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REPORT ON CONVERGENCE IN THE EUROPEAN UNION

IN 1996

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

(presented by the Commission)

CONTENTS

TABLES:

GRAPHS:

1. INTRODUCTION

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

These reports are the first steps of the procedure set out in Article 109j which leads to the Council, meeting in the composition of the Heads of State or Government, deciding for the first time, not later than 31 December 1996, whether a majority of the Member States fulfils the necessary conditions for the adoption of a single currency and whether it is appropriate for the Community to enter the third stage.

In practice it has been clear for some time that, despite the considerable progress made by Member States with all aspects of convergence and with other preparations for EMU, a majority of Member States has not yet achieved a sufficiently high degree of sustainable convergence. This is notably because many Member States have not yet reached a satisfactory situation as regards the sustainability of the government financial situation. The European Council in Madrid in December 1995 already came to the conclusion that conditions would not be appropriate for an early start to the third stage but confirmed that the third stage of EMU would indeed begin on 1 January 1999. This agreement on the starting date was reiterated by the European Council in Florence in June 1996. The decisions about which Member States will be in the first group adopting the single currency will be made as early as possible in 1998.

The role of the present report, apart from meeting the formal requirements of the Treaty, is thus, first, to examine the current state of convergence and of the compatibility of national legislation with Treaty obligations and, second, to review the progress that has been made since the beginning of stage two of EMU on 1 January 1994.

The structure of the report follows that established by Article 109j(1). Chapter 2 examines the compatibility between each Member State's national legislation (including the statutes of its national central bank) and Articles 107 and 108 of the Treaty and the Statute of the ESCB. The following four chapters (Chapters 3-6) examine in turn the convergence performance of the Member States in relation to each of the four criteria, concerning price stability, the government budgetary position, exchange rates and long-term interest rates. Chapter 7 looks at developments in several other areas that are to be taken account of in the Commission and EMI reports: development of the ECU, the results of the integration of markets, the balances of payments on current account, and unit labour costs and other price indices. A final chapter (Chapter 8) summarises the conclusions of the report.

According to the Edinburgh agreement, Denmark has announced that it will not participate in the third stage of EMU, but that it remains fully committed to taking part in economic and monetary cooperation during the second stage of EMU. With this in mind, developments in Denmark have been included in this report.

Similarly, although the United Kingdom has notified the Council, in accordance with paragraph 1 of Protocol No 11, that it does not intend to move to the third stage in 1997, it might do so later and developments in the United Kingdom have also been included in this report.

On the basis of this report and that of the EMI the Commission is separately submitting to the Council a recommendation for the assessment by the Council in accordance with Article 109j(2).

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

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

The present chapter is devoted to this examination. The first section summarizes adaptations of national law since the signing of the Treaty on European Union in February 1992. The second section includes a recapitulation of the relevant provisions of the Treaty and the ESCB Statute. The third section summarizes the results of a review of national central bank legislation in the light of these provisions; it indicates types of provisions which are still found to be incompatible with the requirements of the Treaty or the Statute and which are expected to be changed before the establishment of the ESCB. The fourth section indicates legislative reforms which are at present planned in the perspective of the third stage.

2.1 Adaptation of national law since the signing of the Treaty

Since the signing of the Treaty on European Union and its entry into force, statutes of many national central banks (NCBs) have been adapted in order to comply with the Treaty.

Some of these changes aimed at ensuring compliance with Article 104 which prohibits central bank credit to the public sector and with Article 104a which prohibits the granting of privileged access by governmental or public bodies to financial institutions. These rules are in force since the beginning of the second stage. Member States have adapted their regulatory framework in a satisfactory manner to these requirements, so that no significant difficulties have occured.

The statute of the Banque de France was amended in 1993. The responsibility for the formulation and the implementation of monetary policy has been vested in a "Monetary Policy Council", which must not seek or accept instructions from the government or any other body, whilst a "General Council" carries out all other management responsibilities at the bank. Furthermore, the objective of the bank to ensure price stability has been redefined.

The legal regime of the Banco de España was adapted in 1994. The law established price stability as the primary objective of monetary policy which is to be defined and implemented by the bank. Neither the government nor any other public authority may give instructions to the bank regarding either the objectives or the implementation of monetary policy.

In Belgium, an amendment in 1993 restricted opposition and suspension rights of the Government Commissioner and the Minister of Finance in matters concerning the

definition and implementation of monetary policy, the conduct of foreign exchange operations, the holding and management of official foreign reserves and the promotion of the smooth operation of payment systems.

In Italy, the authority to determine the discount rates has been transferred from the Minister of the Treasury to the Governor of the Banca d'Italia in 1992. Furthermore, the Banca d'Italia has been given the responsibility for setting reserve requirements within certain limits and for overseeing payment systems.

In Portugal, the amendments of the law on the Banco de Portugal were adopted in 1995. The law, inter alia, redefined the primary objective of the bank, i.e. to maintain price stability, taking into account the overall economic policy of the government.

2.2 Recapitulation of relevant provisions of the Treaty and the ESCB Statute

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

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

Article 108 of the Treaty obliges Member States to adapt national legislation in accordance with the requirements of EMU:

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

The article refers to the compatibility of national legislation with the Treaty's provisions in general. This includes compatibility with Article 105(1) of the Treaty which defines the objectives of the ESCB, the first two sentences of which read as follows:

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

The Statute of the ESCB[1] includes in its Article 14.2 rules on the security of tenure:

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[1] See Protocol (No 3) of the Treaty.

"The statutes of the national central banks shall, in particular, provide that the term of office of a Governor of a national central bank shall be no less than five years.

A Governor may be relieved from office only if he no longer fulfils the conditions required for the performance of his duties or if he has been guilty of serious misconduct..."

By each of these four provisions, limits are put on national central bank legislation:

- The prohibitions and obligations formulated in Article 107 apply equally to both the ECB and the NCBs in so far as the performance of ESCB-related tasks is concerned. While the prohibitions formulated in the first sentence of Article 107 are addressed to the NCBs and to their decision-making bodies, it appears that rights of third parties to give instructions in some form or other are incompatible with the prohibitions. Furthermore, any national provisions of which the purpose or effect is for the government to seek to influence the members of the decision-making bodies of the NCB in the performance of their tasks therefore need to be brought in line with the second sentence of Article 107. The term "decision-making bodies" should be understood to mean any organ of an NCB whose decisions may have an impact on the fulfilment of its ESCB-related tasks.

- The primary objective formulated in Article 105(1) is assigned to the ESCB, which according to Article 1.2 of the Statute is composed of the ECB and the NCBs. Therefore, the objective of each member of the ESCB must be compatible with Article 105(1).

- Article 14.2 of the ESCB Statute is exclusively addressed to NCBs; non-compliance with the limits set therein will require adaptations of national law.

- Apart from these specific provisions in the Treaty and the Statute which require compatibility, there are likely to exist a number of national provisions - often of a technical nature - which may prove to be at odds with the prerogatives of the ECB vis-à-vis NCBs and which should be eliminated so that the new compatible provisions 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 initially or with a special status.

It is worth recalling some provisions which refer to the time-frame for any adjustments of national law and to the geographical coverage of the respective rules. Right from its establishment in early 1998, the ECB will have to take decisions which predetermine the conduct of its monetary policy as from 1 January 1999. Article 108 therefore stipulates that compatibility shall be achieved at this date at the latest. Besides, Article 109e(5) calls upon Member States, as appropriate, to start the process leading to the independence of its central bank during the second stage.

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 NCBs' statutes, the Treaty does not make a distinction between Member States with or without a derogation (see Article 109k(3) of the Treaty).

Denmark will be treated as a Member State with a derogation (Article 2, Protocol No 12). Its central bank statute will therefore have to be compatible with Articles 107 and 108.

In the event that the United Kingdom will not participate in Stage Three, Article 2, Protocol No 11 will exempt the United Kingdom from the application of Articles 107 and 108 of the Treaty. Given the formulation of Article 109e(5), until it notifies that it intends to move to the third stage, the United Kingdom is therefore exempted from the obligation to start the process leading to the independence of its central bank.

It is made clear in Article 107 that the requirements for compatibility with the Treaty and the Statute are limited to ESCB-related tasks. Among these are the basic tasks, laid down in Article 105(2) of the Treaty and Article 3.1 of the Statute, which are to define and implement the monetary policy of the Community, to conduct foreign exchange operations consistent with the provisions of Article 109 of the Treaty, to hold and manage the official foreign reserves of the Member States and to promote the smooth operation of payment systems.

2.3. Review of national legislation

Central bank statutes reflect different national traditions and institutional frameworks and vary significantly between Member States with respect to many of their characteristics like the legal form of the central bank, the definition of its objectives and tasks, monetary policy instruments, relations with the national parliament and socio-economic groups, the structure and composition of decision-making bodies, and financial rules. Taking Articles 105 and 107 of the Treaty and Article 14.2 of the ESCB Statute as benchmarks, a review of present legislation in the Member States leads to the following conclusion: Many characteristics of national legislation are within the limits drawn by EC law. However, in a number of cases adaptations are called for. Legislative initiatives for such adaptations have reached an advanced stage in several Member States (see section 2.4).

In a few Member States, legislation allows other bodies to give instructions to the central bank in matters of monetary policy. This is incompatible with the requirements in the third stage of EMU.

In many Member States, other legislative provisions are in force the effect of which may come close to the right of third parties to give straightforward instructions. Such provisions include a right of other bodies to interfere in a decision taken by the ECB, a right to participate in the voting on monetary policy, a right to be consulted before the central bank takes a decision, insufficient financial autonomy of the central bank, or membership in decision-making bodies of the central bank and in bodies outside the ESCB. In some cases, the borderline between compatible and non-compatible provisions is difficult to draw; however, it is clear that most of the existing provisions of this type need to be amended.

In a few Member States, the provisions on the security of tenure for the Governor are not compatible with the provisions of Article 14.2 of the ESCB Statute.

The box on "Review of central bank legislation: some illustrative cases" provides examples of provisions in national legislation which serve to illustrate the issues at stake.

2.4 Current legislative initiatives

In Ireland, Luxembourg, the Netherlands, Finland and - with a more substantial revision than in 1993 - in Belgium, preparatory work on amendments to national legislation concerning central banking is well under way.

In Ireland, draft legislation on the Central Bank of Ireland includes provisions on the Bank's involvement in payment systems, the collection of statistics, prudential supervision and the position of the members of decision-making bodies, including the term of office of Directors, which is fixed at five years.

In Luxembourg, a draft law on the Institut Monétaire Luxembourgeois and the monetary status of Luxembourg was submitted to Parliament in December 1993. The law which is still pending covers inter alia the IML's objectives and tasks.

In the Netherlands, discussions between the Ministry of Finance and the Nederlandsche Bank with a view to adapting the central bank legislation to the requirements of EMU have reached an advanced stage.

In Finland, draft legislation in particular addresses the future role of the Parliamentary Supervisory Council in monetary policy, the minimum term of office for the Governor and the grounds for dismissal.

In Belgium, the government is planning to propose a comprehensive reform of central bank legislation in the near future. The draft law aims at compatibility between the Treaty and the ESCB Statute on the one side and the statute of the National Bank of Belgium on the other.

REVIEW OF CENTRAL BANK LEGISLATION: SOME ILLUSTRATIVE CASES

Compliance with Article 107 of the Treaty

The following rights of third parties seem to be at odds with or to impinge upon the prohibitions and commitments formulated in Article 107:

a. A general right to give instructions

Provisions which subordinate NCBs to instructions are in contradiction with their obligation not to seek or take instructions.

Section 4 of the Bank of England Act[2]

"The Treasury may from time to time give such directions to the Bank as, after consultation with the Governor of the Bank, they think necessary in the public interest."

The right to give such instructions is also incompatible with the Treaty, when the central bank may object but eventually can be defeated.

Article 26 of De Nederlandsche Bank Act

"1. The Minister may, after consultation with the Bank Council, give such directions to the Governing Board as he thinks necessary for the Bank's policy to be properly co-ordinated with the Government's monetary and financial policies. Except as provided in paragraph 2 below, the Governing Board shall comply with such directions.

2. If the Governing Board has any objections to the directions as referred to in paragraph 1 above, it may communicate said objections to the Crown in writing within three days of receiving directions. The Crown shall decide whether or not the directions are to be complied with.

3. (...)

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[2] As already indicated, the provisions of Protocol No 11 exempt the United Kingdom from the application of Article 107, unless the United Kingdom notifies that it intends to move to the third stage.

4. If the Crown decides that the directions are to be complied with, the Governing Board's objections and the decisions of the Crown shall be published in the Nederlandsche Staatscourant, if in the opinion of the Crown this is not contrary to the national interest."

Article 15 of the Act on the Bank of Finland

"The administration of the Bank and management of the affairs thereof shall be under the surveillance of the Parliamentary Supervisory Board in accordance with this Act and the Regulations confirmed by Parliament"

Article 17 of the same Act

"It is the duty of the Parliamentary Supervisory Board to fix the base rate of the bank and other rates of interest applied by the bank and the limits thereof".

b. A right to approve, suspend, annul or defer a NCB's decision

Any such provisions constitute a right to give instructions of a specific type; the assessment is the same as for generally formulated rights to give instructions.

Article 13(2) of the Bundesbank Act

"The members of the Federal Cabinet are entitled to attend the meetings of the Central Bank Council. They have no right to vote, but may propose motions. At their request, a decision shall be deferred for up to two weeks."

c. A right to censor decisions on legal grounds

A right of the Government to control the legality of decisions of a central bank seems incompatible with Article 107. This also applies when the Government's right can only be exerted indirectly.

Article 43 of the Organic Law of the Banco de Portugal

"1. The Governor shall have a casting vote at the meeting which he chairs and may suspend the effectiveness of the decisions taken by the Board of Directors or by executive committees which, in his judgement , are contrary to the law, to the interests of the country or of the bank.

2. The suspension shall be notified to the Government, through the Finance Minister, and shall be considered waived, should the Cabinet not confirm it within fifteen days after its imposition."

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

A right of third parties to vote in decisions related to the tasks of the ESCB as defined in Article 105(2) is inconsistent with their commitment not to seek to influence such decisions.

Article 14 of the Central Bank Act of Ireland

"The Bank shall be conducted and managed in accordance with this Act by a Board of Directors consisting of (a) a Governor and (b) such number of other Directors (not exceeding nine and not including at any time more than two service Directors) as the Minister shall from time to time determine.... Every service Director shall hold office at the pleasure of the Minister and may be removed by the Minister at any time."

e. A right to be consulted before a NCB takes a decision

Article 107 of the Treaty does not, of course, preclude cooperation and dialogue between NCBs and government, parliament or other state bodies. In fact the Treaty provides for such contacts and reporting in a number of provisions. The point is whether the government avails itself of any formal mechanism of which the purpose is to influence the final decision of the NCB. An explicit duty to consult political bodies prior to the decision provides for such a mechanism and appears not to be compatible with the second sentence of Article 107.

Article 42 of Sveriges Riksbank Act

" Prior to the Riksbank making a monetary policy decision of major importance, the Cabinet Minister appointed by the Government shall be consulted. If such consultation is not possible and there is exceptional cause, the Riksbank may make such a decision without consultation."

f. A right to control ex ante the central bank's budget

As for the previous point, the borderline between constraints to which NCBs must be subjected and attempts to influence the members of their decision-making bodies in the performance of their tasks is not easy to draw in each case. A NCB must, of course, be financially accountable. On the other hand, a requirement to have its budget approved beforehand may create a situation where a NCB is unable to avail itself autonomously of the appropriate means to fulfil its mandate.

Article 4.2 of the Law of Autonomy of the Banco de España

"The Bank's draft budget for operating expenses and investments, once approved by its Governing Council according to Article 21.1g), shall be submitted to the Government, which will send it to the Spanish parliament for approval. The Bank's budget shall be estimative in nature, and shall not be consolidated with other state public sector budgets."

g. Membership of members of decision-making bodies in bodies outside the ESCB

Membership in external bodies may entail conflicts of interests between the duties vis-à-vis a NCB (for Governors additionally vis-à-vis the ECB) and the external function. However, it appears to be difficult to establish a general rule with respect to compliance or non-compliance of such membership with Article 107. The point in question is whether the member of the NCB body executes other tasks which might jeopardise his personal independence.

Article 22 of the Österreichische Nationalbank Act

"(3) Only persons holding Austrian citizenship who are not debarred from being elected to the National Council (Nationalrat) may be members of the General Council. The members of the General Council shall be persons prominent in some branch of economic activity or jurists or economists. They shall include representatives of:
1. banks;
2. industry;
3. trade and small businesses;
4. agriculture; and
5. salaried employees and wage-earners.

(4) No person who is in the active service of the Federal Republic or a Land or who is a member of the Nationalrat, the Federal Government or the government of a Land may be a member of the General Council. The restriction with regard to persons in the active service of the Federal Republic shall not apply to university professors in law and economics. Not more than four members of the General Council may in their main occupation be a member of the management of banks; such persons may not be a President or Vice President of the Bank."

Compliance with Article 14.2 of the ESCB Statute

In Article 14.2 of the Statute, the security of tenure for Governors is addressed under the aspect of their term of office and the grounds for their dismissal.

a. Term of office for Governors

Article 14.2 of the Statute requires a minimum term of office for Governors, i.e. five years. Consequently, statutes with a shorter term of office need to be revised.

Statutes which do not explicitly provide for a minimum term of office meet the minimum term requirement, provided that the grounds for dismissal are limited to the cases specified in the second sub-paragraph of Article 14.2 of the Statute (see below).

Article 29 of the statutes of the Bank of Greece

"The Governor and the Deputy Governors (...) shall be appointed (...) by an Act of the Cabinet, for a period of four years on proposal of the Board of Directors of the Bank (...)."

The statute of the Banca d'Italia is silent about the term of office of the Governor and about grounds for dismissal.

Article 19 of the Statute of the Banca d'Italia

"The Board of Directors may appoint and dismiss the Governor, the General Manager and the two Deputy General Managers."

Article 7(3) of the Bundesbank Act

"The President, the Vice-President and the other members of the Directorate are nominated by the Federal Cabinet and appointed by the President of the Federal Republic. Before making such nominations, the Federal Cabinet shall consult the Central Bank Council. Members of the Directorate are appointed for eight years, or in exceptional cases for a shorter term of office, but not less than two years."

b. Grounds for dismissal of a Governor

Article 14.2 of the Statute seeks to avoid the arbitrary dismissal of the Governor by the authorities involved in the appointment procedure. As in this case the Statute contains an explicit requirement on the content of national legislation, any contradictory provision would have to be amended.

Article 12(3) of the Act on the establishment of the Institut Monétaire Luxembourgeois

"The Government may propose to the Grand-Duke the dismissal of the Management if there is a fundamental disagreement between the Government and the Management over the policy of the Institut and the performance of its tasks. In this event, the proposal of dismissal shall relate to the Management collectively. Likewise, the Government may propose to the Grand-Duke the dismissal of a member of the Management who becomes permanently unable to perform his duties. Before transmitting a proposal to the Grand-Duke, the Government shall consult the Council of the Institut."

Article 44 of the Statutes of the National Bank of Belgium

"The governor is appointed and can be dismissed or suspended by the King."

Compliance with Article 105 of the Treaty

The requirement that the objectives of all members of the ESCB must coincide with Article 105(1) does not imply the need to copy in all instances the wording of this paragraph into national statutes. In fact, the formulation of a central bank's objectives is quite disparate among Member States. This to some extent reflects the fact that central bank statutes date from different decades. However, any formulation must avoid casting doubt as to whether the bank in question is bound by the primary objective as laid down in the Treaty.

Article 1 Act n.116 on Danmarks Nationalbank[3]

"Danmarks Nationalbank shall have the object to maintain a safe and secure currency system in this country, and to facilitate and regulate the traffic in money and the extension of credit."

[3] Since Denmark has notified the Council that it will not participate in the third stage, there is no need to adapt the statute of Danmarks Nationalbank in this respect.

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

According to Article 14.3 of the Statute, national central banks are an integral part of the ESCB and shall act in accordance with the guidelines and instructions of the ECB. The scope of necessary adaptations of national law - either in central bank statutes or in other parts of law - which this principle implies will emerge more clearly in the process of preparatory work for the ECB's regulatory framework. It is obvious that national peculiarities may continue to exist to the extent that the effectiveness and uniformity of the single monetary policy are not affected.

An example where national statutory provisions do not respect the prerogatives of the ECB are rules which provide for competencies of government bodies in the process of issuing banknotes.

3. PRICE STABILITY

3.1 Treaty provisions

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

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

National consumer price indices (CPIs) diverge substantially in terms of concepts, methods and practices. Thus, to meet the requirement of Protocol No 6 that inflation must be measured on a comparable basis, the Council adopted on 23 October 1995 a framework Regulation (No 2494/95) which provides for a harmonisation of national CPIs in two steps.

The first step required for the purpose of the report referred to in Article 109j(1), i.e. the present document, was the production by March 1996 of a set of so-called "interim indices of consumer prices" (IICPs), adjusted to reduce differences in coverage of goods and services observed between existing national indices.

The monthly IICPs have been published as from January 1996 with the time series going back to January 1994. As a first step in the harmonisation process, IICPs exclude those categories of the national indices for which existing practices differ most markedly across Member States. As such, IICPs do not include imputed rents of owner-occupied housing, health and educational services, and various other items like mortgage interest payments, financial services, insurance, package holidays and certain local authority services. On the other hand, IICPs incorporate some components, such as prices of alcohol and tobacco, which are excluded from the national CPIs in some Member States. Though not strictly comparable, IICPs are for the time being considered to constitute a more comparable basis for the assessment of inflation convergence among Member States than the national CPIs.

The second step, scheduled for January 1997, will be the launch of comparable harmonised indices (HICPs) based on common definitions and methods such as the use of a common coverage of goods and services for all Member States and harmonisation of the reference period, standards for sampling, frequency of updating weights, demographic and geographical coverage, etc.

3.2 Price stability as assessed by the IICPs

3.2.1 Recent trends

The time series for the IICPs are available only from January 1994. As a result, the analysis of the inflation trend based on this index cannot start before January 1995. Since early 1995, a general tendency towards lower and more convergent inflation has prevailed. Inflation in the Community as a whole as measured by the IICP (percentage change on a year earlier) stood at 2.8% in January 1995 and declined to 2.4% in September 1996. This figure is historically low and not far from what could be called price stability.

