economic Committee on the position, business and management of the Bank and on important matters dealt with by the Council during the year.

A balance sheet of the Bank is published four times a month. The annual accounts and accounting and administration are audited by five auditors, who are elected by Parliament. The Bank publishes an Annual Report.

5. Inconsistencies with the Treaty and Statute requirements and prospective changes to the Bank's statute

The statute of the Bank in its present form contains several inconsistencies with the Treaty and Statute requirements for central bank independence which require adaptation. These inconsistencies mainly concern, as far as institutional independence is concerned, the role of the Parliamentary Supervisory Council, and, as far as personal independence is concerned, the security of tenure of the Governor and other members of the Board. Furthermore, as far as functional independence is concerned, the statute of the Bank does not unambiguously reflect the primacy of maintaining price stability.

The Finnish legislative authorities and the Bank acknowledged the need for adaptations in the past and this resulted in draft legislation which was submitted for consultation to the EMI on 10 April 1996 and on which the EMI delivered its opinion on 13 May 1996 (CON/96/5). The draft legislation mainly concerns the neutralisation of the role of the Parliamentary Supervisory Council in monetary policy matters and an explicit reference to the minimum term of office for the Governor and the grounds for his/her dismissal as laid down in Article 14.2 of the Statute. This security of tenure should be extended to the other members of the Bank's Board as well. The draft legislation also aims to incorporate in the Bank's statute the prohibition on public financing laid down in Article 104 of the Treaty. The EMI noted in its opinion that the draft legislation is a step towards the fulfilment of the Treaty and Statute requirements for Stage Three and that further adaptations will be necessary for participation in Monetary Union. In this connection, Finland has already changed its Currency Act (358/93) in order to allow for its participation in the Exchange Rate Mechanism of the European Monetary System. Draft legislation to this effect was submitted to the EMI for consultation on 9 November 1995 and the EMI delivered its opinion on 11 December 1995 (CON/95/16). As of 14 October 1996, Finland participates in the exchange rate mechanism of the European Monetary System. Finally, the constitutional provision establishing the markka as the lawful currency of Finland will need to be reviewed in the light of the introduction of the euro.

Sveriges Riksbank

1. Legal basis

The statute of the Bank is contained in the Constitution, the Riksdag Act and the Sveriges Riksbank Act (1988:1385) as amended. The Bank is an institution organised under public law, whose capital is wholly owned by the State.

2. Organisational structure

The Riksbank is administered by a Governing Board with eight members. Seven of these are elected directly by Parliament (the Riksdag) for periods coinciding with the parliamentary term, which is normally four years. The eighth member is the Governor, who is elected by the other seven for a five-year term. Terms are renewable. Parliament may dismiss members of the Governing Board by refusing to discharge them from their responsibility for the administration of the Bank. The Governor may be dismissed by the other members of the Governing Board with no grounds being stated. The Governing Board is responsible for all decisions of major importance, but, apart from the Governor, Board members take no part in the day-to-day management of the Bank. Members of the Governing Board may not be members of the Cabinet or of the Board of Directors of a credit institution.

3. Objectives and tasks

The Swedish Constitution makes the Riksbank responsible for all matters of exchange rate and monetary policy. There is no statutory objective for monetary policy, but the Bank follows an inflation target which is compatible with the objective of maintaining price stability.

The Constitution also states that the Bank shall promote a safe and efficient payment system. This is reflected in the Riksbank Act, inter alia in rules mandating the Bank to act as lender of last resort to financial institutions which are under the supervision of the Financial Supervisory Authority. The Constitution assigns the Bank the sole right to issue banknotes and coins.

In addition to the tasks directly related to the constitutional mandate, the Riksbank Act states that the Bank shall receive and make payments for the Government. The Bank is not responsible for bank supervision.