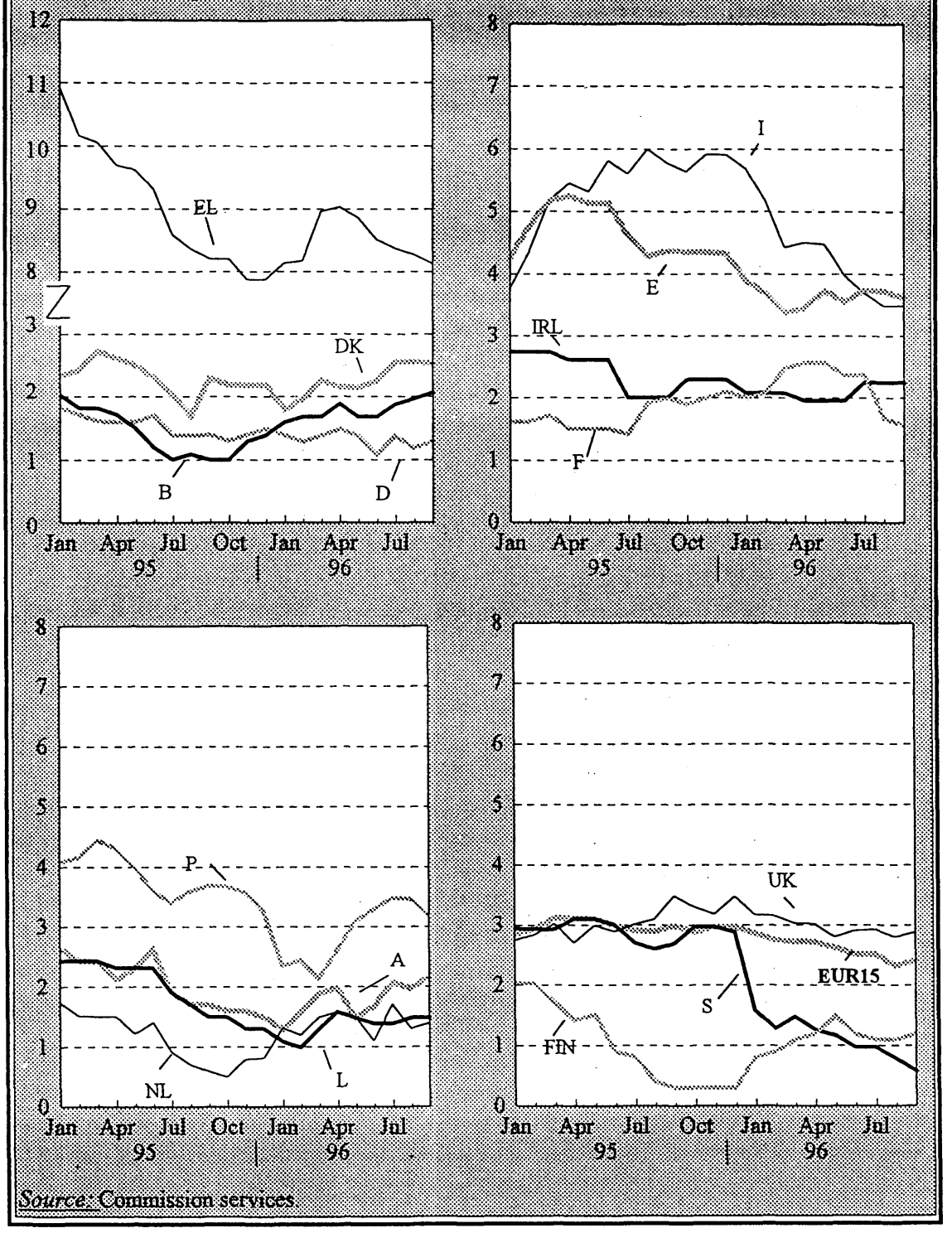
In the seven Member States where the annual inflation rate was below 2.5% in January 1995 (Belgium, Denmark, Germany, France, Luxembourg, the Netherlands and Finland), the pace of price increases either eased further or stabilised at a low level during the subsequent 20 months (see Graph 3.1). In three of the four countries where the annual inflation rate ranged between 2.5% and 3% at the beginning of 1995 (Ireland, Austria and Sweden, the exception being the United Kingdom), it edged down to below 2% in mid-1996. The deceleration was most noticeable in Sweden where the annual inflation rate eased to below 1% since August of this year. In the United Kingdom, progress towards price stability has proved to be gradual and somewhat erratic, but the downward trend has been confirmed during the course of 1996, despite the context of a sustained recovery and earlier downward pressure on sterling.

In the remaining Member States, visible progress has been achieved with inflation performance, but the degree of price stability and price convergence is not yet satisfactory. Spain and Italy experienced a worrying upward movement in inflation during the first half of 1995 due to both the surge in import prices following the marked depreciation of their currencies in the spring and increases in indirect taxation. However, in both countries inflation peaked in the middle of 1995 and since then a steady downward trend has been clearly discernible. Inflation stood at 3.5% in Italy and at 3.6% in Spain in September of this year.But in Spain the deceleration in inflation has stalled in recent months, although underlying inflation (excluding prices of unprocessed food and energy) has continued to edge down. An upward blip in inflation also took place in Portugal in the spring of last year, but the upturn was much smaller and reversed more quickly than in the previous two countries. However, after having eased to close to 2% in March of this year, inflation has accelerated in recent months, reaching 3.2% in September. In Greece, inflation has declined from 10.9% in January 1995 to 8.1% in September 1996, but it is still well above the Community average.

Graph 3.1

HICP for EUR15 and Member States

(percentage change on a year earlier, T/T-12)



Source: Commission services

3.2.2 Price convergence measured against a reference value

In this report, the following operational definitions have been used (for a discussion of the issues involved see the box on the "Calculation of the inflation reference value"). A Member State's inflation is measured by the percentage change in the arithmetic average of twelve monthly indices relative to the arithmetic average of the twelve monthly indices of the previous period[1]. The reference value is calculated as the arithmetic average of the inflation rates of the three best performing Member States plus 1.5 percentage points.

Table 3.1

Inflation convergence
(inflation measured by the percentage change in the IICP)

	Interim indices of consumer prices	
Three best performers	December 1995 (1)	September 1996 (1)
B	1.4	-
D	-	1.3
NL	1.1	1.2
FIN	1.0	0.9
Reference value (2)	2.7	2.6
Member States respecting the reference value		
Number:	9	10
out of:	15	15
B	1.4	1.6
DK	2.3	2.2
D	1.5	1.3
F	1.7	2.1
IRL (3)	2.4	2.1
L	1.9	1.3
NL	1.1	1.2
A	2.0	1.7
FIN	1.0	0.9
S	-	1.6

(1) Measured by the percentage change in the arithmetic average of twelve monthly indices relative to the arithmetic average of the twelve monthly indices of the previous period.
(2) Definition adopted in this report: arithmetic average of the three best performers in terms of inflation plus 1.5 percentage points.
(3) Measured on the basis of quarterly data
Source: Commission services.

Over the period for which a reference value can be calculated[2], the reference value declined marginally from 2.7% in December 1995 to 2.6% in September 1996 (see Table 3.1). Over the period concerned, the composition of the reference group of the three best performers shows little change. The Netherlands and Finland have invariably been part of the group whereas Germany replaced Belgium as from June 1996.

In September 1996, ten Member States had an average inflation rate below the reference value (Belgium, Denmark, Germany, France, Ireland[3], Luxembourg, the Netherlands, Austria, Finland and Sweden), while in two other countries (Portugal and the United Kingdom), the average inflation rate was 0.4 percentage points above the reference value. In Spain and Italy, the average inflation rate exceeded the reference value by 1.2 percentage points and 2.1 percentage points, respectively. In the case of Greece, the gap from the reference value amounted to 5.8 percentage points (see Table 3.2)

1 It should be noted that this measure is different from that usually referred to as the inflation rate (calculated as the percentage change in an index in the latest month over the index of 12 months before), which has been used in Section 3.2.1. and Graph 3.1.

2 The time series for the IICP are available only from January 1994. As a result, the earliest reference value which can be calculated is for December 1995.

3 For Ireland the IICP and national CPI are only available quarterly.

Table 3.2

The average rate of inflation
(measured by IICP; percentage change)

	Interim indices of consumer prices	
	December 1995[(1)]	**September 1996**[(1)]
B	1.4	1.6
DK	2.3	2.2
D	1.5	1.3
EL	9.0	8.4
E	4.7	3.8
F	1.7	2.1
IRL (2)	2.4	2.1
I	5.4	4.7
L	1.9	1.3
NL	1.1	1.2
A	2.0	1.7
P	3.8	3.0
FIN	1.0	0.9
S	2.9	1.6
UK	3.1	3.0
EUR	3.0	2.7

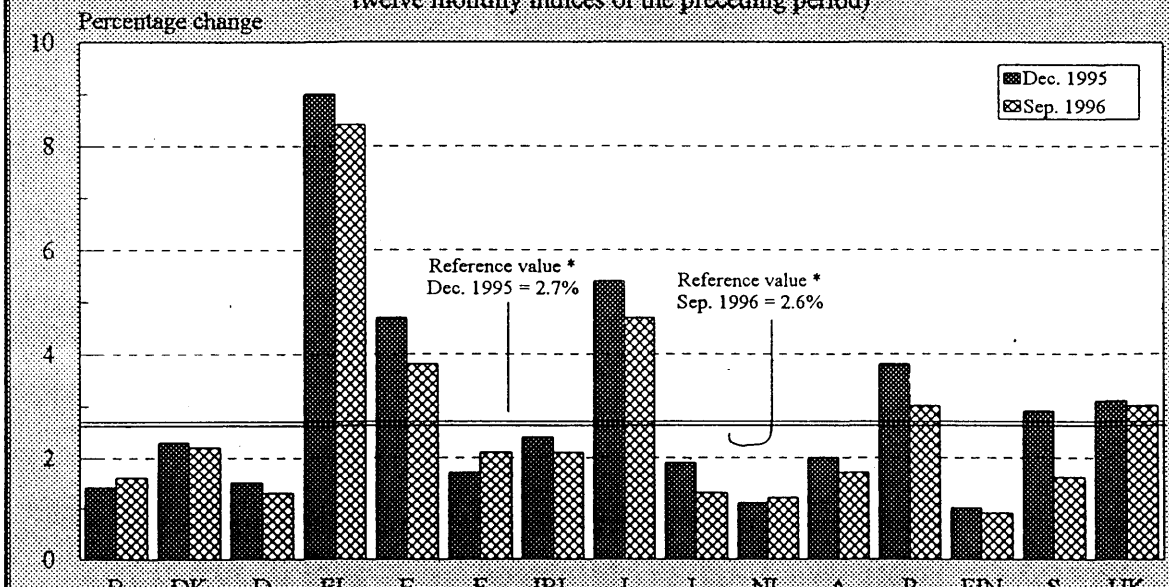
(1) Measured by the percentage change in the arithmetic average of twelve monthly indices relative to the arithmetic average of the twelve monthly indices of the previous period.
(2) Measured on the basis of quarterly data
Source: Commission services.

The convergence situation was better in September 1996 than in December 1995, when nine countries enjoyed average inflation rates below the reference value, and when the distance from the reference value in the other countries was larger than is currently the case.

Graph 3.2

Interim indices of consumer prices (IICP)

(Arithmetic average of twelve monthly indices relative to the arithmetic average of the twelve monthly indices of the preceding period)



* Average of 3 best performers + 1.5 percentage points
Source: Commission services

3.3 Inflation performance during the second stage of EMU

The limited time-span covered by the IICPs does not allow more recent inflation developments to be seen in perspective. To ensure a comprehensive and balanced examination of the degree of price stability and the sustainability of the inflation performance, some other inflation indicators must be considered, including private consumption deflators and CPIs. The box on the "Differences between IICPs and CPIs" examines the scale of such differences.

Developments with regard to private consumption deflators and CPIs confirm that substantial progress in inflation convergence has been achieved in the Community since the start of Stage Two of EMU on 1 January 1994. Between 1993 and 1995, inflation for the Community as a whole, fell from 4% to 3%, as measured by the private consumption deflator, and from 3½% to 3%, as measured by the CPI. This downward trend has continued in 1996, with inflation in the Community on average expected to be just over 2½% on both measures this year (see Table 3.3).

At the country level, the picture painted by the evolution of the private consumption deflator and the CPI is similar to that outlined by the IICPs. The decline in inflation is observed in all the Community countries, although to varying degrees. During Stage Two, Member States which have long participated in the exchange-rate mechanism (ERM) (Belgium, Denmark, Germany, France, Ireland, Luxembourg and the Netherlands) have consolidated their already good initial inflation performances, while the three new Member States (Austria, Finland and Sweden) have converged in terms of price stability towards this first group.

In the United Kingdom, the CPI evolution is strongly influenced by movements in mortgage rates. The latter largely explains the drop to 1.6% in 1993 and the subsequent rise to 3.5% up to 1995. Again, most of the slowdown in the CPI inflation during the first half of 1996 is due to the fall in mortgage rates. However, the private consumption deflator showed an easing in inflation from 3.5% in 1993 to 2.6% in 1995, and it is expected to be slightly lower in 1996.

Table 3.3
Private consumption deflator and consumer price index
(national currency, percentage change)

	Private consumption deflator				Consumer price index			
	1993	1994	1995	1996 (1)	1993	1994	1995	Sep. 96 (2)
B	3.0	3.2	1.6	2.0	2.8	2.4	1.5	1.8
DK	0.3	1.7	2.1	2.0	1.3	2.0	2.1	2.0
D	3.9	2.7	2.0	1.8	3.6	2.7	1.8	1.6
EL	13.7	10.8	9.3	8.5	14.4	10.9	9.3	8.6
E	5.5	4.9	4.7	3.6	4.6	4.7	4.7	3.8
F	2.2	2.1	1.7	1.9	2.1	1.7	1.8	2.1
IRL	1.9	2.6	2.0	2.0	1.4	2.3	2.6	1.8
I	5.4	4.6	5.8	3.9	4.5	4.0	5.2	4.6
L	7.0	2.4	2.0	1.7	3.6	2.2	1.9	1.3
NL	2.1	2.7	0.9	1.9	2.6	2.8	1.9	1.9
A	3.4	3.0	2.3	2.0	3.6	3.0	2.2	1.8
P	7.1	4.8	4.2	3.3	6.4	5.2	4.1	3.3
FIN	4.2	1.4	0.2	0.9	2.2	1.1	1.0	0.5
S	5.7	3.1	2.7	1.7	4.6	2.2	2.5	1.2
UK	3.5	2.5	2.6	2.5	1.6	2.5	3.4	2.6
EUR	4.1	3.3	3.0	2.6	3.4	3.1	3.1	2.7
CV	0.73	0.63	0.75	0.66	0.85	0.68	0.66	0.74
CV ERM	0.62	0.35	0.48	0.34	0.49	0.40	0.41	0.43
CV Non-ERM	0.59	0.59	0.76	0.63	0.81	0.63	0.67	0.66

(1) Autumn 1996 economic forecasts.
(2) Measured by the percentage change in the arithmetic average of twelve monthly indices relative to arithmetic average of the twelve monthly indices of the previous period.
CV = Coefficient of variation (ratio of the standard deviation to the mean of the data).
CV ERM is the coefficient of variation for ; B, DK, D, E, F, IRL, L, NL, P for 1993 and 1994. A is included in 1995 and 1996. FIN is included in 1996.
The Non-ERM includes EL, I, UK for 1993 and 1994. FIN and S are included in the CV Non-ERM for 1995 and S also for 1996.
Source: Commission services.

In the remaining Member States (Spain, Greece, Italy and Portugal), a clear improvement has been observed since 1993, but in Spain and Portugal the downward trend in inflation was interrupted in the spring of 1996.

The generalised reduction in inflation throughout the Community has been accompanied by a narrowing in inflation differentials between Member States. One indication of how inflation in the Member States has tended to converge is provided by the coefficient of variation[4] , a statistical measure of dispersion. The coefficient of variation for inflation, measured by the private consumption deflator, declined from 0.73 in 1993 to 0.66 in 1996 for the Community as a whole. The convergence process has been even greater within the ERM group, with the coefficient of variation declining from 0.62 in 1993 to 0.34 in 1996. On the other hand, substantially greater variability continues to characterise inflation within the non-ERM group.

[4] The coefficient of variation shows the dispersion of individual Member State's inflation around the average rate of inflation for each year; the higher the value, the greater the dispersion of inflation in any given year.

3.4 The sustainability of price convergence

The process of inflation convergence which has been evident in the Community for more than a decade results in large part from fundamental changes in the attitude of all economic actors towards inflation.

The most important structural change has undoubtedly been the determined implementation of monetary policies targeted at price stability. Several Member States have adopted explicit inflation targets, or indirect objectives (like a money growth target or an exchange rate target), and accordingly they have conducted their monetary policies credibly.

Institutional changes such as the prohibition of central bank financing of budget deficits and the prohibition of privileged access of the public sector to financial institutions (which entered into force with the start of Stage Two) as well as the granting of independence to central banks (as required by the Treaty by the end of Stage Two, see Chapter 2) have helped to strengthen the effectiveness and credibility of a stability-oriented monetary policy in the Member States.

Besides its direct effect on inflation, monetary policy also exerts a curbing impact on price increases through its influence on economic agents' behaviour. By remaining firm on an anti-inflation policy, monetary authorities raise the credibility of price stability objectives and strongly contribute to reduce inflation expectations. Nominal wage moderation has been progressively achieved over the past ten years (see section 7.4.1). This trend suggests that the Social Partners have increasingly internalised the price-stability objective in their wage settlements.

But other key structural factors have contributed importantly to the low inflation environment currently prevailing in the Community. The completion of the single market has exerted - and will continue to do so - downward pressure on price inflation at the firm and sectoral level mainly through two channels. Firstly, the removal of national trade barriers has increased competition in many markets for goods and services, with a subsequent squeeze of rents which resulted from imperfect market situations. Secondly, greater competition has also induced a more efficient allocation of resources within the Community, fostering the efficiency of the supply side. Production costs have thus been curbed, with an obvious downward impact on prices.

Since the 1980s, most Member States have re-oriented their budgetary policy. The use of discretionary budgetary instruments for regulating economic activity has been increasingly regarded as inefficient and even damaging, as persistent excessive deficits and the accumulation of public debt have been accompanied by serious adverse supply-side and inflation effects. Initially, the success of budgetary consolidation policies was mixed, but, in recent years, efforts to reduce budget deficits have intensified and have proved to be more credible, as examined in Chapter 4. The shift towards greater budgetary discipline, aimed at balanced positions in the medium term, has fostered low and stable inflationary expectations, thereby facilitating the task of monetary policy to achieve and maintain price stability with lower interest rates.

Beside structural factors, cyclical forces have also helped to bring about the current favourable inflation performance in the Community. The persistence of output levels below full capacity has exerted a strong disincentive for companies to raise prices or to allow significant wage increases.

CALCULATION OF THE INFLATION REFERENCE VALUE

Protocol No 6 states that the inflation reference value should be calculated on the basis of *"an average rate of inflation, observed over a period of one year of, at most, the three best performing States"*.

As to the question of the average, in this report preference is given to an arithmetic average as opposed to a geometric one as it is the most commonly used method. Furthermore, the difference between the arithmetic and geometric average is very small, especially if inflation is low.

Regarding the period of one year, two main approaches are possible: either using the year-on-year change of a monthly indicator (for instance, September 1996/September 1995), or using the average change of the last twelve months over the preceding twelve months. The advantage of the first approach is that it is straightforward and easy understandable. But disadvantages outweigh this advantage. Indeed, results may vary importantly from month to month, because of possible base effects due for instance to changes in indirect taxes. Furthermore, and more importantly, as the criterion should assess the sustainability of price stability and of inflation convergence, taking into account a longer period seems more appropriate.

Concerning the number of countries to be included in the calculation of the reference value, different approaches are conceivable. A first group takes one country to calculaate the reference value:

Method 1: the best performing country +1.5 percentage points.

Method 2: the second best performing country +1.5 percentage points.

Method 3: the third best performing country +1.5 percentage points.

A second group of interpretations would take an average of two or three countries:

Method 4: *an unweighted average of the two best performing countries +1.5 percentage points.*

Method 5: *the unweighted average of the three best performing countries +1.5 percentage points.*

Method 6: *a weighted average of the three best performing countries +1.5 percentage points.*

Table 3.4

Inflation convergence according to alternative methods for the calculation of the reference value, HCP

	December 1995 (1)		September 1996 (1)	
	Reference value	Number of member states respecting the reference value (3)	Reference value	Number of member states respecting the reference value (3)
1. The best performing country +1.5 percentage points.	2.5	9	2.4	10
2. The second best performing country +1.5 percentage points.	2.6	9	2.7	10
3. The third best performing country +1.5 percentage points.	2.9	9	2.8	10
4. The two best performing countries, unweighted average +1.5 percentage points.	2.5	9	2.6	10
5. The three best performing countries, unweighted average +1.5 percentage points.	2.7	9	2.6	10
6. The three best performing countries, weighted(2) average +1.5 percentage points.	2.7	9	2.8	10

(1) Measured by the percentage change in the arithmetic average of twelve monthly indices relative to the arithmetic average of the twelve monthly indices of the previous period.
(2) Weighted according to shares of private consumption in 1995 at current prices, PPS.
(3) 9 countries respecting the reference value in December 1995: B, DK, D, F, IRL, L, NL, A, FIN.
10 countries respecting the reference value in September 1996: B, DK, D, F, IRL, L, NL, A, FIN, S.
Source: Commission services.

A reference value has been calculated according to these six methods both for December 1995 and for September 1996. For the purpose of this report, the Commission has adopted method 5. Table 3.4 shows that the number of countries with inflation below the reference value is the same, both in December 1995 and in September 1996, whatever the method used.

These results may be explained by two factors. First, there is an important group of countries which has achieved low and convergent inflation in a sustained way. As a result, neither the number of countries taken into account nor the composition of the reference group has a major effect on the magnitude of the reference value. Secondly, the inflation performance of the remaining Member States is still too distant from the low inflation group such that small variations in the reference value do not allow these countries to be below the reference value.

DIFFERENCES BETWEEN IICPS AND CPIS

The differences between IICPs and CPIs depend very much on the existing structure of national CPIs.

For countries where the CPIs incorporate items like health care or imputed rents on owner-occupied housing, the IICPs will tend to be lower than the CPIs as the prices of these items tend to rise faster than those of internationally traded goods. On the other hand, for countries where alcohol and tobacco prices are excluded from the CPIs, the difference with the IICPs will be positive as price increases on these goods are typically higher than average. Countries where mortgages are included in the national CPIs will see erratic differentials. At the Community level and for a number of countries, differences between the CPI and the IICP are minor, with the discrepancy in the range of ±0.1 percentage point to ±0.3 percentage point (see Table 3.5). But for some countries, differences vary from ±½ percentage point to nearly 1 percentage point (Ireland, the Netherlands, Finland, Sweden and the United Kingdom).

Table 3.5

Difference between IICPs and CPIs
(percentage change)

	1995(1)			March 1996(2)			September 1996(2)		
	IICP	CPI	Difference IICP - CPI	IICP	CPI	Difference IICP - CPI	IICP	CPI	Difference IICP - CPI
B	1.4	1.5	-0.1	1.7	2.0	-0.3	2.1	1.9	0.2
DK	2.3	2.1	0.2	2.3	2.1	0.2	2.5	2.3	0.2
D	1.5	1.8	-0.3	1.4	1.7	-0.3	1.3	1.4	-0.1
EL	9.0	9.3	-0.3	8.9	9.1	-0.2	8.1	8.5	-0.4
E	4.7	4.7	0.0	3.4	3.4	0.0	3.6	3.6	0.0
F	1.7	1.8	-0.1	2.5	2.3	0.2	1.6	1.6	0.0
IRL (3)	2.4	2.6	-0.2	2.1	2.0	0.1	2.2	1.4	0.8
I	5.4	5.2	0.2	4.4	4.5	-0.1	3.5	3.4	0.1
L	1.9	1.9	0.0	1.3	1.2	0.1	1.5	1.4	0.1
NL	1.1	1.9	-0.8	1.5	2.1	-0.6	1.4	2.0	-0.6
A	2.0	2.2	-0.2	1.8	1.8	0.0	2.2	2.0	0.2
P	3.8	4.1	-0.3	2.1	2.4	-0.3	3.2	3.4	-0.2
FIN	1.0	1.0	0.0	1.1	0.6	0.5	1.2	0.6	0.6
S	2.9	2.5	0.4	1.5	1.5	0.0	0.6	-0.1	0.7
UK	3.1	3.4	-0.3	3.0	2.7	0.3	2.9	2.1	0.8
EUR	3.0	3.1	-0.1	2.7	2.7	0.0	2.4	2.3	0.1

(1) Annual percentage change.
(2) Percentage on a year earlier, T/T-12.
(3) Measured on the basis of quarterly data.
Source: Commission services.

Table 3.6

Inflation convergence using IICPs and CPIs
(percentage change)

	Interim indices of consumer prices (1)		Consumer Price Index (1)	
Three best performers	Dec. 1995[(1)]	Sep. 1996[(1)]	Dec. 1995[(1)]	Sep. 1996[(1)]
B	1.4	-	1.5	-
D	-	1.3	-	-
F	-	-	1.8	-
NL	1.1	1.2	-	-
L	-	-	-	1.3
FIN	1.0	0.9	1.0	0.5
S	-	-	-	1.2
Reference value(2)	2.7	2.6	2.9	2.5
Member States respecting the reference value				
Number:	9	10	10	10
Out of:	15	15	15	15
B	1.4	1.6	1.5	1.8
DK	2.3	2.2	2.1	2.0
D	1.5	1.3	1.8	1.6
F	1.7	2.1	1.8	2.1
IRL (3)	2.4	2.1	2.6	1.8
L	1.9	1.3	1.9	1.3
NL	1.1	1.2	1.9	1.9
A	2.0	1.7	2.2	1.8
FIN	1.0	0.9	1.0	0.5
S	-	1.6	2.5	1.2

(1) Measured by the percentage change in the arithmetic average of twelve monthly indices relative to arithmetic average of the twelve monthly indices of the previous period.
(2) Definition adapted in this report: arithmetic average of the three best performers in terms of inflation plus 1.5 percentage points.
(3) Measured on the basis of quarterly data.

Source: Commission services.

Furthermore, since the inflation criterion is defined in relative and not in absolute terms, the use of the IICPs does not significantly influence the results. As indicated in Table 3.6, the number of countries respecting the reference value does not differ if the CPI is used instead of the IICP. However, the group of the three best performing countries is different.

4. GOVERNMENT BUDGETARY POSITION

4.1 Existence of an excessive deficit

Fulfilment of the criterion on the sustainability of the government financial position depends, as the second indent of Article 109j(1) makes clear, on a Member State having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104c(6). Protocol No 6 on the convergence criteria further states, in Article 2, that:

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

The role of this report, therefore, is not to make an independent assessment of whether or not Member States currently fulfil the criterion on the government budgetary position. This is already determined by the Council decisions on the existence of an excessive deficit. The first section of this chapter describes the application of the excessive deficit procedure during the second stage of EMU and the decisions on the existence of an excessive deficit which are currently in force. In the remaining sections of this chapter recent budgetary developments in the Member States are reviewed.

The provisions of the excessive deficit procedure (Article 104c with the exception of paragraphs 1, 9, 11 and 14, together with the associated Protocol (No 5)) have applied since the beginning of the second stage of EMU in January 1994. The practice since then has been for the Commission and Council to implement the procedure on an annual basis. Each year the various steps of the procedure have been applied following the March reporting of budgetary data by Member States (as required by Council Regulation (EC) No 3605/93). The box on the "Excessive deficit procedure" describes the main features of the procedure during the second stage.

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

In 1995 the procedure was applied for the first time to the three new Member States (Austria, Finland and Sweden) and the Council decided[2] that an excessive deficit

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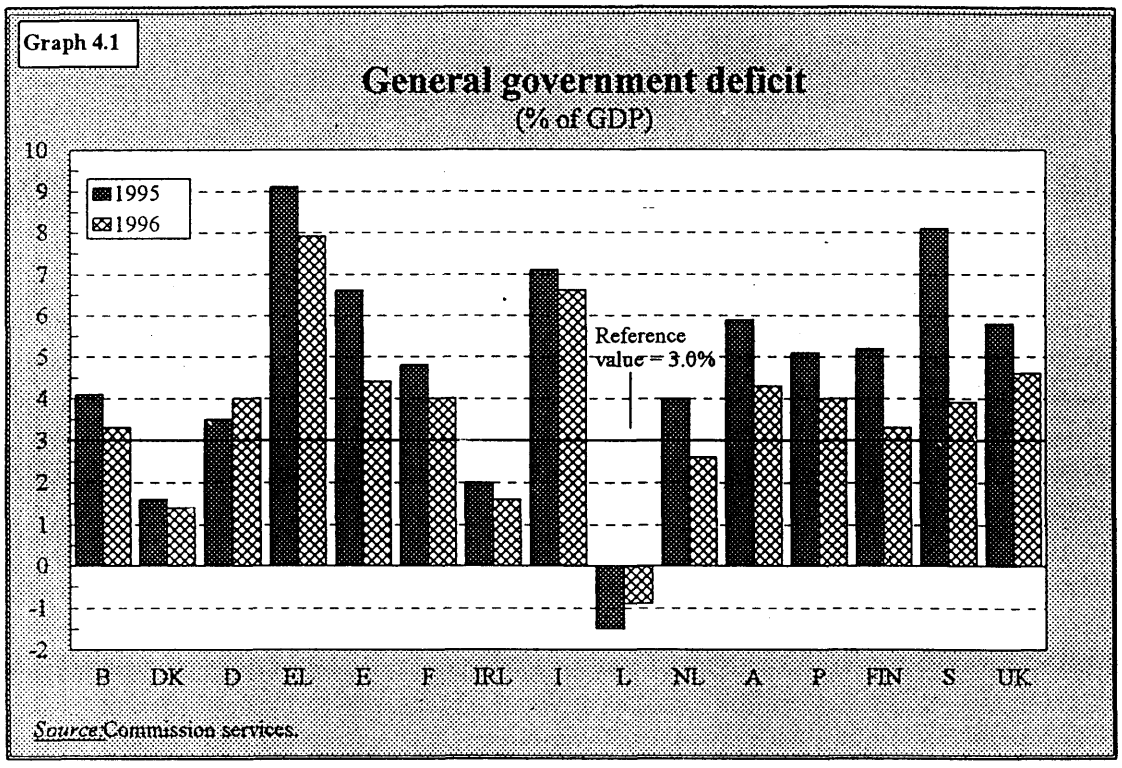
1 Council decisions of 26 September 1994. None of the documents for the application of the procedure has been published in the *Official Journal.*

2 Council decisions of 10 July 1995.

existed in each of them. At the same time the Council decided[3] in accordance with Article 104c(12) to abrogate the decision on Germany: the government deficit in Germany had fallen below the reference value in 1994 and was expected then to remain below in 1995, and the government debt ratio remained below the reference value.

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

Thus twelve Member States are currently the subject of a Council decision that an excessive deficit exists. At present, only three Member States (Denmark, Ireland and Luxembourg) are not the subject of such a decision and so fulfil the criterion on the government budgetary position.



4.2 Budgetary developments in 1996

Efforts at budgetary consolidation in 1996 have been made within the context of a pause in economic growth. The Commission services forecast real GDP growth of 1.6% this year for the European Union as a whole, and growth rates below this

3 Council decision of 10 July 1995.
4 Council decision of 27 June 1996.
5 Council decision of 27 June 1996.

average are expected for Belgium, Germany, France, Italy and Austria. Despite the unfavourable economic climate almost all Member States are expected to make further progress in reducing government deficits in 1996. According to the latest forecasts of the Commission services (see Table 4.1 and Graph 4.1), only Germany is likely to see a widening of its deficit in 1996. In all the other Member States and in the European Union as a whole the deficit is expected to decline (in Luxembourg, the surplus is likely to be smaller). Particularly large reductions in the deficit of more than 1% of GDP are likely in Greece, Spain, the Netherlands, Austria, Portugal, Finland, Sweden and the United Kingdom.

Table 4.1
General government deficit
(% of GDP)

	1993	1994	1995	1996 (1)
B	7.5	5.1	4.1	3.3
DK	3.9	3.5	1.6	1.4
D	3.5	2.4	3.5	4.0
EL	14.2	12.1	9.1	7.9
E	6.8	6.3	6.6	4.4
F	5.6	5.6	4.8	4.0
IRL	2.4	1.7	2.0	1.6
I	9.6	9.0	7.1	6.6
L (2)	-1.7	-2.6	-1.5	-0.9
NL	3.2	3.4	4.0	2.6
A	4.2	4.4	5.9	4.3
P	6.9	5.8	5.1	4.0
FIN	8.0	6.2	5.2	3.3
S	12.3	10.8	8.1	3.9
UK	7.8	6.8	5.8	4.6
EUR	6.2	5.4	5.0	4.4

(1) Autumn 1996 economic forecasts.
(2) Negative sign indicates a surplus
Source: Commission services.

On present estimates, it seems likely that in 1996 one more Member State (the Netherlands) will succeed in reducing its deficit to below the 3% of GDP reference value, thus joining the three Member States which have already achieved this - Denmark, Ireland and Luxembourg (in surplus). Two Member States (Belgium and Finland) are likely to achieve a deficit of between 3% and 3½% of GDP this year and a further six (Germany, Spain, France, Austria, Portugal and Sweden) are expected to have a deficit below 4½% of GDP.

Persisting government deficits and relatively low growth of nominal GDP (due to both poor real growth and a good or improving inflation performance) imply that the government gross debt ratio, all other things being equal, is likely to continue rising in several Member States in 1996 and in the European Union as a whole (see Table 4.2 and Graph 4.2). However, in Belgium, Denmark, Greece, Ireland, Italy, the Netherlands, Portugal and Sweden the debt ratio is expected to decline this year.

Table 4.2

General government gross debt
(% of GDP)

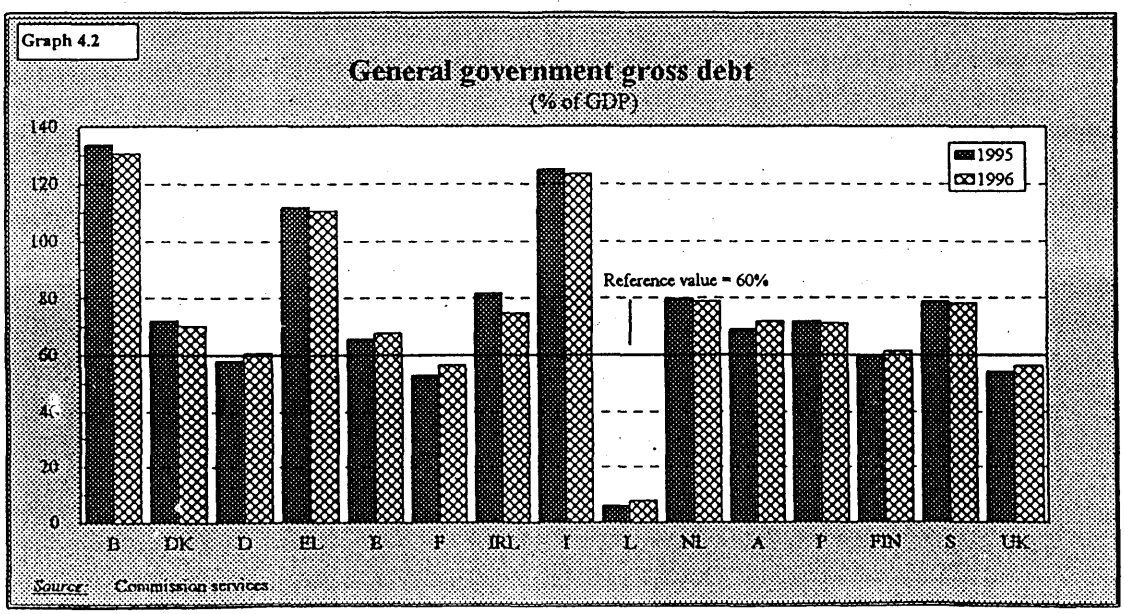
	Level				Change		
	1993	1994	1995	1996 (1)	94/93	95/94	96/95
B	137.0	135.0	133.7	130.6	-2.0	-1.3	-3.1
DK (2)	80.1	76.0	71.9	70.2	-4.1	-4.1	-1.7
D (3)	48.2	50.4	58.1	60.8	2.2	7.7	2.7
EL	111.8	110.4	111.8	110.6	-1.4	1.4	-1.2
E	60.5	63.1	65.7	67.8	2.6	2.6	2.1
F	45.6	48.4	52.8	56.4	2.8	4.4	3.6
IRL	94.5	87.9	81.6	74.7	-6.6	-6.3	-6.9
I	119.3	125.5	124.9	123.4	6.2	-0.6	-1.5
L	6.2	5.7	6.0	7.8	-0.5	0.3	1.8
NL	80.8	77.4	79.7	78.7	-3.4	2.3	-1.0
A	62.8	65.1	69.0	71.7	2.3	3.9	2.7
P	68.2	69.6	71.7	71.1	1.4	2.1	-0.6
FIN	57.3	59.5	59.2	61.3	2.2	-0.3	2.1
S	76.0	79.3	78.7	78.1	3.3	-0.6	-0.6
UK	48.5	50.4	54.1	56.3	1.9	3.7	2.2
EUR	66.1	68.1	71.3	73.5	2.0	3.2	2.2

(1) Autumn 1996 economic forecasts.
(2) Government deposits with the central bank, government holdings of non-governmental bonds and public enterprises related debt amounted to some 18 percent of GDP in 1995.
(3) The sharp increase in the German debt ratio in 1995 is mainly caused by the take-over by the government of off-budget unification-related liabilities, the most important of which is the debt of the "Treuhandanstalt".

Source: Commission services.

At the end of 1996 the debt ratio is expected by the Commission services to be below the 60% of GDP reference value in three Member States - France, Luxembourg and the United Kingdom. The debt ratio is likely to rise to just above the 60% level in Germany and Finland and to be in the range between 60 and 70% of GDP also in Spain. In Denmark, Ireland, the Netherlands, Austria, Portugal and Sweden the debt ratio is likely to be in the range between 70 and 80% of GDP. Finally, in three Member States (Belgium, Greece and Italy) the debt ratio will remain higher than 110% of GDP.

Graph 4.2



4.3 Progress with budgetary consolidation during the second stage of EMU

At the beginning of the second stage of EMU budgetary positions in most Member States were in very serious imbalance; deficits had risen in many cases to record levels in 1993 as a result of the sharp recession and debt ratios were on an upward trend in all Member States except Ireland and Luxembourg.

During the last three years efforts by Member State governments at budgetary consolidation have been intensified on a broad front. There has been a rising awareness of the risks for inflation, interest rates and economic growth from uncorrected budgetary imbalances generating debt trends which are very difficult to reverse. During this period financial markets have tended more clearly to attach a risk premium to countries with untackled budgetary problems. In addition, policy in the Member States has drawn support from the need for a high degree of convergence in view of the single currency.

All the Member States with high levels of deficits have adopted ambitious medium-term programmes for budgetary consolidation. Reducing budgetary imbalances is at the core of the convergence programmes presented by Member States at Community level.

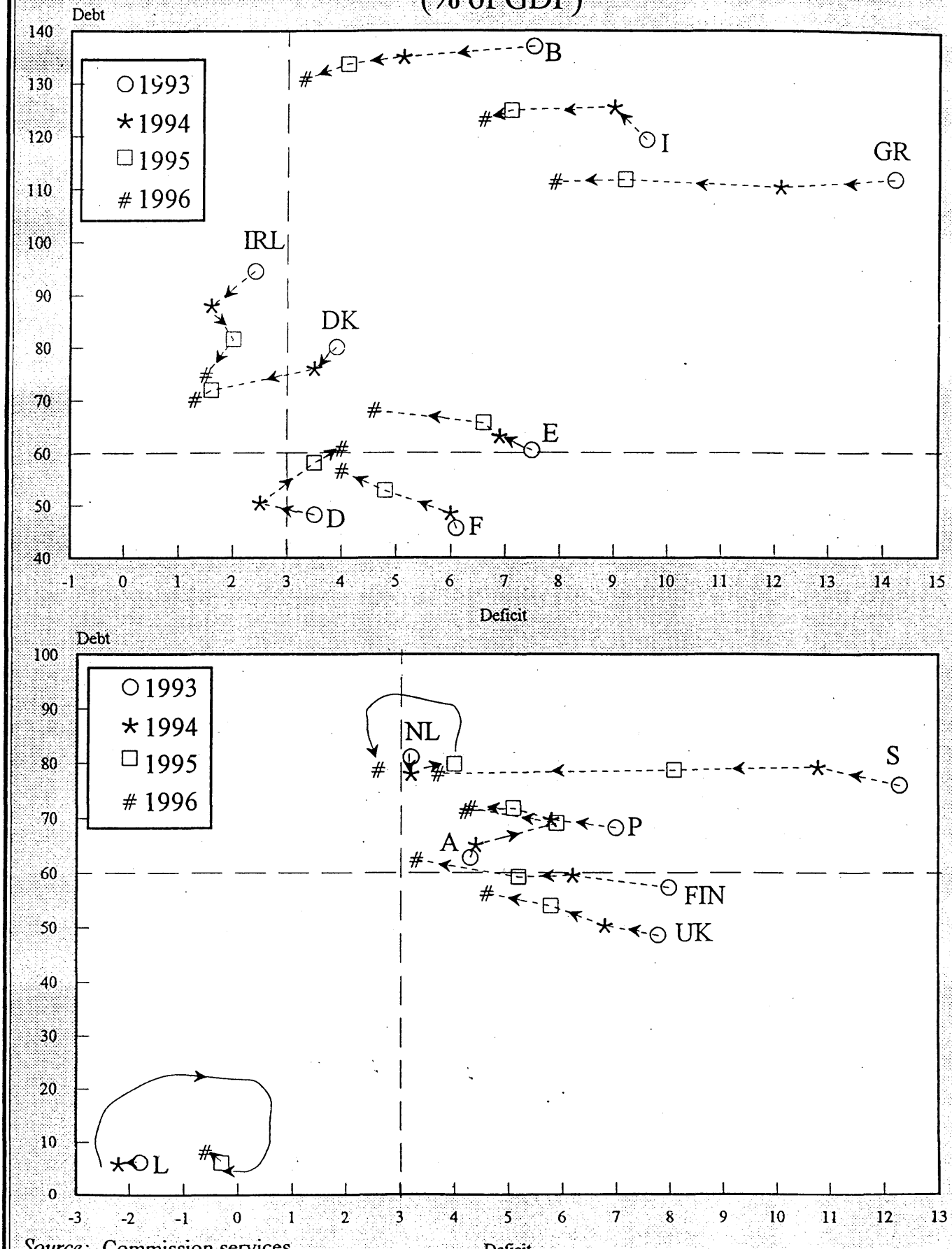
Although in several cases progress has not been as rapid as originally planned and there have been a few setbacks, the experience since 1993 in most Member States has been one of steady narrowing of government deficits (see Table 4.1 and Graph 4.3). The only exceptions are Germany, where after the deficit declined in 1994 it has risen again in both 1995 and 1996, Spain, where the deficit increased in 1995 before declining again in 1996, the Netherlands, where the deficit widened in 1994 and 1995 before declining in 1996, and Austria, which also saw its deficit continue to rise in 1994 and 1995 before a reduction in 1996. The surplus in Luxembourg has fluctuated from year to year.