The Bank has full responsibility for the formulation and implementation of monetary policy. The Riksbank Act specifies the available policy instruments, but the use of these instruments is determined exclusively by the Bank. Prior to taking decisions of major importance, the Bank must consult the Minister of Finance, but the latter does not have any powers to veto or delay a decision by the Bank. Consequently, the Bank is independent with regard to its goals and the instruments it uses to achieve them.

The rules for exchange rate policy are the same as those for monetary policy, i.e. the Bank has authority to decide on all matters of exchange rate policy, including the choice of the exchange rate regime and, under fixed exchange rates, the central parity rate. The Bank holds and manages the foreign exchange reserves.

The Bank can oblige financial institutions which are under the supervision of the Financial Supervisory Authority to provide the Bank with statistics that it considers necessary.

4. Relations with political bodies

The Bank is responsible to the Riksdag. This means, for example, that the Riksdag annually determines whether to discharge the Governing Board from responsibility for its administration during the preceding year. The Bank has a statutory obligation to submit an Annual Report on the administration of the Bank to Parliament and to the Parliamentary Auditors. The Riksbank's profit and loss account and balance sheet at the end of the financial year are approved by Parliament. The Bank's budget is decided by the Governing Board, giving the Bank budgetary independence.

In addition, the Governor appears before hearings of the Riksdag's Finance Committee three or four times a year at which information is given on the monetary situation. Recently, some of these hearings have been open to the public.

5. Inconsistencies with the Treaty and Statute requirements and prospective changes to the Bank's statute

There are several inconsistencies in the Swedish Constitution and the Bank's statute with Treaty and Statute requirements for central bank independence which require adaptation.

As far as institutional independence is concerned, an obligation for the Bank to consult the Minister of Finance on decisions of major importance provides for an explicit statutory mechanism to influence such decisions, thus infringing the requirement of central bank independence.

As far as personal independence is concerned, the minimum term of office of five years should extend to all members of the Governing Board. Also, grounds for dismissal should be brought into line with those mentioned in Article 14.2, and the refusal to discharge members of the Governing Council from their responsibility for the administration of the Bank, as contained in the Swedish Constitution, on grounds other than serious misconduct must not jeopardise the independence of members of the Bank's decision-making bodies. The same applies to the grounds for dismissal of the Governor. Moreover, if members of Parliament are appointed as members of the Bank's Governing Board, there is a clear potential for conflicts of interest between their duties vis-à-vis the Bank and the interests of their electorate. Simultaneous membership of Parliament and the Governing Board is therefore deemed to be incompatible with the principle of central bank independence.* Along the same lines, the status of non-parliamentary members of the Governing Board needs to be scrutinised with regard to potential conflicts of interest.

As far as functional independence is concerned, the statute of the Bank does not unambiguously reflect the primacy of maintaining price stability.

Legislation in order to comply with the requirements of the Treaty with a view to Stage Three of EMU will be proposed during the current legislative period. Amendments to the Constitution cannot enter into force before 1 January 1999 as such amendments require the endorsement of two consecutive Parliaments.

* *Sveriges Riksbank is of the opinion that membership of Parliament does not in itself entail conflicts of interest and is therefore not incompatible with simultaneous membership of the Bank's Governing Board.*

Bank of England

1. Legal basis

The Bank of England was originally formed as a corporation incorporated by Royal Charter in 1694. As a corporation, the Bank has powers to own property, has issued capital and can sue and be sued in its own name. Subsequently, much of the original Royal Charter was replaced by a further Royal Charter in 1946 together with the Bank of England Act 1946. The 1946 Act had the effect of nationalising the Bank, by transferring its capital to the Treasury.

2. Organisational structure

The governing body of the Bank is the Court of Directors, which is responsible for managing the Bank's affairs and its internal administration. The Court of Directors consists of the Governor, the Deputy Governor and sixteen Directors, up to four of whom may have executive responsibilities within the Bank. The Governor, Deputy Governor and the executive Directors are required to render their exclusive service to the Bank. The non-executive Directors are not placed under any such obligation.