Especially large deficit reductions of over 4% of GDP have been achieved between 1993 and 1996 in Belgium, Greece, Finland and Sweden, while reductions of between 2% and 4% of GDP have been seen in Denmark, Spain, Italy, Portugal and the United Kingdom. Nonetheless many of these countries started from very high deficits and have not yet reached satisfactory deficit levels. Although the short-term focus is on bringing deficits down to 3% of GDP, this has to be seen as only a step on the way towards re-establishing sound budgetary positions. As shown by the recent discussions about a stability pact on which proposals were adopted by the Commission on 16 October 1996, the 3% of GDP deficit reference value is to be considered not as a target but as a ceiling; it would be appropriate for Member States to aim in the medium term for budgetary positions close to balance or in surplus so as to foster growth and employment.

Graph 4.3

Government deficit and debt ratios - 1993-96

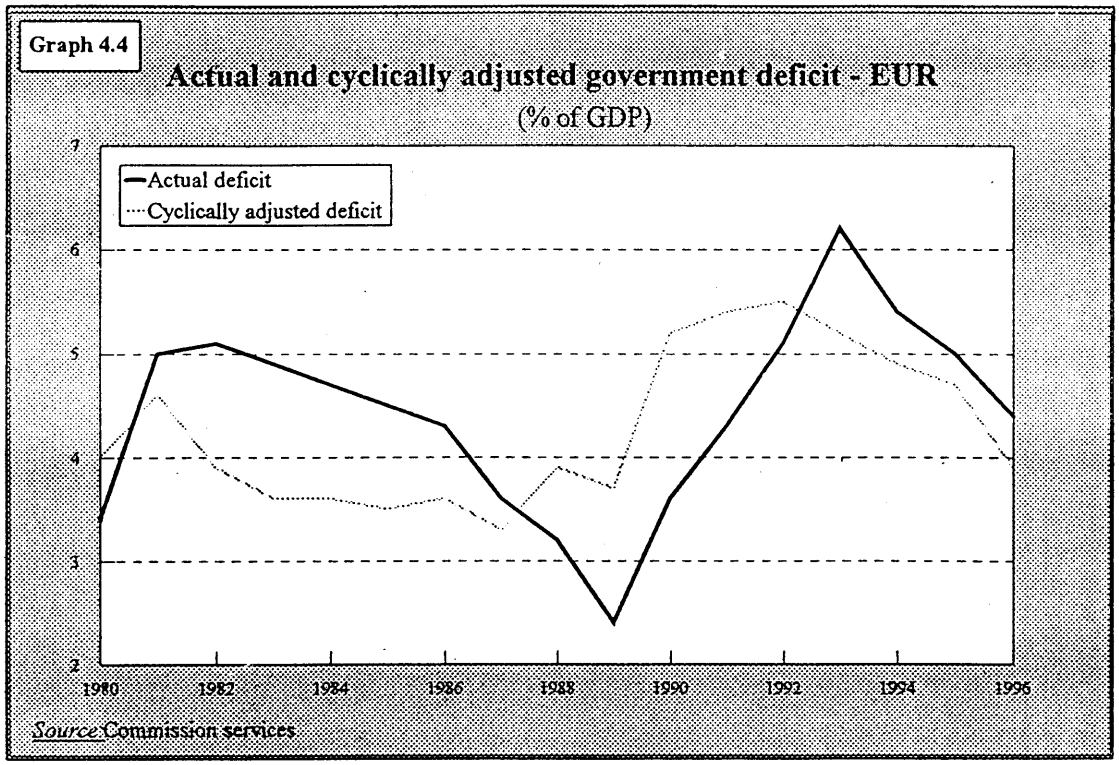
(% of GDP)



Source: Commission services.

4.3.1 Influence of the economic cycle

Just as deficits in 1993 were swollen by the impact of recession, so part of the improvement in deficits since then can be ascribed to the effects on spending and tax revenues of the recovery in economic activity. In 1994 and 1995 more than half of the



deficit reduction in the EU as a whole can be ascribed to these cyclical influences, according to the prudent cyclical adjustment method used by the Commission services (see Table 4.3 and Graph 4.4). Between mid-1995 and mid-1996 there was a pause in growth which has generally depressed GDP growth rates for 1996 and in several countries has had an adverse impact on budget balances. According to latest estimates, while for the EU as a whole a reduction of 0.6% of GDP in the government deficit is expected in 1996, cyclical influences have had a negative impact on this figure of 0.2% of GDP, and the decline in the cyclically adjusted deficit is estimated at 0.8% of GDP.

Table 4.3

Changes from previous year in the actual and cyclically adjusted general government deficit
(% of GDP)

	Change in deficit			Change in cyclically-adjusted deficit		
	1994	1995	1996	1994	1995	1996
B	-2.3	-1.0	-0.8	-2.0	-1.0	-1.0
DK	-0.4	-1.8	-0.2	1.1	-1.3	-0.3
D	-1.0	1.1	0.5	-0.8	0.9	0.0
EL	-2.1	-3.0	-1.2	-2.2	-2.9	-0.9
E	-0.4	0.3	-2.2	-0.6	0.6	-2.3
F	0.0	-0.8	-0.8	0.5	-0.6	-1.2
IRL	-0.7	0.3	-0.4	0.1	2.8	0.4
I	-0.5	-1.9	-0.5	-0.2	-1.2	-0.9
L (1)	-1.0	1.1	0.6	n.a.	1.5	0.3
NL	0.2	0.7	-1.4	0.7	0.4	-1.4
A	0.2	1.5	-1.6	0.7	1.2	-2.0
P	-1.1	-0.7	-1.1	-1.7	-0.7	-1.0
FIN	-1.8	-1.0	-1.9	0.1	1.0	-1.7
S	-1.5	-2.7	-4.1	-0.4	-1.3	-3.8
UK	-1.0	-1.0	-1.1	-0.1	-0.7	-1.1
EUR	-0.7	-0.4	-0.6	-0.2	-0.2	-0.8

A negative (positive) sign indicates a reduction (increase) in the deficit;
(1) Luxembourg has a surplus, thus a negative (positive) sign indicates an increase (a reduction) in its surplus.
Source: Commission services; figures for 1996 from Autumn 1996 economic forecasts.

Table 4.4

Cyclical adjustment of government deficit in 1996
(% of GDP)

	Government deficit	Cyclical component	Cyclically adjusted deficit
B	3.3	0.6	2.7
DK	1.4	0.2	1.2
D	4.0	0.5	3.5
EL	7.9	0.4	7.5
E	4.4	0.9	3.5
F	4.0	0.6	3.4
IRL	1.6	-2.0	3.6
I	6.6	0.4	6.2
L	-0.9	0.4	-1.3
NL	2.6	0.3	2.3
A	4.3	0.2	4.1
P	4.0	0.8	3.2
FIN	3.3	1.1	2.2
S	3.9	0.9	3.0
UK	4.6	0.6	4.0
EUR	4.4	0.5	3.9

Source: Commission services, Autumn 1996 economic forecasts.

Because of the recession in the early 1990s and the hesitant recovery since then, levels of GDP in 1996 still remain below their trend in all Member States except Ireland. Such a negative output gap implies that the deficit adjusted for cyclical influences is not as high as the recorded deficit. Using the cyclical adjustment method of the Commission services, three Member States (Belgium, Finland and Sweden) which are likely to record deficits over 3% of GDP this year are estimated to have cyclically adjusted deficits equal to or below 3% of GDP (see Table 4.4).[6]

[6] This method is, however, rather prudent: according to figures from the IMF published in the *World Economic Outlook* of October 1996 for instance, of the Member States with deficits over 3% of GDP this year, the structural deficit was estimated to be below or equal to 3% in Belgium, Germany, Spain, France, the Netherlands, Portugal, and the United Kingdom.

4.3.2 Trends in the debt ratio

Although there has been widespread progress in reducing budget deficits, this has only been sufficient in a few cases to clearly reverse the upward trend in the debt ratio (see Table 4.2 and Graph 4.3). In Belgium the debt ratio has fallen each year from the very high level of 137.0% of GDP reached in 1993 and is expected to decline to 130.6% in 1996. In Denmark, similarly, the ratio peaked at 80.1% of GDP in 1993 and is likely to be at 70.2% in 1996. The earlier decline in the debt ratio in Ireland has continued since 1993, from 94.5% of GDP in that year to an estimated 74.7% in 1996.

Table 4.5

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

	1989-93	1994-96
	annual average	annual average
B	1.0	-1.4
DK	3.7	-2.0
D	2.1	2.9
EL	8.1	1.7
E	2.8	0.6
F	0.9	0.5
IRL	1.7	-0.3
I	1.8	1.3
L	2.5	2.6
NL	0.1	-0.7
A	1.4	0.8
P	3.4	0.6
FIN	7.6	-0.5
S	5.1	-2.9
UK	-0.4	-0.6
EUR	0.9	0.6

Source: Commission services.

In Greece the debt ratio expected in 1996 at 110.6% of GDP is below its level in 1993. In the Netherlands the debt ratio in 1996 is also expected to be below its level of 1993.

Elsewhere debt ratios have risen significantly over the last three years; by at least 5% of GDP in Germany, Spain, France, Austria and the United Kingdom. In Italy, after a sharp rise in 1994 the debt ratio fell marginally in 1995 and is expected to do so again in 1996. A decline in the debt ratio is also expected in Portugal in 1996. In Finland, after a small decline in 1995, the debt ratio is likely to rise again this year. In Sweden the debt ratio will have fallen in both 1995 and 1996 but remains above the level in 1993

The change in the absolute level of the government gross debt is, according to Treaty definitions, affected not only by the borrowing to finance the government deficit each year, but also by a variety of other factors which are reflected in the liabilities in the government balance sheet. Thus, the value in national currency of debt denominated in foreign currency may change because of exchange rate movements; liabilities may be added to in order to finance on-lending to other sectors of the economy; the proceeds of privatisation sales or the running down of stocks of financial assets may be used to reduce the level of gross debt, etc. In most Member States these factors taken together have in the past tended to add regularly to the level of the debt stock. Indeed, in the period 1989-93, they added more than 2 percentage points of GDP per year on average to the level of the debt stock in eight Member States and had an appreciable upward effect in all but the Netherlands and the United Kingdom (see Table 4.5). On average in the three years 1994-96 the annual impact on the debt stock has been reduced compared with the previous period in almost all Member States, with the notable exception of Germany where there have been large unification-related debt assumptions. Indeed the average annual effect has been negative (i.e. reducing the debt stock) in seven Member States in this recent period and has only exceeded a positive effect of 1% of GDP per year in four Member States. There are a number of explanations for this change, including reduced exchange rate turbulence after 1993 and less need for the emergency financing of banking and

other sectors which had occurred in several countries. However, there is also evidence that, since the gross debt ratio has become more closely monitored during the second stage, governments have been managing their balance sheets more carefully.

4.3.3 The sources of budgetary adjustment

For the European Union as a whole the reduction in the government deficit of 1.8% of GDP between 1993 and 1996 has been achieved through a reduction in the share in GDP of non-interest government expenditure. Between these two years the shares of current revenues and of interest payments have remained almost unchanged (see Table 4.6).

Table 4.6

Revenue and expenditure shares, 1993 and 1996
(% of GDP)

	Current revenues			Non-interest expenditure			Interest payments		
	1993	1996 (1)	Change 96/93	1993	1996 (1)	Change 96/93	1993	1996 (1)	Change 96/93
B	49.2	50.5	+1.3	45.9	45.3	-0.6	10.8	8.5	-2.3
DK	58.3	58.8	+0.5	54.5	53.8	-0.7	7.8	6.4	-1.4
D	46.4	45.7	-0.7	46.6	45.9	-0.7	3.3	3.8	+0.5
EL	34.4	38.0	+3.6	35.7	34.1	-1.6	12.8	11.9	-0.9
E	42.8	40.3	-2.5	44.4	39.4	-5.0	5.2	5.4	+0.2
F	49.5	50.6	+1.1	51.7	50.9	-0.8	3.4	3.8	+0.4
IRL	37.8	34.7	-3.1	33.8	31.8	-2.0	6.5	4.5	-2.0
I	47.4	46.3	-1.1	44.9	42.4	-2.5	12.1	10.5	-1.6
L	44.7	41.7	-3.0	42.5	40.4	-2.1	0.4	0.3	-0.1
NL	52.9	48.3	-4.6	49.9	45.3	-4.6	6.2	5.6	-0.6
A	49.4	48.2	-1.2	49.4	48.0	-1.4	4.3	4.5	+0.2
P	37.7	41.5	+3.8	38.1	41.0	+2.9	6.8	4.9	-1.9
FIN	53.8	55.3	+1.5	57.2	52.8	-4.4	4.6	5.9	+1.3
S	60.3	63.0	+2.7	66.4	59.4	-7.0	6.2	7.5	+1.3
UK	35.9	37.7	+1.8	40.8	38.6	-2.2	2.9	3.8	+0.9
EUR	46.2	46.2	+0.0	47.1	45.2	-1.9	5.4	5.4	+0.0

(1) Autumn 1996 economic forecasts.

Source: Commission services.

The pattern at the level of individual Member States is more varied. Most Member States have benefited from lower interest rates. Those Member States with steadily declining debt ratios have enjoyed a marked decline in their interest payments (Belgium, Denmark, Ireland) and some others have benefited from declining nominal interest rates to an extent that has also cut their interest payments (Greece, Italy, the Netherlands and Portugal). In most of the remaining Member States the rising debt ratio has outweighed any favourable impact from lower nominal interest rates and the share of interest payments has risen - particularly sharply in Finland and Sweden.

Non-interest government expenditure has been reduced as a share of GDP between 1993 and 1996 in all Member States except Portugal. Especially large declines of more than 4% of GDP have been achieved in Spain, the Netherlands, Finland and Sweden.

Several of the Member States have increased taxation to achieve part of their budgetary adjustment. The share in GDP of current government revenues has risen between 1993 and 1996 in Belgium, Denmark, Greece, France, Portugal, Finland, Sweden and the United Kingdom. Elsewhere this share has declined;there have been particularly sharp declines in this revenue ratio in Ireland, Luxembourg and the Netherlands.

In most Member States, however, the major part of budgetary adjustment has come from a reduction in the total expenditure ratio. Some Member States have used part or almost all of the reduction in expenditure to finance lower taxation. By contrast, other Member States have supplemented their expenditure-cutting efforts by also raising taxation. The reduction in the deficit between 1993 and 1996 achieved through higher revenues has been at least as important as the reduction due to a lower total expenditure ratio in Greece, France and the United Kingdom. Portugal stands out from the other Member States during this period, in that it has used a sharp rise in tax revenues, albeit starting from a relatively low level, to finance both a rise in the expenditure ratio and deficit reduction.

4.3.4. Deficits and fixed investment

In its monitoring of budgetary developments for the excessive deficit procedure the Commission, as well as examining compliance with the government deficit and debt criteria, has also to take into account whether the government deficit exceeds government investment expenditure. Table 4.7 shows figures for gross fixed capital formation by general government in 1995 and latest estimates for 1996 in each of the Member States and compares these with the corresponding government deficits.

Table 4.7
Government investment and deficit
(% of GDP)

	Government fixed investment		Government deficit	
	1995	1996	1995	1996 (1)
B	1.3	1.2	4.1	3.3
DK	2.0	2.0	1.6	1.4
D	2.5	2.3	3.5	4.0
EL	2.9	2.9	9.1	7.9
E	3.6	3.2	6.6	4.4
F	3.0	3.1	4.8	4.0
IRL	2.3	2.3	2.0	1.6
I	2.3	n.a.	7.1	6.6
L (2)	4.6	4.8	-1.5	-0.9
NL	2.7	2.7	4.0	2.6
A	3.1	3.1	5.9	4.3
P	4.0	4.3	5.1	4.0
FIN	2.7	2.7	5.2	3.3
S	3.3	3.2	8.1	3.9
UK	1.8	1.5	5.8	4.6
EUR	2.6	2.5 (3)	5.0	4.4

(1) Autumn 1996 economic forecasts.
(2) Negative figure indicates a surplus.
(3) Excluding Italy
Source: Commission services.

In those Member States where the government deficit remains above the 3% of GDP reference value, the deficit is larger than government expenditure on fixed investment (with the exception of Portugal in 1996). Apart from the Member States already with low deficits (Denmark, Ireland and Luxembourg),

current government expenditure elsewhere is in part being financed through borrowing (i.e. government saving in most Member States is negative).

4.4 Sustainability of budgetary convergence

Budgetary consolidation efforts have been strengthened during the course of 1996. Most Member States, including all of those with deficits currently still above the 3% of GDP reference value, are aiming for a further reduction in their deficits in 1997. Budget plans presented so far during the autumn of 1996 have made clearer how governments intend to achieve this.Table 4.8 shows the objectives for the general government deficit in 1997 announced by Member State governments in their latest convergence programmes or in more recent budget statements.

Table 4.8

Objectives for the general government deficit in 1997
(% of GDP)

B	2.9
DK	0.6
D	2.5
EL	4.2
E	3.0
F	3.0
IRL	<3
I	3.0
L	n.a.
NL	2.2
A	3.0
P	2.9
FIN	1.4
S	2.6
UK (1)	3

(1) Financial year 1997/98.
Source: National convergence programmes or more recent budget statements.

Several Member States expect to be clearly below the 3% level in 1997. Another group is aiming at a deficit next year in line with the reference value. Only Greece is targeting a deficit in 1997 higher than 3% of GDP; in its revised convergence programme Greece set the objective of bringing the deficit below the reference value in 1998.

Beyond 1997 many Member States are already aiming for further reductions in their budget deficits, often with balance or surplus as a medium-term goal. Achieving sound and sustainable budgetary positions, leading to declining debt ratios where they are too high, is an essential condition for maintaining stability, keeping interest rates low and fostering the growth of output and employment. The Commission's proposals for a stability pact involve a firm implementation of Treaty provisions so as to ensure budgetary discipline in the third stage.

EXCESSIVE DEFICIT PROCEDURE

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

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

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

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

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

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

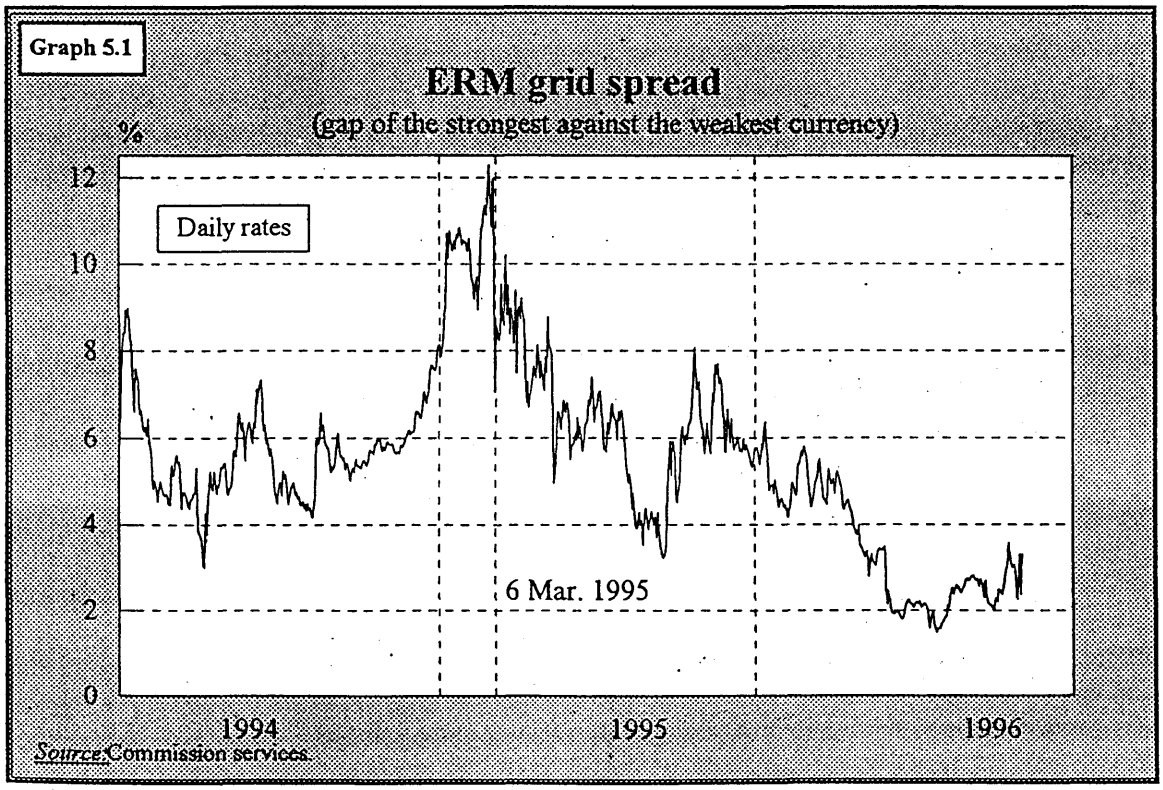
Subsequent steps in the procedure include the formulation by the Monetary Committee of an opinion on the report of the Commission (paragraph 4); the addressing of an opinion to the Council by the Commission, if it considers that an excessive deficit exists (paragraph 5); and then a decision by the Council after an overall assessment whether an excessive deficit exists (paragraph 6). Finally, the Council makes non-public recommendations to the Member State for which the existence of an excessive deficit has been decided with a view to bringing that situation to an end within a given period (paragraph 7). The Council may subsequently make its recommendations public, where it establishes that there has been no effective action in response to its recommendations within the period laid down (paragraph 8). When, in the view of the Council, the excessive deficit in the Member States concerned has been corrected, the Council abrogates its decision (paragraph 12). The provisions of Article 104c in paragraphs 9 and 11 are not applicable during the second stage of EMU

5. EXCHANGE RATES

5.1 Treaty provisions

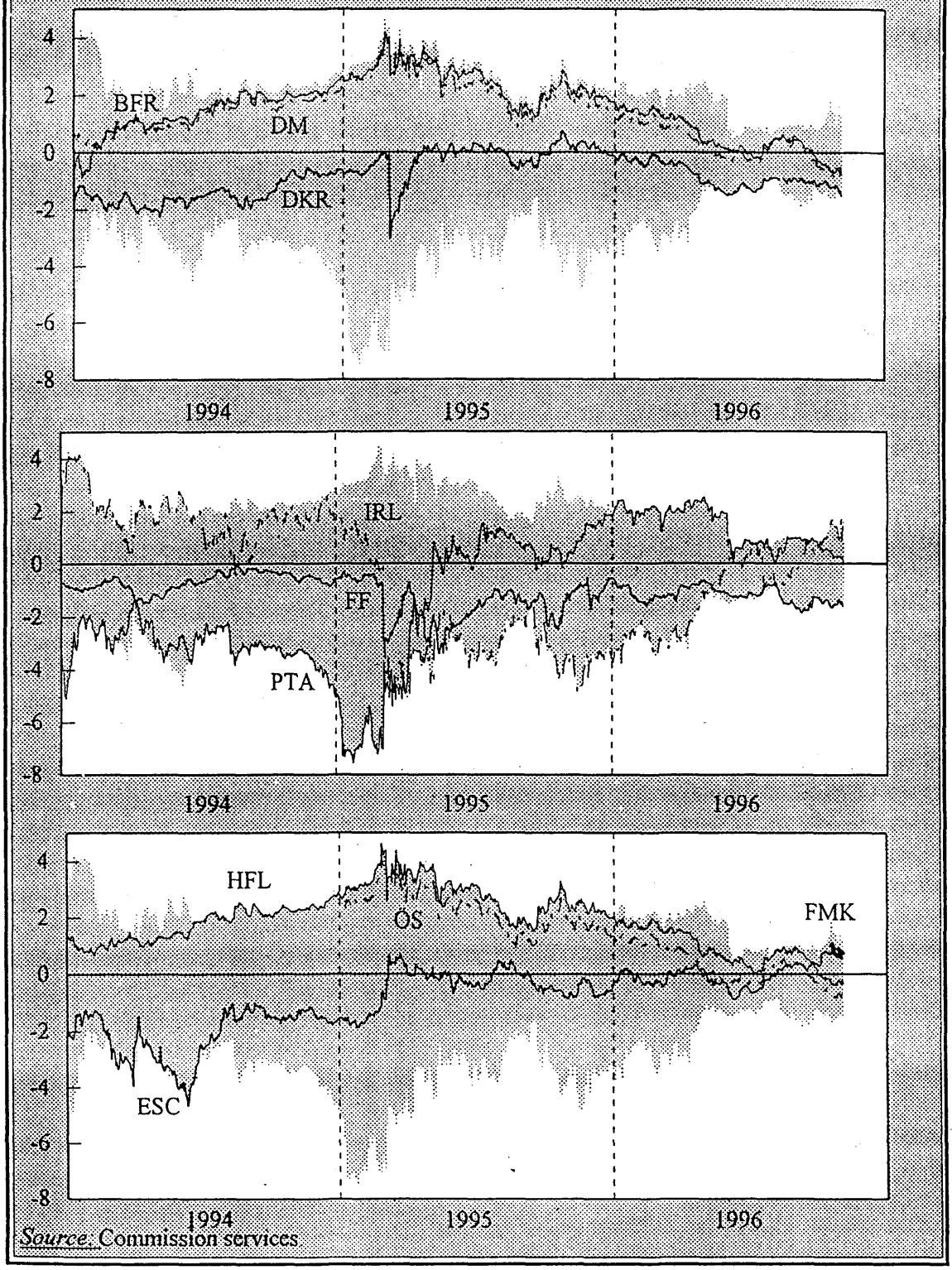
The exchange rate criterion, as set out in the third indent of Article 109j(1) of the Treaty, is defined as *"the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System for at least two years, without devaluing against the currency of any other Member State"*. The fourth indent of the same Article refers to *"the durability of convergence achieved by the Member State and of its participation in the exchange-rate mechanism of the European Monetary System being reflected in the long-term interest-rate levels"*. In addition, Article 3 of the Protocol (No 6) on the convergence criteria specifies that: *"The criterion on participation in the exchange-rate mechanism of the European Monetary System referred to in the third indent of Article 109j(1) of this Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period"*.

Eleven currencies are currently participating in the ERM. The Austrian schilling joined the ERM at the beginning of 1995 and has continued to trade in its traditional, very narrow range against the DM. The Finnish markka joined the ERM on 14 October 1996. The drachma and the Swedish krona have remained outside the ERM, while the lira and sterling have not re-joined since leaving the mechanism in September 1992.



Graph 5.2

Movements within the ERM band
(% deviation from ECU central rate)



Source: Commission services

In the first half of 1995, exchange rate tensions emerged at the international level, reflecting mainly the financial crisis in Mexico and US-Japan trade tensions; these caused a pronounced weakening of the US dollar which, combined with country-specific problems in Europe, contributed to a strengthening of the DM against many of the ERM currencies and to the increase in the volatility of these currencies. As a result, tensions emerged within the ERM that led to a realignment on 6 March 1995: at the request of the Spanish authorities, the Ministers and Central Bank Governors decided the devaluation of the peseta by 7%; by the same decision, the escudo was devalued by 3.5%.

Tensions in the ERM are reflected in the spread between the strongest and the weakest currencies in the mechanism, as shown in Graph 5.1. The spread widened to about 12% in February 1995. As international financial markets stabilised the spread declined to just 4% in late Summer 1995. After a temporary increase in September, mainly caused by a weakness of the US dollar, the spread resumed its downward trend by the end of 1995. By June 1996 the spread had narrowed to below 2%. This rather promising performance continued until the autumn. In general, although temporary tensions occurred, the ERM has been characterised by a high degree of stability during most of 1996.

Within the ERM band (see Graph 5.2), the DM, the guilder, the schilling and the Belgian franc have been strong throughout the two-year period. In 1995, the peseta recovered sharply in the two months after its devaluation, and it has remained strong in 1996. By contrast, the Irish punt, affected by the course of the dollar and sterling, weakened considerably in the first quarter of 1995 and, though it strengthened thereafter, it remained below its central rate until May 1996, but it has since recovered strongly. The French franc traded in the lower part of the band for most of the two years, but more recently the French franc recovered closer to its central rate. The escudo and the Danish krone generally remained close to their central rates.

In sum, currently nine currencies have been members of the ERM for over two years: DKR, BFR, DM, PTA, FF, IRL, LFR, HFL and ESC. The Austrian schilling will have completed two years of membership by the end of 1996. With the exception of the PTA and the ESC, these currencies have not modified their central ERM parities over the past two years and, while large fluctuations have taken place in the band, none of these eight currencies can be said to have undergone severe tensions. The central rate of the peseta was devalued, in March 1995, at the request of the Spanish authorities. The central rate of the Portuguese escudo was also adjusted downwards following the decision to change the central rate of the Spanish currency[1]. Since the middle of October 1996 the Finnish markka has also been a member of the ERM.

5.2 Further analysis of exchange rate stability

Similar indications are obtained if stability of exchange rates is considered in terms of the coefficient of variation[2] , which enables cross-currency comparisons. Graph 5.3 depicts variability against the DM.

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1 EU Communiqué, 6 March 1995

2 Defined as the standard deviation divided by the mean

It can be seen that, after the turbulence of the first half of 1995, the variability of most currencies returned to previously prevailing levels. Also, ERM currencies varied by less than those outside: in the two-year period, on average, the five currencies outside the ERM are also the ones that displayed the greatest variability; among these, the Finnish markka has fluctuated the least and has been comparatively stable in 1995 and 1996. The lira and the Swedish krona were the most volatile. Inside the ERM, the guilder, the schilling and the Belgian franc have displayed minimal variability and the Danish krone joined that group from November 1995. The variability of the other ERM currencies has also tended to be lower in 1996 than in earlier years.

Domestic causes of foreign exchange unrest include concern over the capacity of countries or the willingness of governments to achieve the high degree of convergence required for a single currency. In addition, the development of fundamentals, mainly public finance and inflation but also unemployment, exerted direct influence on exchange rate developments. Some influence, mostly towards appreciation and stability, was exerted on the Finnish markka and the Italian lira, as a result of expectations for joining the ERM.

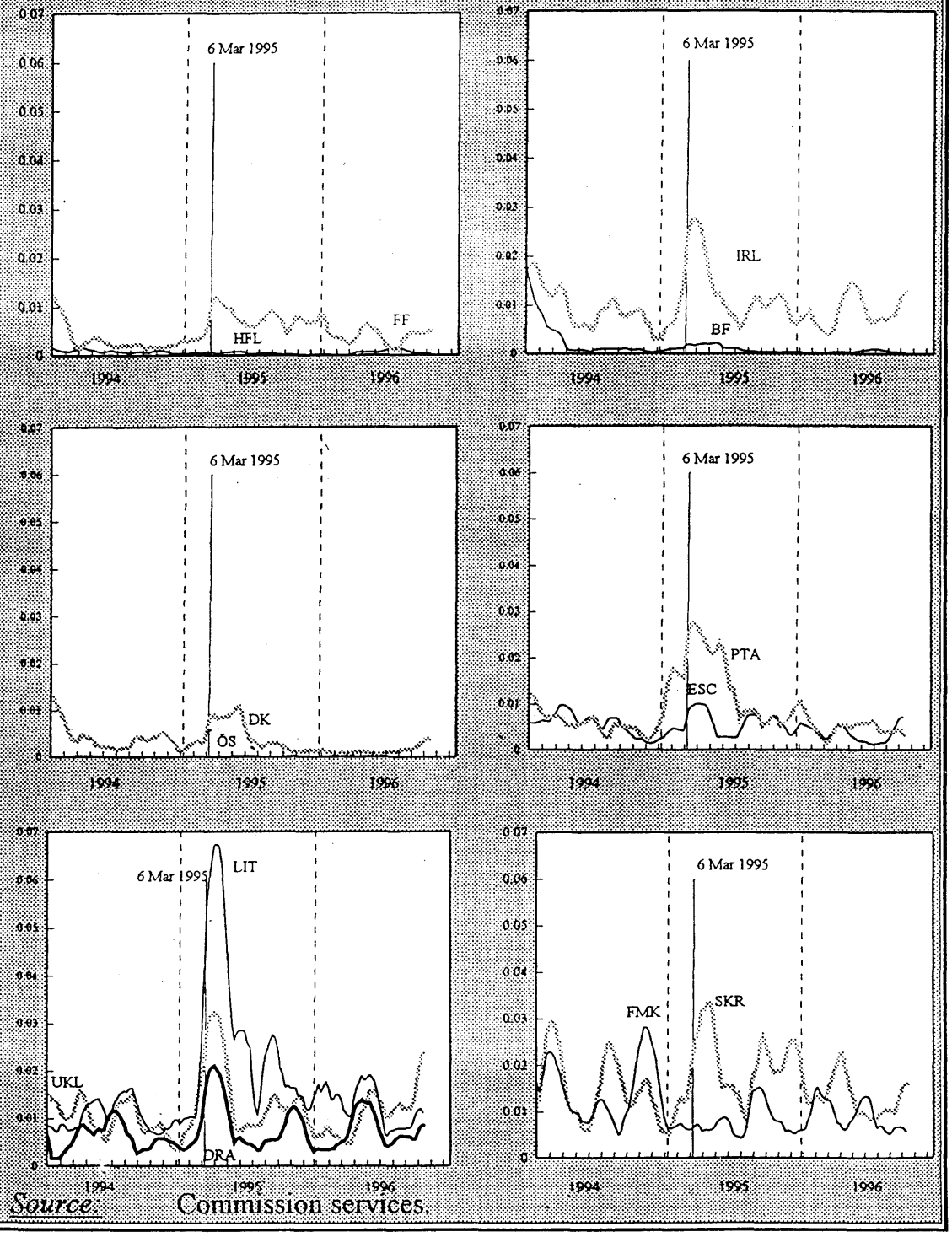
In 1996, a number of factors contributed to the easing of tensions in foreign exchange markets. Firstly, the recovery of the US dollar played a most important role: from below 1.40 DM in late 1995, the dollar rose to about 1.54 DM in June 1996; the dollar pulled upwards mainly sterling and the punt and generally reinforced the weaker European currencies against the stronger group. This also had a considerable bearing on the functioning of the ERM by reducing the spread between the weakest and the strongest currencies. Subsequently, a temporary weakening of the dollar, which fell to 1.48 DM in July 1996, did not have a substantial effect on the ERM spread; renewed strength in the dollar in September and October 1996 was accompanied by a slight widening of the spread as the punt appreciated further and became the strongest currency in the ERM.

Secondly, a more synchronised cycle in the European economies and prospects for disinflation in the higher inflation countries allowed parallel monetary policy moves and reduced the scope for speculative behaviour.

Finally, trading in relation to convergence prospects was a very important factor. From the second half of 1995, governments increasingly took conspicuous measures to improve their convergence situation. At the same time, the European authorities demonstrated repeatedly their determination to proceed to Monetary Union; particularly after the Madrid European Council, where the realisation of EMU in 1999 became a certainty. These prospects contributed to the calming of exchange rates and to the substantial reduction of interest rate differentials.

Graph 5.3

Stability of exchange rate vis-à-vis the DM: 13-week moving coefficient of variation January 1994 - October 1996



Source: Commission services.

6. LONG-TERM INTEREST RATES

6.1 Interest rate convergence

The criterion addressed here, as defined by the fourth indent of Article 109j(1) of the Treaty, is *"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"*. This criterion on the convergence of interest rates is developed further in the Protocol No 6 on the convergence criteria, Article 4 of which states that the criterion *"shall mean that, observed over a period of one year before the examination, a Member State has had an average long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability"*. It goes on to say that *"Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions."*

The unweighted arithmetic average of the 12-month average of the long-term interest rate of the three best performers in terms of inflation has been used in this report for the calculation of the reference value (see also analysis of Chapter 3). For most Member States, the yield on the ten-year benchmark bond is the one used in the calculations. Efforts have been made to make these data as comparable as possible. Further details on the interest rates used for each Member State are contained in the box on "Data and reference value for the interest rate convergence criterion". All references to the long-term interest rate in this section refer to the average over the latest 12 months of the nominal long-term interest rate.

The three best performing Member States with respect to consumer price inflation[1] in September 1996 were: Germany, the Netherlands and Finland. The average nominal long-term interest rates for these countries in September were, respectively: 6.3%, 6.3% and 7.4%, producing a reference value of 8.7% (see Table 6.1). Two of these three countries also had the lowest average interest rates, namely, Germany and the Netherlands. In all, eleven Member States had average interest rates below the reference value in September 1996. These were: Belgium, Denmark, Germany, France, Ireland, Luxembourg, Netherlands, Austria, Finland, Sweden and the United Kingdom. Four Member States (Greece, Spain, Italy, and Portugal) had average interest rates above the reference value. Sweden's average interest rate was above the reference value at the end of 1995 but, having declined during 1996, it moved below the reference value in August 1996.

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[1] The price index used to establish the three best performers is the interim index of consumer prices (IICP) from December 1995 and the consumer price index (CPI) before then (see Chapter 3).

Table 6.1

Long-term interest rate convergence in the Member States

	12-month average			
	1993	1994	1995	1996 (1)
Three best price performers				
B	-	-	7.5	-
DK	7.3	7.9	-	-
D	-	-	-	6.3
F	-	7.2	-	-
IRL	7.7	-	-	-
L	-	7.7	-	-
NL	-	-	6.9	6.3
FIN	-	-	8.8	7.4
UK	7.5	-	-	-
Reference value [2]	9.5	9.6	9.7	8.7
Member States respecting the reference value				
Number: out of:	8 12	8 12	10 15	11 15
B	7.2	7.9	7.5	6.7
DK	7.3	7.9	8.3	7.4
D	6.5	7.1	6.9	6.3
F	6.8	7.2	7.5	6.6
IRL	7.7	7.9	8.3	7.5
L	6.5	7.7	7.6	7.0
NL	6.3	6.9	6.9	6.3
A	-	-	7.1	6.5
FIN	-	-	8.8	7.4
S	-	-	-	8.5
UK	7.5	8.2	8.3	8.0

(1) Oct. 1995 to Sep. 1996

(2) Definition adopted in this report: arithmetic average of the 12-month average of interest rates of the three best performing Member States in terms of price stability plus 2 percentage points.

Source: EMI.

This impression of an improvement in the convergence situation since the end of 1995 is confirmed when the underlying situation of individual Member States is considered (see Graph 6.1 and Table 6.2). During this period, the reference value gradually declined, and the dispersion around this reference value diminished from 2.0 at the end of 1995 to 1.6 by September 1996 (see Table 6.2). Underlying this general trend are somewhat different developments in Member States satisfying the criterion and those not satisfying the criterion at the end of 1995. Although all countries experienced falling average rates, the pace of the fall was considerably less among those Member States in the former group than those in the latter group. Finland, with a fall in the average rate of 1.4 percentage points between the end of 1995 and September 1996, provided an exception to this latter observation. Indeed, the fall in Finnish rates accounts for the major part of the fall in the reference value, while the falls in the five Member States not respecting the reference value at the end of 1995 help to explain the reduction in dispersion. Compared with December 1995, the interest rate convergence gap (the difference between the average domestic interest rate and the reference value) fell for Greece, Italy, Spain and Portugal, respectively to 6.4 percentage points (-1.3), 1.6 percentage points (-0.9), 0.8 percentage points (-0.8), and 0.7 percentage points (-1.1). Greece remains the least convergent Member State, while Sweden moved from a divergence of 0.5 percentage points at the end of 1995 to being 0.2 percentage points below the reference value in September 1996.

Table 6.2

Development of long-term interest rates

	12-month average			
	1993 (1)	1994(1)	1995(1)	1996(1) (2)
B	7.2	7.9	7.5	6.7
DK	7.3	7.9	8.3	7.4
D	6.5	7.1	6.9	6.3
EL	23.3	20.8	17.4	15.1
E	10.2	10.0	11.3	9.5
F	6.8	7.2	7.5	6.6
IRL	7.7	7.9	8.3	7.5
I	11.2	10.5	12.2	10.3
L	6.5	7.7	7.6	7.0
NL	6.3	6.9	6.9	6.3
A	6.7	7.0	7.1	6.5
P	9.7	10.5	11.5	9.4
FIN	8.8	9.1	8.8	7.4
S	8.5	9.7	10.2	8.5
UK	7.5	8.2	8.3	8.0
pro memoria				
Average of 3 best price performers	7.5	7.6	7.7	6.7
Dispersion from average of 3 best price performers (3)	1.6	1.5	2.0	1.6

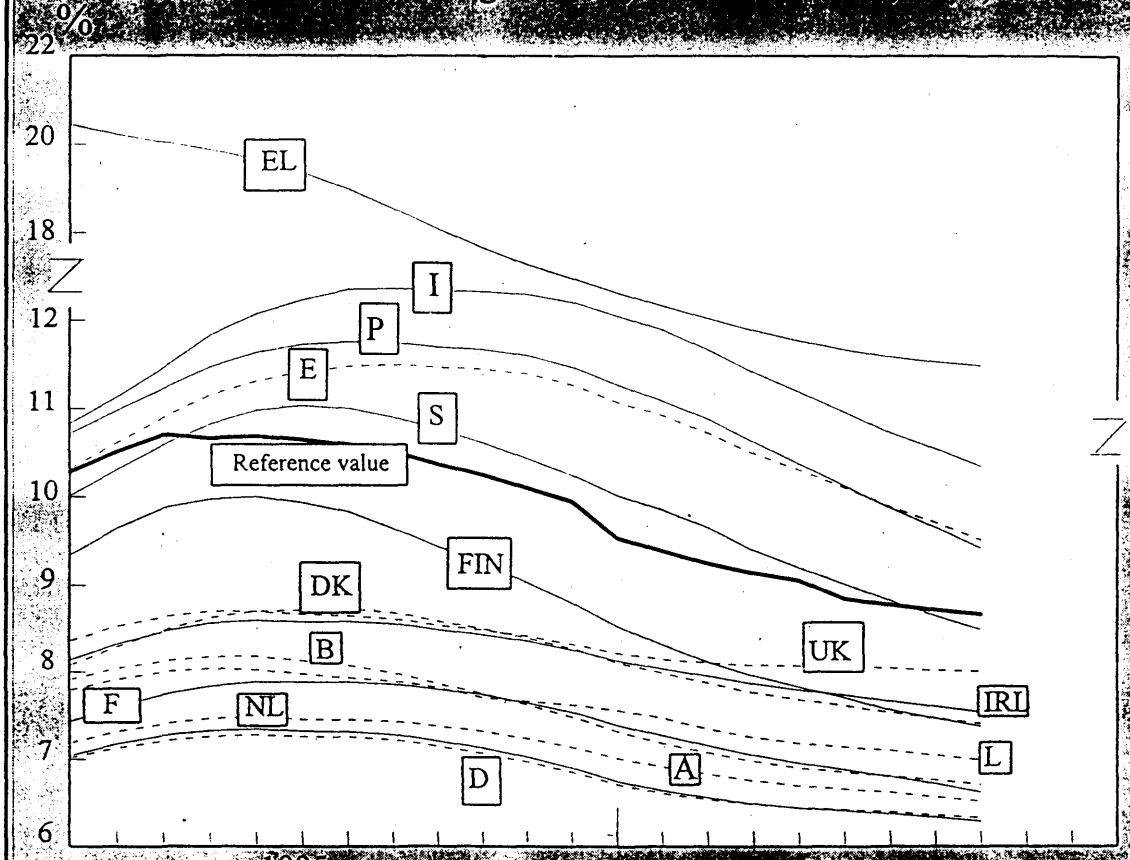
(1) For 1993, data are non-comparable for Luxembourg (January -September) and Portugal (January-June). For Greece data are non-comparable.
(2) Average of October 1995 to September 1996.
(3) Measured by the standard deviation around the average of the 3 best price performers (Greece omitted from calculations in all years; Luxembourg omitted from calculations in 1993).
Source: EMI.

Within the group of countries meeting the criterion, the picture was somewhat different. In general, the pace of the decline in average long-term rates over the review period was less than in the group of countries not satisfying the criterion. This was to be expected since long-term rates in these countries were already low (see Graph 6.1). Finland provides an exception to the general trend. The strong decline in Finnish long-term rates, together with the levelling off of rates in the United Kingdom, saw the latter replacing Finland as the Member State in this group with the highest long-term rates.[2] The dispersion within the group itself declined. Excluding Sweden, the spread between the lowest interest rate (Germany: 6.9%) and the highest interest rate (Finland: 8.8%) was 1.9 percentage points at the end of 1995. This fell to 1.7 percentage points (=8.0% for the United Kingdom less 6.3% for the Netherlands) in September 1996. Including Sweden, the spread in September 1996 was higher at 2.2 percentage points.