The Governor, Deputy Governor and Directors are appointed by the Crown on the advice of the Prime Minister. The Governor and the Deputy Governor are appointed for renewable five-year terms, and Directors for renewable four-year terms. A Governor may be dismissed during his/her period of office under certain, specified conditions.

Members of the Court of Directors are not individually subject to instructions from political authorities. However, the Treasury has the legal power to issue "directions" to the Bank "in the public interest" after consultation with the Governor, although this power has never formally been invoked.

3. Objectives and tasks

There are no explicit statutory objectives in the monetary policy field. The Banking Act 1987 gives the Bank, in its role as banking supervisor, the objective of protecting the interests of depositors. The Bank's overall objectives, in practice, are to maintain the integrity and the value of the currency; maintain the stability of the financial system, both domestic and international; and seek to ensure the effectiveness of the United Kingdom's financial services.

The main tasks of the Bank are to formulate advice on monetary policy; implement monetary policy; issue the currency; manage official reserves; supervise banks; and promote sound and efficient payment and settlement systems.

Monetary policy is determined with reference to the Government's target for retail price inflation. Monetary policy is effected through short-term interest rates, the Bank being responsible for advising on the appropriate interest rate level which will be required to achieve the inflation target. The Bank's advice is made known through the publication - two weeks after the subsequent meeting - of the minutes of regular (usually monthly) meetings on monetary policy between the Governor and the Chancellor of the Exchequer.

In the light of the advice received from the Governor, the Chancellor takes decisions on any changes to the interest rate. The precise timing of such changes is now delegated to the Bank. Interest rate objectives are pursued through the Bank's daily money market operations.

The Bank acts as fiscal agent for the Government.

Foreign exchange market activities are conducted by the Bank as agent for the Government, which owns the foreign exchange reserves. In carrying out this function, the Bank operates within guidelines set by the Treasury.

4. Relations with political bodies

The Bank presents an Annual Report to Parliament containing its accounts for the previous year. It also presents a second Annual Report to Parliament describing its conduct of banking supervision. In addition, the Bank publishes a quarterly Inflation Report, which describes progress towards achieving the Government's inflation target and the Bank's views on the future prospects for inflation. The Governor frequently appears before Committees of Parliament. Formally, however, the Chancellor of the Exchequer, or another Treasury Minister, answers for the Bank in Parliament.

As part of the monetary framework, which was adopted after the United Kingdom left the exchange rate mechanism of the European Monetary System, a number of measures have been taken to make the monetary policy process more transparent to the public. As noted above, these include the announcement of a quantitative Government target for inflation, the publication of a quarterly Inflation Report by the Bank, and the publication of the minutes of the regular meetings on interest rate policy between the Chancellor and the Governor. In addition, the Treasury publishes a monthly compendium of data relevant to monetary policy.

5. Inconsistencies with Treaty and Statute requirements and prospective changes to the Bank's statute

The statute of the Bank does not comply with the Treaty requirements for central bank independence and would need to be adapted if the United Kingdom were to decide to participate in Monetary Union.

As far as institutional independence is concerned, it is noted that competence for monetary policy is vested in the Government rather than in the Bank. This would be incompatible with the Treaty and Statute if the United Kingdom were to adopt the single currency. Adaptations would need to acknowledge that competence for monetary policy in participating Member States is exclusively vested in the Governing Council of the ECB and that the Bank would be an integral part of the ESCB. Such adaptations would have implications for all the provisions in the statute of the Bank which determine the relationship between the Bank and the Government, such as the power of the Treasury to issue directions to the Bank and the Bank's advisory role in the conduct of monetary policy. In addition, the appearance of the Governor before Committees of Parliament would need to respect the principles set out in Section 2.1 of Chapter II of this Report. This would also apply to other measures which are designed to make the Bank's policy transparent to the general public.

As far as functional independence is concerned, the statutory objective of the Bank does not unambiguously reflect the primacy of maintaining price stability.

No changes have been made to date and no prospective legislative changes have been notified to the EMI.