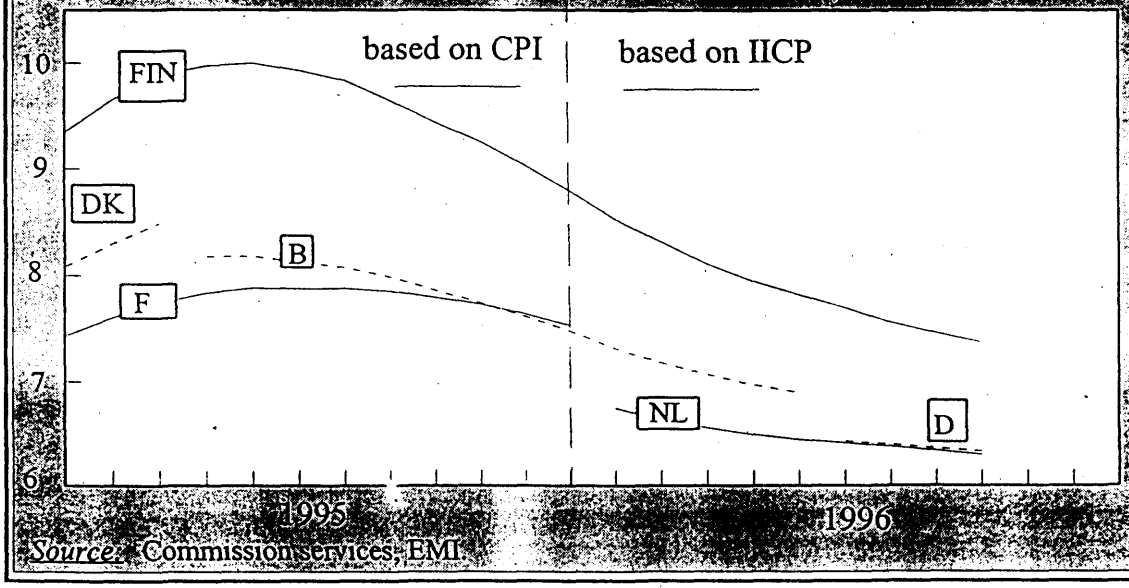
[2] Until Sweden became a member of this group in August 1996.

Graph 6.1

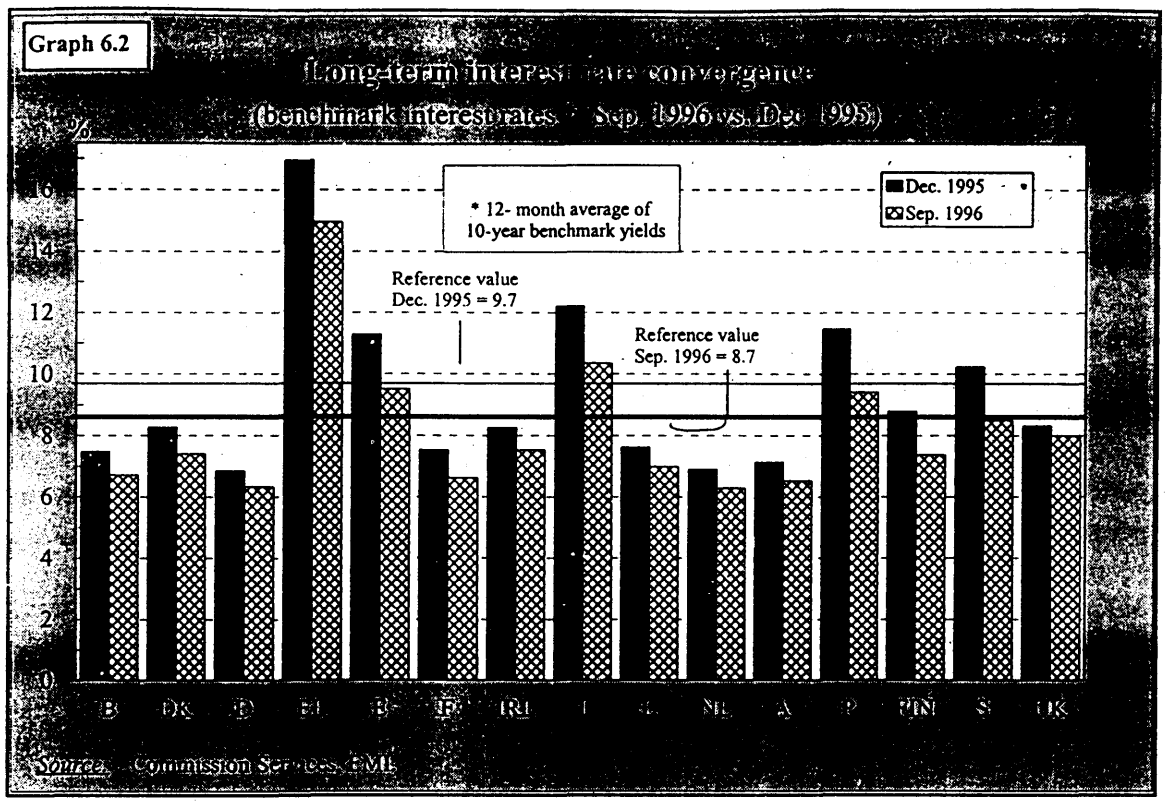
Recent evolution of long-term interest rates
(12-month average of 10-year benchmark yields)



Interest rates of 3 best performers



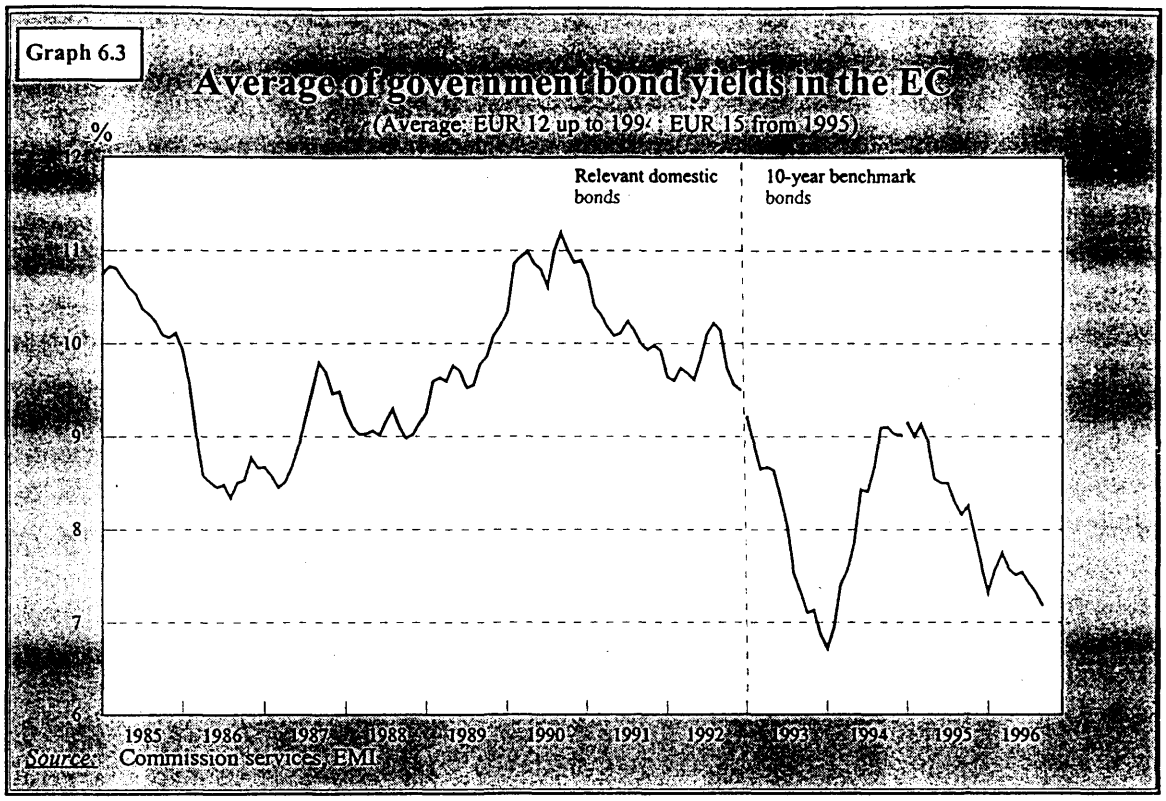
Source: Commission services; EMI



6.2 Recent developments in long-term interest rates

In this section, the recent evolution of long-term interest rates is analysed by a consideration of the paths followed by monthly nominal long-term interest rates (as opposed to the 12-month averages of the previous section) in the Member States and at the level of the Union as a whole. The sharp upward movement in nominal long-term rates in the European Union in 1994, was followed by a steady downward trend in 1995. After a brief interruption at the beginning of the year, this downward path has continued in 1996 (see Graph 6.3). Falling long-term interest rates in 1995 were generally seen as an international phenomenon stemming from a slowdown of growth in the USA, deflationary pressures in Japan, and perceptions of lower inflationary pressures in Europe.

Revisions in market expectations about the likelihood of official interest rates cuts in Germany and the US were widely cited as the reason for the upward spike in long-term interest rates at the beginning of 1996. Expectations that a policy of monetary easing in Germany had reached a turning point surfaced towards the end of January. This was compounded in February by expectations of a tightening of monetary policy in the USA, the effect of which spilled over from US to European bond markets. This international trend was driven partly by market fears of excess global liquidity following the sustained reduction in interest rates in the major economies throughout 1995.



The resumption of downward trend in average nominal long-term rates in the EU since April 1996 may be explained by a number of factors. These include: a decoupling of trends in the USA and some European bond markets in the second quarter of 1996; and, in the third quarter, another shift in market expectations concerning US and Japanese monetary policy, this time away from a near-term tightening, which resulted in internationally falling long-term rates. In September 1996, the average level of bond yields in the EU recorded a level of 7.2%, 1 percentage point lower than in September 1995 and below the level of 7.3% recorded in January 1996.

A number of features in the evolution of long-term interest rates across Member States may be highlighted. First, although long-term rates fell in all EU countries over the period between September 1995 and September 1996, the size of the fall varied across countries (see Table 6.3). In general, those countries with the highest long-term rates experienced the largest falls: Italy, Portugal, Spain and Sweden recorded reductions in the range of 1.8-2.9 percentage points.

Table 6.3

Recent evolution of long-term interest rates

	Monthly average of daily data		
	September 1995	September 1996	Change(pps)
B	7.0	6.5	-0.5
DK	7.8	7.2	-0.6
D	6.6	6.2	-0.4
EL	15.8	14.8 (Feb)	-1.0
E	10.8	8.4	-2.4
F	7.4	6.2	-1.2
IRL	8.0	7.2	-0.8
I	11.5	9.2	-2.3
L	7.4	6.8	-0.6
NL	6.6	6.1	-0.5
A	6.9	6.3	-0.6
P	11.2	8.3	-2.9
FIN	8.0	6.9	-1.1
S	9.6	7.8	-1.8
UK	8.1	8.0	-0.1
EUR (1)	8.2	7.2	-1.0

(1) : weighted average using 1995 GDP weights

Source: EMI.

In Greece the decline was less, so that long-term rates remain high[3] . Among the countries already with lower interest rates, Finland, also benefiting from lower inflation expectations, recorded a substantial reduction (1.1 percentage points). Given that the largest interest rate reductions, over the year to September 1996, were realised by those Member States with the highest nominal long-term rates, interest rate differentials over corresponding German bonds narrowed[4] during the year, with Spain, Italy, Portugal and Sweden experiencing the largest reductions.

Second, while all EU countries shared common trends in nominal long-term rates between August 1995 and March 1996, there has been some divergence of experience among Member States since then. Following the brief upward blip in the first quarter, all countries except the United Kingdom recorded reductions once again during April. For Belgium, Denmark, Germany, Luxembourg and Austria, long-term rates rose over the period May-June, before dropping once again in July-August. On the other hand, the downward trend persisted in the high-yield countries, namely, Spain, Italy and Portugal.

6.3 Explanatory factors and assessment

Progress was made over the last year in terms of interest rate convergence, with Sweden satisfying this convergence criterion from August 1996 and the remaining four countries (Greece, Spain, Italy and Portugal) moving nearer the reference value. Spain, Italy and Portugal also recorded considerable narrowing of their interest rate convergence gaps. Indeed, if the current levels of interest rates were to be maintained, the average long-term rates for Spain and Portugal would very shortly come under the

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3 It should be noted that the data for Greece are not comparable to the data for other Member States. In the absence of a long-term capital market a bond with an original maturity of 5 years is used. In addition, the existence of a reporting lag in the receipt of the data hampers up-to-date comparisons.

4 For all countries except the United Kingdom.

reference value. This favourable development may be attributed to a number of underlying factors. One important factor is the declining inflation rates in these countries, which in turn helped to reduce inflation expectations. This is particularly the case for Spain, Portugal and Sweden, which recorded sizeable reductions in average inflation rates between December 1995 and September 1996. Compared to the previous year, the rapid reduction in inflation in Portugal appears to have affected long-term interest rates. Greece's less spectacular progress in terms of inflation, given the high starting point, may help explain the slower progress in terms of reducing the interest rate gap in this country.

A second important explanatory factor was the efforts made in these countries in terms of reducing government deficits. Such progress in government deficit consolidation contributed to a more balanced policy mix and thus to reducing the credit risk premium. The progressive calming of exchange rate markets during the 1996 created conditions for a stabilising of bond markets.

DATA AND REFERENCE VALUE FOR THE INTEREST RATE CONVERGENCE CRITERION

Data

According to Article 4 of the Protocol on the convergence criteria:

"Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions."

According to Article 5 of the same Protocol, the Commission shall provide the statistical data for the application of the interest rate convergence criterion. In agreement with the European Monetary Institute, which has a comparative advantage in the analysis of financial statistics and has advised the Commission on the issue, interest rates with the following characteristics have been deemed the most appropriate for the examination of the interest rate criterion:

- maturity: residual maturity close to 10 years (9 to 10.5 years)
- issuer: central government (in Germany including Treuhandanstalt)
- choice of bonds: liquidity is the main selection criterion; the choice between a single benchmark or the average of a sample should be based on this requirement; most (eleven) Member States choose a benchmark (Belgium, Denmark, France, Ireland, Italy, Luxembourg, Netherlands, Austria, Finland, Sweden, United Kingdom), while three Member States choose an average (Germany, Spain, Portugal)
- aggregation: simple average should be used if there is more than one bond in the sample
- gross of tax
- yield calculation: ISMA-formula for yield to maturity
- coupon: fixed

In Greece, in the absence of a long-term capital market a bond with an original maturity of 5 years was selected. Its coupon is indexed to the 12-month treasury bill and adjusted yearly. Contrary to the other Member States where daily quotations are available, an end-of-month figure is used.

The present evaluation of the long-term interest rate criterion is based on harmonised long-term interest rates, incorporating the above characteristics.

Reference value

According to Article 4 of the Protocol on the convergence criteria, the criterion on the convergence of interest rates *"shall mean that, observed over a period of one year before this examination, a Member State has had an average nominal long term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability."*

The unweighted arithmetic average interest rate of the three best performers in terms of price stability is used in this examination of the interest rate criterion for the calculation of the reference value.

7. SUPPLEMENTARY INFORMATION

This chapter reviews developments is several other areas which are required by Article 109j(1) to be taken account of by the Commission (and the EMI) in their reports. The following sections examine the developments of the ECU, the results of the integration of markets, the situation and development of the balances of payments on current account and the development of unit labour costs and other price indices.

7.1 Development of the ECU

The ECU markets encountered difficult conditions in 1995 and much of 1996. Primary bond market activity contracted to historically low levels, though secondary market turnover proved to be more robust. A degree of stability was provided by sovereign issuers through the continuation of regular debt programmes in ECU but, with private issuers largely ignoring the ECU, liquidity in the market was much reduced. From the start of the second half of 1996 interest in the ECU began to recover as confidence in the EMU process developed and perceived uncertainties, like the start date of monetary union, the 1:1 substitution of the euro for the ECU and continuity of ECU contracts, began to crumble. With the release of the regulations on the legal framework for the euro positive market sentiment towards the ECU has firmed, and market analysts now anticipate a return to growth in the ECU markets in the run up to 1 January 1999 and the start of monetary union.

One manifestation of the ECU's difficulties was the emergence from the middle of 1994 of a persistent spread, in excess of 50 basis points, between the market exchange rate value of the ECU and its theoretical value. In an historical context, ±20 basis points had been considered to be the normal trading range of the spread; moreover, on those occasions when the spread exceeded its normal range, in particular during the ERM crises in 1992 and 1993, it had done so for only a short period of time before arbitrage activity by the so-called "basket makers" brought the spread rapidly down to more normal levels. Towards the end of 1994, the spread - though still volatile - had contracted, reaching around 20 basis points. However, with the subsequent re-emergence of ERM tensions in early 1995 the spread rapidly increased reaching a high of 152 basis points by the end of March 1995. Though it subsequently fell to under 100 basis points this was only a temporary respite. The spread reached over 300 basis points at the end of 1995. During the first half of 1996 confidence began to return to the ECU markets and the spread tended to fluctuate between 150 and 250 basis points, with a slow fall commencing in May. During the second half of 1996 the spread stabilised at approximately 100 basis points during July and August, and then fell to below 60 basis points by the end of September. Subsequently the spread has contracted further to between 30 to 20 basis points.

The underlying reasons, and their relative importance, for the behaviour of the spread are difficult to determine precisely, but a number of factors have demonstrably played a role. First, exchange rate tensions in the ERM have had a negative impact on the ECU. Second, there has been an increase in the perceived risk of running open positions in

ECU, which has been reflected in the switch by the basket maker banks from a long-term strategy, in which they were willing to hold open positions in ECU for considerable periods of time, to a short-term strategy in which profits are taken as soon as possible even though greater profits would potentially have been generated by holding the position for longer.

In part also, the increase in perceived risk stems from a growing awareness that since 1987 there has been no institutionalised link between the market ECU and the basket apart from the conversion of ECU into euro at 1:1 upon the start of Stage Three, on 1 January 1999[1]. For many market operators the level of uncertainty, over the EMU timetable and legal issues, was such that they took little comfort from the 1:1 provision in the Treaty. Thus uncertainty over EMU fed through to concerns over the future value of the ECU. However, since the European Council in Madrid in December 1995, market confidence has been growing as the high level of political commitment to monetary union has been repeatedly demonstrated and the uncertainties over legal issues, such as the continuity of contracts and the 1:1 conversion of ECU into euro, have largely been removed by the regulations proposed by the Commission.

The exchange rate value of the ECU may also have been damaged by the high level of net redemptions of ECU denominated bonds in 1995 and 1996. Given a contraction in the stock of outstanding ECU denominated bonds, the proceeds from repayments, funded by the drawing down of existing ECU deposits, have tended to be exchanged for other currencies for reinvestment. This has put downward pressure on the exchange rate value of the ECU; however, as confidence in EMU has grown so too confidence in the ECU markets has slowly been returning and the spread has reduced.

During 1995, the amount of bond issues denominated in ECU was significantly lower than the amount of maturing paper with the result that the stock of outstanding debt in ECU declined by 6% to ECU 127 billion (excluding Greek ECU-linked bonds). This compares to a historic peak of ECU 140 billion stock outstanding in 1993. During the first nine months of 1996, demand for ECU from institutional investors remained subdued and private issuers were few in number and wary. Issue activity was therefore low, with periods of no issuing. The total amount issued during the first nine months of 1996 amounted to ECU 10.9 billion compared with ECU 13.5 billion over the same period in 1995. Thus with ECU 18.9 billion of maturing paper the stock of outstanding ECU denominated debt fell to ECU 119 billion by the end of September 1996.

In the secondary market, average turnover in ECU bonds rose in value terms by 8% in 1995, its highest level since 1992. In the first nine months of 1996 there was a further rise of 4%. As a percentage of the total secondary market the share of the ECU declined from 5.6% in 1993 to 5.2% in 1994 and 1995, but rose slightly to 5.3% in 1996 (up to the end of September).

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[1] Until 1987 the institutionalised link was also provided by the acceptance by the ECU Banking Association of delivery of the basket in the settlement of ECU positions in the clearing

In contrast to the steady contraction of the ECU bond markets other ECU markets have performed better but have nevertheless registered decreases in activity. The approximate measure of commercial and financial activity provided by the daily average turnover in the EBA ECU Clearing System has experience a modest fall in activity, from ECU 50.0 billion during 1994 to ECU 46.8 billion during 1995, a year on year decrease of 6.5%. For the first nine months the average daily turnover in 1996 is some 2.1% lower than for 1995 at ECU 45.8 billion.

Studies of ECU flows related to commercial transactions (i.e. purchase of goods and services) as opposed to purely financial transactions suggest that commercial payments account for a small portion of total payments (1996 results: 7.1% in volume terms, 0.7% value), but that nevertheless commercial ECU payments can be estimated to be in the region of ECU 50 billion to ECU 75 billion.

7.2 Results of the integration of markets

With an average of about 93% of Single Market legislation transposed into domestic legislation by all Member States, the Single Market is becoming reality. It is not yet complete, but the achievement so far should not be underestimated. It has already made the European Union the most economically integrated collection of nation states in the world. Evidence of this deepening integration is accumulating.

7.2.1 Market integration through trade

By removing trade barriers between countries, the Single Market was expected to expand trade among EU Member States. In fact, between 1985 and 1995, the share of intra-EU imports in total manufacturing imports has indeed increased on average by 6.7 percentage points from 61.2% in 1985 to 67.9% in 1995. Furthermore, intra-EU penetration ratios increased much more in fifteen manufacturing industries identified *ex ante* as particularly sensitive to the Single Market project (SMP) than in all other manufacturing sectors. For services during the same period 1985-1995, the share of intra-EU exports in total services exports has increased on average by 3.1 percentage points from 46.9% in 1985 to 50.0% in 1995. Direct and pro-competitive effects of the SMP on trade almost fully explain these changes in the market share of intra-EU imports.

Increasing economic integration may lead to greater country specialisation on the basis of their respective comparative advantages (inter-industry trade) or it may favour intra-industry trade, the simultaneous import and export of similar product lines between Member States.

Inter-industry trade between different countries carries efficiency gains, with each country specialising in those activities in which it is relatively more efficient, and consumers gaining lower prices as a consequence. However, this would imply a deeper specialisation between the less developed Member States and the more advanced, each country experiencing a contraction of some sectors and expansion of others, which may imply significant adjustment costs.

By contrast, intra-industry trade benefits the consumer by leading to a much wider variety of products, whilst producers face lower adjustment costs. Here, adjustments would take place amongst firms inside industries rather than amongst industries.

At the beginning of the 1980s, most trade within the Community could be classified as inter-industry[2] (around 45%). However, the preparation phase of the Single Market was accompanied by a decrease in the share of inter-industry trade in Europe and a rise in intra-industry trade - which itself could be further subdifferentiated: either intra-industry trade in similar products in terms of prices and quality or intra-industry trade in products differentiated by price and quality (for example, one country exporting brand-name expensive shirts and the other inexpensive low quality shirts). The rise in intra-industry trade has predominantly been the latter type (from less than 35% in 1985 to more than 42% in 1994), whilst intra-industry trade in similar products[3] remained rather stable (around 20% of total intra-EU trade). The SMP has therefore increased the range of products available to consumers in terms of prices and quality, and encouraged differing business strategies: either emphasising design, research and development, and advertising in some cases (high price-quality) or production cost-minimising in others (low price).

In the period 1985-94, all EU countries have experienced a decrease in inter-industry trade, but especially Spain, the United Kingdom, France and Germany. Nevertheless, in 1994, inter-industry trade still accounted for over 58% of the total manufacturing trade of Greece, Portugal, Ireland and Denmark. At the same time, conversely, intra-industry trade in price and quality-differentiated products represented over 42% of total trade for the United Kingdom, Germany, France, Belgium, Luxembourg and the Netherlands, a share which grew between 1987 and 1994 for all this group of countries plus Spain and Portugal.

Analysis of price and quality-differentiated intra-industry trade shows a striking difference between northern and southern countries. Scrutiny of the contribution to the trade balance of low, medium and high price quality product ranges spotlights different country groupings. Germany has a comparative advantage in high price and quality product ranges, France in medium to high price and quality ranges, the United Kingdom, the Netherlands, Belgium, Luxembourg and Denmark only in medium price and quality ranges, Spain in medium to low price and quality ranges, and Greece and Portugal only in low price and quality ranges. These specialisations have been unaffected by monetary fluctuations.

In the period 1985-94, the share of medium price and quality products in overall intra-EU trade has declined (by some 10 percentage points) to the benefit of high price quality

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2 There is inter-industry trade between two countries when one country's trade flow (imports or exports) with the other in a sector represents less than 10% of the other country's trade flow (imports or exports) with it in the same sector.

3 There is intra-industry trade in similar products when export and import unit values differ by less than 15% and there is intra-industry trade in differentiated products when unit values differ by more than 15%.

products (plus 7 percentage points) and low price and quality products. This is especially so for the most advanced European economies, but even in the southern Member States, specialisation has changed and the share of low price and quality products has generally fallen whilst the share of high price and quality products has increased.

Growing intra-industry trade with price differentiation implies that Member States are more and more specialised inside industries on products with differing price level ranges. For most advanced countries such an evolution involves growing intangible investment in R&D, training, innovations to compete in traditional mature industries, and for less advanced countries, the possibility of entering high tech and high value added sectors and competing on price.

7.2.2 Market integration through foreign direct investment

Trade is not the only mechanism by which markets can become more integrated. Foreign direct investment (FDI) is an alternative to trade as a way of supplying foreign markets. Multinational companies are the main source of FDI flows, and the sales of multinational foreign affiliates are now by some estimates worth double the value of world exports.

In fact, impact on FDI of the SMP seems to have been even more positive than its impact on trade. The European Union absorbed 44.4% of FDI inflows from all countries in the world at the beginning of the 1990s, compared to 28.2% in the period 1982-87. Moreover, intra-EU FDI (i.e., FDI flows between Member States) increased four times faster than intra-EU trade in the period 1984-92. Altogether, between 1984-85 and 1992-93, EU FDI inflows from all sources increased five times (seven times for intra-EU inflows).

The impact on the domestic economy of FDI (FDI inflows relative to GDP) differs widely amongst Member States. At the beginning of the 1990s, annual Irish FDI inflows were worth over 9% of GDP. In Belgium and Luxembourg, the ratio was 4.7% a year. The Netherlands (2.7%) came next, then Portugal (2.6%), the UK (1.8%) and Spain (nearly 1.8%). By contrast, in Germany (less than 0.4%), Italy (0.4%) and Greece (0.6%) these figures were very low. Over the period 1986-93, two Member States (Belgium and Ireland) have gained considerable ground in terms of attractiveness as locations for FDI. In general, Ireland, Portugal, Spain and the Benelux countries are among the ones which have benefited most from the Single Market in terms of FDI.

7.2.3 Market integration and competition conditions inside the EU

Cost reductions related to size achieved over the period 1985-93 have been mostly the result of exploiting scale advantages linked to fixed investments in marketing, brand development, R&D spending and development of new production processes. Few efficiency improvements have been the consequence of exploiting purely technical efficiency gains related to the size of establishments.

Nevertheless, sectors such as distribution and road freight transport do show remarkable productivity gains. Productivity and efficiency gains in the more regulated sectors (telecommunications, banking, airlines) have been less pronounced and, in general, it is very uncertain the extent to which observed changes can be linked to the SMP. Large gains have been observed only in liberalised telecommunication services.

Evidence on price cost margins and business perceptions seems to indicate that the efficiency gains associated with large size have been passed on to consumers and users thanks to increased competition associated with the SMP. Over the period 1980-1992, European manufacturing industry registered a trend recovery of price-cost margins, at a yearly rate of about 2%, controlling for the evolution of the economic cycle and the diverging industrial structures of the EU Member States. Within this overall trend, however, statistical analysis confirms that implementation of the SMP imposed increasing pressure on price-cost margins, thus ensuring that cost reductions have been passed on to consumers and downstream users. It is estimated that the SMP has led to a yearly 1% reduction in margins since 1986/87. That is, in the absence of the SMP, margins would have grown faster over the period.

Competitive conditions in services have also been significantly altered by the SMP. A significant increase in competition is noticeable in sectors such as telecommunication services or retail banking, but also in airlines, where implementation of the SMP has only been partial so far. Overall, however, the increase in competition seems to be less strong than in manufacturing sectors, reflecting that many regulations are still maintained on services and that the SMP has not been fully implemented in several domains. This increased competition has resulted in substantial and quite general reductions in prices in sectors such as telecommunications, and a more selective decline of prices in segments of the airline and banking industries.

In road freight transport, the margins for cross-border traffic have declined sharply over the period 1986-94. The result has been a reduction in real transportation prices which, together with efficiency gains in the distribution sectors, have led to substantial changes in the sourcing patterns of manufacturing and retailing firms. A wider range of sourcing possibilities has contributed to declines in input costs.

The changes in structures and the degree of competition of European markets prompted by the implementation of the SMP have also resulted in increased price convergence across the EU for many goods. Between 1990 and 1993 the variation between Member States in prices (including taxes) has decreased from 22.8% to 19.6% in consumer goods and from 31.8% to 28.6% in services, but increased 28% to 31.7% in energy.

7.3 Situation and development of balances of payments on current account

Following deficits in both 1991 and 1992, the current account of the Union as a whole has recorded either a zero balance, in 1993 and 1994, or a small surplus, in 1995; a larger surplus is expected in 1996. These balances, apart from being indicators of the amount of national savings, have in recent years become signals of the state of domestic absorption relative to domestic output. With complete liberalization of capital movements, and the removal of residual exchange controls by some Member States in the past two years, financial integration has continued to progress, and the Union's financial markets are now closely integrated with international financial and capital markets. Consequently, the international allocation process of excess domestic savings or excess domestic spending is facilitated. Several Member States have systematically recorded current account surpluses since the beginning of the 1990s (Belgium, Denmark, France, Ireland, Luxembourg and the Netherlands), while in others current account deficits of earlier years have become surpluses (Spain, Italy, Finland and Sweden); in five Member States (Germany, Greece, Austria, Portugal and the United Kingdom) the current account has remained in deficit since the beginning of the decade (see Table 7.1).

Table 7.1

Current account balance
(national accounts definition, % of GDP)

	1993	1994	1995	1996 (1)
B	3.8	4.0	4.5	4.1
DK	2.9	1.6	0.6	1.0
D	-1.1	-1.4	-1.2	-0.9
EL	-1.7	-1.0	-2.7	-3.0
E	-1.0	-1.2	0.9	0.9
F	1.0	1.0	1.6	1.7
IRL	5.3	3.4	4.3	3.7
I	1.0	1.5	2.4	3.6
L	15.2	15.9	17.9	16.3
NL	4.9	5.2	5.2	4.9
A	-0.4	-1.0	-2.3	-1.9
P	-2.1	-1.8	-0.2	-1.0
FIN	-1.3	1.3	4.5	4.0
S	-1.4	-0.7	0.6	1.2
UK	-2.5	-2.1	-1.8	-1.8
EUR	0.0	0.0	0.2	1.0

1) Autumn 1996 economic forecasts.
Source: Commission services.

In a majority of Member States the current account balance has been improving, despite the recovery of economic growth, since the end of the recession of the early 1990s. An important factor in this has been the reduction of fiscal imbalances and the consequent increase in national savings. Balance of payments positions relative to GDP in 1996 are not estimated to change markedly compared to the previous year; latest estimates by the Commission services show reductions in the surplus in Belgium, Ireland, Luxembourg, the Netherlands and Finland, and a widening of the deficit in Greece and Portugal. The surplus is likely to rise in 1996 in Denmark, France, Italy and Sweden, and the deficit is expected to narrow in Germany and Austria. The current account surplus in Spain and the deficit in the United Kingdom are likely to be similar in scale in 1996 to the previous year.

7.4 Examination of development of unit labour costs and other price indices

Developments in various consumer price indices (IICP, CPI, private consumption deflator) contain important, albeit incomplete, information on the inflation environment prevailing in an economy (see Chapter 3). To ensure a comprehensive and balanced examination of the degree of price stability and the sustainability of the inflation

performance, the Treaty (Article 109j (1)) also requires that *"the development of unit labour costs and other price indices"* should be considered.

7.4.1 Unit labour costs

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

At the Community level, growth in nominal compensation per employee has slowed down steadily from 4.2% in 1993 to 3.4% in 1996, thereby reaching a level never attained over the past 35 years. This deceleration was common to most Community countries, though to a varying extent (see Table 7.2). The salient exceptions are Italy, Sweden, and, to a lesser extent, Denmark. Over the same period, the increase in nominal compensation per employee accelerated from 3.7% to 6.2% in Italy, and from 4.4% to 6.6% in Sweden. This means that wage growth is now above the inflation rate, which could generate wage/price tensions when economic activity speeds up.

Three major factors seem to explain the generally observed moderation in nominal wages. Firstly, as already noted, wage settlements appear to increasingly incorporate inflation expectations consistent with the price objectives announced by the monetary authorities. Secondly, wage negotiations seem to have increasingly taken into account developments in the real side of the economy (output growth, labour market situation, profitability concerns). Thirdly, actions to improve labour market flexibility have been undertaken in several Member States, including among others incentives for unemployed people to look for a job more actively, reforms of the educational and training system, measures to increase flexibility of working time and of rules governing employment conditions, and measures to improve the efficiency of employment services. This set of structural measures should help to avoid excessive upward pressure on wages when activity speeds up, allowing unemployment to come down.

The second element which influences unit labour costs is labour productivity. The latter has shown the usual cyclical pattern over the past few years. After slowing down during the recession of 1993, gains in labour productivity picked up in 1994, along with the rebound in economic activity. However, the growth slowdown experienced in the Community from mid-1995 again drove down apparent labour productivity growth, both in 1995 and in 1996.

As a result, growth in nominal unit labour costs was very modest over the 1994-1995 period. In 1994, eight countries showed an actual decline in unit labour costs, while in 1995, growth in unit labour costs was at or below 2½% in all Member States, with the exception of Greece. Thus, apart from Greece, growth in unit labour costs was below the inflation rate in all the Community countries over this two year period. This favourable

evolution is mainly the result of moderate wage increases but is helped by the cyclical rebound in labour productivity growth.

The moderate trend in unit labour costs has continued in 1996. While an acceleration is noticeable, the increase in unit labour costs remains consistent with continued favourable inflation trends in the Community and in most Member States. An acceleration in unit labour costs is expected in Spain, Italy and Sweden, and to a lesser extent in Denmark, Portugal, Finland, and the UK. For most of these countries, this acceleration remains moderate and leaves the increase in labour costs below or close to the inflation rate, with the exception of Italy. In addition, this strengthening could be short-lived as it partly reflects cyclical factors.

Table 7.2

Labour costs
(percentage change, total economy)

	Nominal compensation per employee				Labour productivity growth				Nominal unit labour costs			
	1993	**1994**	**1995**	**1996** (1)	**1993**	**1994**	**1995**	**1996** (1)	**1993**	**1994**	**1995**	**1996** (1)
B	3.5	4.4	2.5	1.6	0.0	2.9	1.5	1.5	3.5	1.4	1.0	0.1
DK	1.6	3.6	3.6	4.1	2.5	5.0	1.1	1.5	-0.8	-1.4	2.5	2.6
D	4.3	3.2	3.8	2.6	0.6	3.6	2.2	2.2	3.6	-0.4	1.5	0.4
EL	10.1	11.9	12.7	11.1	-3.2	-0.4	1.1	1.2	13.7	12.3	11.5	9.8
E	6.5	3.1	3.0	3.9	2.6	2.7	1.1	0.8	3.7	0.4	1.9	3.1
F	2.8	2.2	2.3	2.2	-0.2	2.9	1.0	1.3	2.9	-0.7	1.4	0.9
IRL	6.7	2.3	1.1	4.0	3.0	4.1	6.1	4.3	3.6	-1.7	-4.6	-0.2
I	3.7	3.0	5.2	6.2	1.8	3.7	3.4	0.5	1.9	-0.7	1.7	5.7
L	5.2	3.7	3.8	3.4	-1.7	1.0	0.9	1.1	7.0	2.7	2.8	2.2
NL	3.3	2.4	2.0	1.0	0.9	3.3	0.2	1.0	2.5	-0.8	1.8	0.0
A	4.6	3.1	3.8	2.9	0.8	2.9	2.1	1.7	3.7	0.2	1.6	1.2
P	9.1	8.2	5.3	5.8	0.7	0.9	2.9	2.0	8.3	7.2	2.3	3.8
FIN	1.0	3.5	4.7	4.0	5.7	5.6	3.1	1.0	-4.4	-2.0	1.5	2.9
S	4.4	5.4	3.1	6.6	3.2	3.6	1.4	2.3	1.2	1.7	1.7	4.1
UK	4.3	3.5	2.9	3.3	3.7	3.8	1.8	1.9	0.5	-0.3	1.2	1.4
EUR	4.2	3.3	3.5	3.4	1.4	3.3	1.9	1.5	2.7	0.0	1.5	1.9

1) Autumn 1996 economic forecasts.
Source: Commission services.

7.4.2 Import prices

Given the increased degree of international openness of the Community economy, the evolution of import prices plays an important role in domestic price formation. Import prices in domestic currency are the synthesis of the evolution of several different factors: the value of the exchange rate, international prices, the geographical composition of imports and the price-setting behaviour of foreign suppliers.

Table 7.3

Import price inflation

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

	1993	1994	1995	1996 (1)
B	-2.6	0.9	0.5	1.6
DK	-1.1	0.4	1.3	2.1
D	-1.5	0.5	0.7	0.7
EL	9.1	8.3	7.1	4.0
E	6.6	6.0	4.2	0.9
F	-2.5	1.7	1.3	1.8
IRL	4.4	2.8	4.2	0.5
I	12.1	5.0	11.7	-0.6
L	5.4	0.2	0.5	3.1
NL	-2.3	0.6	0.2	2.0
A	0.8	0.7	0.9	1.2
P	8.9	4.5	1.5	1.2
FIN	8.7	-0.3	0.4	2.3
S	14.5	3.3	5.1	-3.1
UK	8.4	1.9	7.3	2.0
EUR	3.1	2.2	3.8	1.1

(1) Autumn 1996 economic forecasts.

Source: Commission services.

Several elements had helped in keeping the growth in import prices very moderate between 1990 and 1992: low oil prices, a weak US dollar, progress in trade liberalisation, coupled with the completion of the internal market. As a result, contributions of import prices to final demand inflation were negative in most Member States (and to varying degree) over this period.

However, the effects of some of these factors were reversed or weakened during the 1993-95 period. Oil prices increased at a relatively fast pace in the first half of 1994 and again in early 1995, while the dollar strengthened somewhat in 1993 and 1994. In addition, the curbing impact on prices exerted by the single market gradually faded.

The upward impact of these factors on import prices varied strongly country by country, depending on developments on the exchange rate front. In countries whose currencies remained strong (Belgium, Denmark, Germany, France, the Netherlands and Austria), increases in import prices remained subdued (see Table 7.3), and their contributions to final demand inflation were still negative in 1993 and marginally positive in 1994-95 (see Table 7.4). On the other hand, in those countries which experienced marked depreciation between 1993 and 1995 (Spain, Italy, Sweden and the United Kingdom), import prices increased strongly over the period. However, the knock-on effects on domestic inflation were relatively limited, particularly owing to the appropriate economic policy response, but also to the weak growth environment prevailing in these countries.

Most commodity prices have experienced another fall since mid-1996 (see Graph 7.1). On the other hand, the dollar has recovered somewhat since mid-1995. European currencies which depreciated significantly in early 1995 also strengthened during the course of 1995 and 1996. Consequently, the rise in import prices should remain moderate throughout the Community in 1996. Their contributions to overall inflation are thus expected to narrow in Member States whose currencies have appreciated recently, and to remain moderate in other Member States (around 0.5%).

Table 7.4

Contribution of import prices to the change of the final uses deflator.
(percentage change)

	1993	1994	1995	1996 (1)
B	-1.0	0.4	0.2	0.6
DK	-0.3	0.1	0.3	0.5
D	-0.2	0.1	0.1	0.1
EL	1.9	1.7	1.5	0.9
E	1.1	1.0	0.8	0.2
F	-0.4	0.3	0.2	0.3
IRL	1.5	1.0	1.5	0.2
I	2.0	0.8	2.0	-0.1
L	2.6	0.1	0.2	1.4
NL	-0.7	0.2	0.1	0.6
A	0.2	0.2	0.2	0.3
P	2.4	1.2	0.4	0.4
FIN	1.8	-0.1	0.1	0.5
S	3.0	0.8	1.2	-0.8
UK	1.7	0.4	1.6	0.4

(1) Autumn 1996 economic forecasts.
Source: Commission services.

Table 7.5

Nominal effective exchange rate changes relative to 23 industrial countries;
(annual percentage changes)

	1993	1994	1995	1996 (1)
B/L	1.4	2.6	5.4	-1.4
DK	3.1	0.8	5.1	-0.4
D	4.1	2.0	6.8	-1.6
EL	-7.0	-4.8	-1.5	-0.8
E	-11.5	-5.3	1.2	1.7
F	3.0	2.0	4.7	0.8
IRL	-5.3	0.7	0.6	1.9
I	-15.8	-2.5	-8.0	9.7
NL	3.7	1.5	4.8	-1.4
A	3.3	1.2	4.2	-1.3
P	-6.3	-3.7	2.3	-0.2
FIN	-13.0	9.0	11.4	-2.5
S	-18.5	-0.3	0.4	10.1
UK	-7.9	1.5	-3.4	0.6
EUR (2)	-10.5	3.4	7.9	4.7

(1) Based on the geometric average of monthly exchange rates until 23 October 1996.
(2) Relative to 9 non-member countries. USA, Japan, Mexico, Canada, Switzerland, Norway, Australia, New Zealand and Turkey.
Source: Commission services.

7.4.3. Effects of indirect tax changes on inflation

Although during Stage Two the progress in budgetary consolidation has been achieved predominantly through a reduction in the share of government expenditure relative to GDP, all Member States have also made use of increases in indirect taxes to this end but to varying degree. In several countries, increases in indirect taxes have contributed importantly to increases in inflation, as is suggested in Table 7.6 which shows estimates of the direct mechanical impact under the assumption of a full pass-through of changes in indirect taxes to consumer prices.

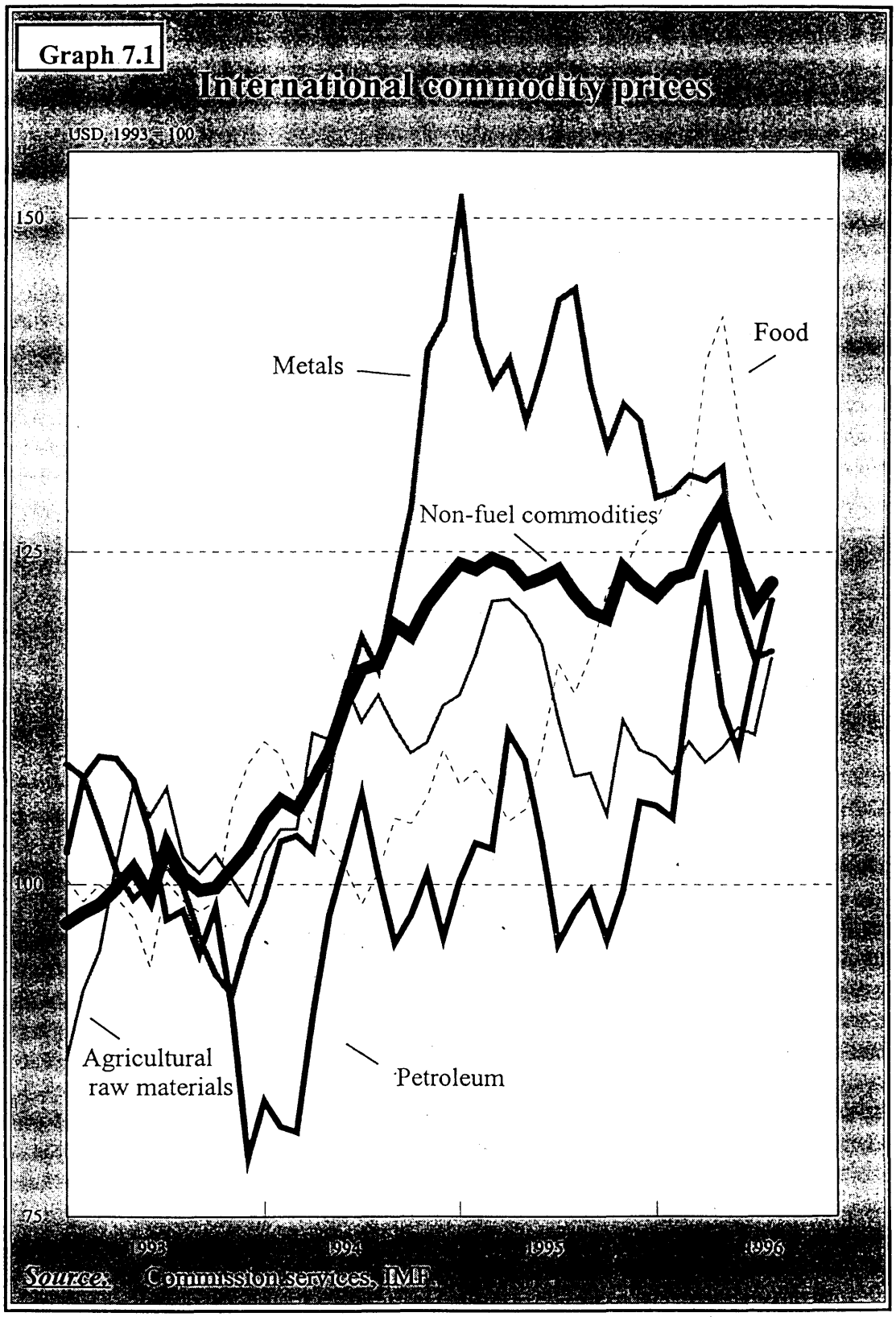
Table 7.6.

Effects of indirect tax changes on consumer price inflation
(percentage points)

	1994	1995	1996
B	0.7	0.1	0.2
DK	0.4	0.4	0.4
D	0.4	0.0	-0.2
GR	0.8	0.6	0.8
E	0.3	1.0	0.2
F	0.1	1.1	0.1
IRL	0.3	0.1	0.2
I	0.3	0.8	0.0
L	0.1	0.1	0.0
NL	0.2	0.1	0.4
A	0.2	0.5	0.2
P	0.2	0.5	-0.2
FIN	0.7	1.1	0.7
S	0.3	0.4	0.3
UK	0.7	0.6	0.4

Source: Commission services.

The most important contributions of indirect tax increases to inflation have been observed in Belgium (1994), France (1995), Italy (1995), Finland (1995-1996) and the United Kingdom (1994-95). However, more than the direct impact - which is, by definition, a one-off effect - what matters is the risk that increases in indirect taxes raise inflation expectations and thus trigger a wage/price spiral. This does not appear to have been the case in any of these countries. After showing a blip during the year in which increases in indirect tax occurred, inflation came down swiftly to its previous pattern within a short delay.


Graph 7.1
International commodity prices
USD, 1993 = 100
150
125
100
75
Metals
Food
Non-fuel commodities
Agricultural raw materials
Petroleum
1993
1994
1995
1996
Source: Commission services, IMF

8. CONCLUDING SUMMARY

8.1 General assessment

This report has been prepared in accordance with the procedure and timetable set out in Article 109j of the Treaty.

Substantial progress towards the achievement of a high degree of sustainable convergence has been made in all Member States since the beginning of the second stage of EMU. This progress gathered greater momentum during 1996, when efforts to achieve convergence (especially in the budgetary field) were intensified in many Member States. Other necessary preparations for the third stage are also advancing at the national level and at Community level, where during the past year agreement has been reached on the scenario for the introduction of the single currency, the Commission has recently presented proposals for the legal status of the euro and for a stability pact to ensure budgetary discipline in the third stage, a consensus is emerging on the design of the so-called "ERM II" and a communication campaign has been launched.

The examination in Chapter 2 of this report of the compatibility between national legislation and Articles 107 and 108 of the Treaty and the Statute of the ESCB first of all set out the requirements that will have to be satisfied by the start of stage three. It then identified types of existing provisions, mainly in the statutes of national central banks, which do not yet conform. In virtually all Member States there continue to exist provisions that will need to be amended. Several Member States are preparing or have already brought forward proposals for changes in their legislation.

In the next four chapters progress by each Member State in relation to each of the convergence criteria has been examined.

The steady progress made in the European Union as a whole and by individual Member States in moving towards or maintaining a high degree of price stability has continued in 1996. The assessment of price convergence has been made using the recently available interim indices of consumer prices (IICPs), which are more comparable than national indices but not yet fully harmonised. The average rate of inflation for each Member State has been calculated as the percentage change in the average IICP in the latest 12 months relative to the average index in the preceding 12 months. The reference value has been calculated for the purpose of this report as the simple arithmetic average of the average inflation rates in the three best performing Member States plus 1.5 percentage points. Calculated in this way and according to the latest available information (September 1996), the three best price performers were Finland, the Netherlands and Germany, and the reference value was 2.6% (see Table 8.1). Ten Member States (Belgium, Denmark, Germany, France, Ireland, Luxembourg, the Netherlands, Austria, Finland and Sweden) had average inflation rates below this reference value. A box in Chapter 3 shows that the number of Member States respecting the price stability criterion is not at present sensitive to the method chosen to calculate the reference value. Five Member States still have average inflation rates above the reference value in September (Greece, Spain, Italy, Portugal and the United Kingdom), but the differentials have tended to narrow in recent years and again

in 1996. Portugal and the United Kingdom are less than ½ percentage point above the reference value.

Only three Member States (Denmark, Ireland and Luxembourg) are currently not the subject of a Council Decision on the existence of an excessive government deficit and so respect the criterion on the government budgetary position. The most recent decisions under the excessive deficit procedure (Article 104c) were made in June 1996. Chapter 4 also reviewed budgetary developments in the Member States during the second stage and presented estimates of likely outturns in 1996. Significant progress has been made since 1993 by most Member States in reducing government deficits; in 1996 four countries (Denmark, Ireland, Luxembourg and the Netherlands) are expected to achieve a government balance better than the 3% of GDP deficit reference

Table 8.1

Performance of the Member States in relation to convergence in 1996

	Inflation	General government budgetary position						Exchange rates	Long-term interest rates
	Interim index of consumer prices (1)	Existence of an excessive deficit	Deficit (% of GDP) (2)	Debt (% of GDP) (2)				ERM participation	
	Oct. 1995 - Sep. 1996	Council decisions, 26.9.1994, 10.7.1995 and 27.6.1996	1996	1996	Change 94/93	Change 95/94	Change 96/95	October 1996	Oct. 1995 - Sep. 1996
Reference value	2.6 (3)		3.0	60					8.7 (4)
B	1.6	yes	3.3	130.6	-2.0	-1.3	-3.1	yes	6.7
DK	2.2	no	1.4	70.2	-4.1	-4.1	-1.7	yes	7.4
D	1.3	yes	4.0	60.8	2.2	7.7	2.7	yes	6.3
EL	8.4	yes	7.9	110.6	-1.4	1.4	-1.2	no	15.1
E	3.8	yes	4.4	67.8	2.6	2.6	2.1	yes	9.5
F	2.1	yes	4.0	56.4	2.8	4.4	3.6	yes	6.6
IRL	2.1 (5)	no	1.6	74.7	-6.6	-6.3	-6.9	yes	7.5
I	4.7	yes	6.6	123.4	6.2	-0.6	-1.5	no	10.3
L	1.3	no	-0.9	7.8	-0.5	0.3	1.8	yes	7.0
NL	1.2	yes	2.6	78.7	-3.4	2.3	-1.0	yes	6.3
A	1.7	yes	4.3	71.7	2.3	3.9	2.7	yes	6.5
P	3.0	yes	4.0	71.1	1.4	2.1	-0.6	yes	9.4
FIN	0.9	yes	3.3	61.3	2.2	-0.3	2.1	yes	7.4
S	1.6	yes	3.9	78.1	3.3	-0.6	-0.6	no	8.5
UK	3.0	yes	4.6	56.3	1.9	3.7	2.2	no	8.0
EUR	2.7		4.4	73.5	2.0	3.2	2.2		7.6

(1) Percentage change in average level of index in latest 12 months over average in previous 12 month period
(2) Estimates from Commission services' Autumn 1996 Economic Forecasts.
(3) Definition adopted in this report: arithmetic average of the three best performers in terms of inflation plus 1.5 percentage points.
(4) Definition adopted in this report: arithmetic average of the 12-month average of interest rates of the three best performing Member States in terms of price stability plus 2 percentage points.
(5) Measured on the basis of quarterly data.

Source: Commission services.

value; Belgium and Finland are likely to have deficits smaller than 3½% of GDP. By the end of 1996 three Member States (France, Luxembourg and the United Kingdom) are expected to have a government gross debt ratio below the 60% of GDP reference value. In Germany and Finland, the debt ratio is likely to exceed the reference value of 60% by the end of 1996, after having been consistently below that value. Several Member States have succeeded in reversing the earlier upward trend in the debt ratio, with a steady reduction since 1993 in Belgium, Denmark and Ireland and declines expected in 1996 also in Greece, Italy, the Netherlands, Portugal and Sweden.

Since the turbulence in foreign exchange markets that led to the realignment in March 1995 within the ERM of the Spanish peseta, followed by the Portuguese escudo, exchange rate conditions have not been subject to severe tensions and the gap between the strongest and weakest currencies within the ERM band has tended to narrow (as described in Chapter 5). There are currently eleven currencies participating in the ERM. Nine of these (the currencies of Belgium, Denmark, Germany, Spain, France, Ireland, Luxembourg, the Netherlands and Portugal) have been members of the ERM for well over two years. Austria joined the ERM at the beginning of 1995 and Finland in the middle of October 1996. Four Member States (Greece, Italy, Sweden and the United Kingdom) are not currently participating in the ERM; the last three of these countries have seen a significant appreciation of their currencies during 1996, following the weakness of earlier years.

The fourth criterion, on the durability of convergence as reflected in long-term interest rates, has been examined in Chapter 6. The assessment is based on the interest rates on comparable 10-year benchmark bonds (not fully comparable for Greece) , using an average rate over the latest 12 months. The reference value has been calculated as the simple arithmetic average of the long-term interest rates of the three best performing Member States in terms of price stability plus 2 percentage points. In September 1996 the reference value was 8.7%. Eleven Member States (Belgium, Denmark, Germany, France, Ireland, Luxembourg, the Netherlands, Austria, Finland, Sweden and the United Kingdom) have average interest rates below the reference value. Developments in bond markets during 1996, and especially in September, have resulted in a significant narrowing in interest rate differentials, especially among the higher-yielding countries where the criterion is not yet respected.

The Treaty also requires that this report should examine developments in several other areas relevant to economic integration and convergence. These are dealt with in Chapter 7. Financial markets in ECU have tended to decline in importance since the severe currency turbulence of 1992 and 1993, but significant amounts of commercial transactions are settled in ECU. The spread between the private and public ECU is reducing as the certainty of the 1 for 1 convertibility between the ECU and the euro is incorporated by the markets. The Single Market project has been having a significant impact on economic integration, particularly on the structure of trade between Member States, on foreign direct investment flows, on competition conditions and on price convergence for certain categories of goods and services. The current account of the balance of payments reflects the national savings in each Member State; the European Union as a whole and ten Member States are expected to be in surplus in 1996. Additional indicators for unit labour costs and import prices confirm the picture given

in Chapter 3 of a satisfactory and soundly based price performance in most Member States.

Mainly as a consequence of the persistence of budgetary imbalances (although they are being reduced) and as illustrated by the existence of excessive government deficits in twelve Member States, it is clear that currently a majority of Member States has not yet made sufficient progress in the achievement of a high degree of sustainable convergence.

8.2 Summary by Member States

In this final section of the report performance in relation to the convergence criteria is presented on a country-by-country basis in accordance with Article 109j(1) which requires an examination of the achievement of a high degree of sustainable convergence by reference to the fulfilment *by each Member State* of the criteria. The criteria on inflation and long-term interest rates have been examined using data covering the period up to September 1996. The reference value has, in both cases, been calculated using the average of the three best performing Member States in terms of inflation. As regards the criterion on the government budgetary position, where relevant, Commission estimates of budgetary data for 1996 as a whole are presented.

In **Belgium** the average inflation rate in the year ending in September 1996 stood at 1.6% which is below the reference value; during the same period nominal long-term interest rates were, on average, 6.7% which is also below the reference value. The Council has not yet abrogated its Decision of 26 September 1994 according to which an excessive government deficit exists in Belgium. In 1996 the general government deficit is expected to be reduced by 0.8 percentage points to 3.3% of GDP; the government gross debt ratio is likely to decline from 133.7% of GDP in 1995 to 130.6 % in 1996. Belgium has been a member of the ERM since its inception; in the latest two years the BFR has respected the fluctuation margins of the ERM and has not been subject to severe tensions and the BFR bilateral central rate has not been devalued.

In **Denmark** the average inflation rate in the year ending in September 1996 stood at 2.2% which is below the reference value; during the same period nominal long-term interest rates were, on average, 7.4% which is also below the reference value. The Council decided on 27 June 1996 to abrogate its Decision of 26 September 1994 on the existence of an excessive government deficit in Denmark. In 1996 the general government deficit is expected to be reduced by 0.2 percentage points to 1.4% of GDP; the government gross debt ratio is likely to decline further to 70.2% in 1996 from 71.9% of GDP in 1995. Denmark has been a member of the ERM since its inception; in the latest two years the DKR has respected the fluctuation margins of the ERM and has not been subject to severe tensions and the DKR bilateral central rate has not been devalued.

In **Germany** the average inflation rate in the year ending in September 1996 stood at 1.3% which is the third best performance in the EU and is therefore below the reference value; during the same period nominal long-term interest rates were, on average, 6.3% which is also below the reference value. The Council decided on 27 June 1996 that an excessive government deficit exists in Germany. In 1996 the

general government deficit is expected to increase to 4.0% of GDP from 3.5% in 1995; the government gross debt ratio which has been below 60% of GDP is likely to increase in 1996 reaching 60.8% of GDP. Germany has been a member of the ERM since its inception; in the latest two years the DM has respected the fluctuation margins of the ERM and has not been subject to severe tensions and the DM bilateral central rate has not been devalued.

In **Greece** the average inflation rate in the year ending in September 1996 stood at 8.4% which is significantly above the reference value; during the same period nominal long-term interest rates were, on average, 15.1%, also clearly above the reference value. The Council has not yet abrogated its Decision of 26 September 1994 according to which an excessive government deficit exists in Greece. In 1996 the general government deficit is expected to be reduced by 1.2 percentage points to 7.9% of GDP; the government gross debt ratio is likely to decline from 111.8% of GDP in 1995 to 110.6% in 1996. The DR does not participate in the ERM.

In **Spain** the average inflation rate in the year ending in September 1996 stood at 3.8% which is above the reference value; during the same period nominal long-term interest rates were, on average, 9.5% which is also above the reference value. The Council has not yet abrogated its Decision of 26 September 1994 according to which an excessive government deficit exists in Spain. In 1996 the general government deficit is expected to be reduced by 2.2 percentage points to 4.4% of GDP; the government gross debt ratio is likely to increase from 65.7% of GDP in 1995 to 67.8% in 1996. Spain has been a member of the ERM since June 1989; in March 1995 the bilateral central rate of the peseta was devalued by 7%, at the initiative of Spain; since then the PTA has respected the fluctuation margins of the ERM and has not been subject to severe tensions.

In **France** the average inflation rate in the year ending in September 1996 stood at 2.1% which is below the reference value; during the same period nominal long-term interest rates were, on average, 6.6% which is also below the reference value. The Council has not yet abrogated its Decision of 26 September 1994 according to which an excessive government deficit exists in France. In 1996 the general government deficit is expected to be reduced by 0.8 percentage points to 4.0% of GDP; the government gross debt ratio continues to be below 60% of GDP in 1996. France has been a member of the ERM since its inception; in the latest two years the FF has respected the fluctuation margins of the ERM and has not been subject to severe tensions and the FF bilateral central rate has not been devalued.

In **Ireland** the average inflation rate in the year ending in September 1996 stood at 2.1% which is below the reference value; during the same period nominal long-term interest rates were, on average, 7.5% which is also below the reference value. Ireland is not the subject of a Council decision on the existence of an excessive government deficit. The general government deficit has been below 3% of GDP since 1989 and is expected to be reduced further by 0.4 percentage points to 1.6% of GDP in 1996; the government gross debt ratio is likely to decline further to 74.7% in 1996 from 81.6% of GDP in 1995. Ireland has been a member of the ERM since its inception; in the latest two years the IRL has respected the fluctuation margins of the ERM and has not

been subject to severe tensions and the IRL bilateral central rate has not been devalued.

In **Italy** the average inflation rate in the year ending in September 1996 stood at 4.7% which is clearly above the reference value; during the same period nominal long-term interest rates were, on average, 10.3% which is also above the reference value. The Council has not yet abrogated its Decision of 26 September 1994 according to which an excessive government deficit exists in Italy. In 1996 the general government deficit is expected to be reduced by 0.5 percentage points to 6.6% of GDP; the government gross debt ratio is likely to decline from 124.9% of GDP in 1995 to 123.4 % in 1996. Italy was a member of the ERM from its inception until September 1992 when the intervention obligations for the LIT were suspended; since then the LIT has not re-entered the ERM.

In **Luxembourg** the average inflation rate in the year ending in September 1996 stood at 1.3% which is below the reference value; during the same period nominal long-term interest rates were, on average, 7.0% which is also below the reference value. Luxembourg is not the subject of a Council decision on the existence of an excessive government deficit. The general government financial position has traditionally been in a surplus, expected to amount to 0.9% of GDP in 1996. The government gross debt ratio continues to remain significantly below 60% of GDP. Luxembourg has been a member of the ERM since its inception; in the latest two years the LFR has respected the fluctuation margins of the ERM and has not been subject to severe tensions and the LFR bilateral central rate has not been devalued.

In the **Netherlands** the average inflation rate in the year ending in September 1996 stood at 1.2% which is the second best performance in the EU and is therefore below the reference value; during the same period nominal long-term interest rates were, on average, 6.3% which is also below the reference value. The Council has not yet abrogated its Decision of 26 September 1994 according to which an excessive government deficit exists in the Netherlands. In 1996 the general government deficit is expected to be reduced by 1.4 percentage points to 2.6% of GDP; the government gross debt ratio is likely to decline from 79.7% of GDP in 1995 to 78.7 % in 1996. The Netherlands have been a member of the ERM since its inception; in the latest two years the HFL has respected the fluctuation margins of the ERM and has not been subject to severe tensions and the HFL bilateral central rate has not been devalued.

In **Austria** the average inflation rate in the year ending in September 1996 stood at 1.7% which is below the reference value; during the same period nominal long-term interest rates were, on average, 6.5% which is also below the reference value. The Council has not yet abrogated its Decision of 10 July 1995 according to which an excessive government deficit exists in Austria. In 1996 the general government deficit is expected to be reduced by 1.6 percentage points to 4.3% of GDP; the government gross debt ratio is likely to increase from 69.0% of GDP in 1995 to 71.7 % in 1996. Austria has been a member of the ERM since early January 1995; since then the ÖS has respected the fluctuation margins of the ERM and has not been subject to severe tensions and the ÖS bilateral central rate has not been devalued.

In **Portugal** the average inflation rate in the year ending in September 1996 stood at 3.0% which is above the reference value; during the same period nominal long-term interest rates were, on average, 9.4% which is also above the reference value. The Council has not yet abrogated its Decision of 26 September 1994 according to which an excessive government deficit exists in Portugal. In 1996 the general government deficit is expected to be reduced by 1.1 percentage points to 4.0% of GDP; the government gross debt ratio is likely to decline from 71.7.% of GDP in 1995 to 71.1% in 1996. Portugal has been a member of the ERM since April 1992. In March 1995, following the devaluation of the Spanish peseta, the bilateral central rate of the Portuguese escudo was devalued by 3.5%. Since then the ESC has respected the fluctuation margins of the ERM and has not been subject to severe tensions.

In **Finland** the average inflation rate in the year ending in September 1996 stood at 0.9% which is the best performance in the EU and is therefore below the reference value; during the same period nominal long-term interest rates were, on average, 7.4% which is also below the reference value. The Council has not yet abrogated its Decision of 10 July 1995 according to which an excessive government deficit exists in Finland. In 1996 the general government deficit is expected to be reduced by 1.9 percentage points to 3.3% of GDP; the government gross debt ratio which has been below 60% of GDP is likely to increase in 1996, reaching 61.3% of GDP. Finland has been a member of the ERM since mid-October 1996.

In **Sweden** the average inflation rate in the year ending in September 1996 stood at 1.6% which is below the reference value; during the same period nominal long-term interest rates were, on average, 8.5% which is below the reference value. The Council has not yet abrogated its Decision of 10 July 1995 according to which an excessive government deficit exists in Sweden. In 1996 the general government deficit is expected to be reduced by 4.2 percentage points to 3.9% of GDP; the government gross debt ratio is likely to decline from 78.7% of GDP in 1995 to 78.1% in 1996. The SKR does not participate in the ERM.

In the **United Kingdom** the average inflation rate in the year ending in September 1996 stood at 3.0% which is above the reference value; during the same period nominal long-term interest rates were, on average, 8.0% which is below the reference value. The Council has not yet abrogated its Decision of 26 September 1994 according to which an excessive government deficit exists in the United Kingdom. In 1996 the general government deficit is expected to be reduced by 1.2 percentage points to 4.6% of GDP; the government gross debt ratio continues to be below 60% of GDP in 1996. The currency of the United Kingdom entered the ERM in October 1990; the participation of the UKL in the ERM was suspended in September 1992 and has not been resumed.

79

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