EUROPEAN MONETARY INSTITUTE

PROGRESS TOWARDS CONVERGENCE

REPORT PREPARED IN ACCORDANCE WITH ARTICLE 7 OF THE EMI STATUTE

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CONTENTS

CHAPTER II: MONETARY POLICY INSTRUMENTS AND THE PREPARATION OF THE PROCEDURES NECESSARY FOR CARRYING OUT A SINGLE MONETARY POLICY IN THE THIRD STAGE

CHAPTER III: STATUTORY REQUIREMENTS TO BE FULFILLED BY NATIONAL CENTRAL BANKS TO BECOME AN INTEGRAL PART OF THE ESCB

LIST OF BOXES, TABLES AND CHARTS *

Boxes

Tables

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* All boxes, tables and charts are to be found in Chapter I with the exception of Table 5.3.1 which appears in Chapter II.

* **Convention used in the tables:**
"-" Not applicable or not available
"..." Nil or negligible

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

Charts

ABBREVIATIONS

Countries*

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

Currencies

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

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

EXECUTIVE SUMMARY

EXECUTIVE SUMMARY

This is the first fully-fledged Report referred to in Article 7 of the EMI Statute (see box below). It follows the 1994 Annual Report of the EMI, published in April 1995. To some extent, the current Report may also be seen as preparatory to the role the EMI will play in the forthcoming examination of the convergence process according to Article 109j (1) of the Treaty. For the first time in 1996, the EMI and the Commission shall each report to the EU Council "on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of economic and monetary union".

> Article 7 of its Statute requires the European Monetary Institute (EMI) to once a year address a report to the Council on the state of the preparations for the third stage. *"These reports shall include an assessment of the progress towards convergence in the Community, and cover in particular the adaptation of monetary policy instruments and the preparation of the procedures necessary for carrying out a single monetary policy in the third stage, as well as the statutory requirements to be fulfilled for national central banks to become an integral part of the ESCB".*

1. CONVERGENCE

1.1 The purpose of examining convergence

The assessment of convergence serves two primary purposes: in the first place the convergence criteria may be seen as crucial elements of sound economic management, and their achievement is hence essential for the Member States themselves as well as being a prerequisite for a smooth start for monetary union. Secondly, beyond a successful process of convergence during Stage Two, the Treaty stresses the sustainability of convergence. Basically, sustainability implies that the achievements made should not only hold at a specific point in time, but should also be durable. This durability of convergence is essential for a sustainable European currency area in Stage Three. Taking the example of the fiscal criteria, monetary policy risks becoming overburdened when other economic policies do not contribute sufficiently to the achievement of price stability over the medium term.

1.2 Approach taken

Chapter 1 assesses the progress made towards convergence in the Community. The approach taken is to examine performance under each of the criteria outlined in the Treaty: price stability and sustainable fiscal balances, exchange rate stability and convergence in long-term interest rates. Other factors mentioned in the Treaty are also taken into account. In a final section, an attempt is made to assess performance on a country-by-country basis.

In its assessment of the degree of convergence achieved, the EMI Council intends to express its views independently. For the application of the convergence criteria, a number of general guiding principles are used by the EMI. First, the individual criteria are interpreted and applied in a strict manner. Second, the convergence criteria constitute a coherent and integrated package and they must all be satisfied. Third, the convergence criteria have to be met on the basis of current data, i.e. in the assessment of the degree of convergence achieved, reference is made only to the latest 1995 data available; forecasts and expectations for 1996 are not taken into account. Fourth, the application of the criteria should be consistent, transparent and simple.

Data used for fiscal positions (as a percentage of GDP) are the latest Commission projections[1] of deficits and debts for 1995. Exchange rates are evaluated over the two-year period October 1993-September 1995. Assessments on inflation and long-term interest rates relate to the most recent data available for a twelve-month period - that is, the average from October 1994 to September 1995. It should be noted that these are national, non-harmonised or not fully harmonised, figures.

Issues relating to the choice of the reference value for the inflation criterion are discussed in the Report. Price stability may in principle be best reflected by the country with the lowest inflation rate. However, the average of the three best performers in terms of price stability may provide a good starting-point if there are no outliers. As the latter consideration applies for the period under review, the assessment is based on the average of the three best inflation performers, without prejudice to any future judgement. The role of outliers is also addressed in relation to the criterion on long-term interest rates. Following the procedure applied for the price criterion, the assessments are based on the average of the long-term interest rates of those three countries with the lowest inflation rates.

1.3 Assessment of convergence achieved in the Community

Overall, progress towards convergence in the Community is insufficient. Most Member States must significantly improve their performance, and at present there does not exist a majority of EU Member States which satisfy all the criteria. Differences continue both in performance across countries and in relation to the fulfilment of each individual criterion. On the positive side, there is a sizable group which complies with the criterion on price stability and convergence in long-term interest rates; much less encouraging is the fact that public finances in most Member States continue to be far from satisfactory. Exchange rate developments have been characterised by alternating phases of calm and tension, which have affected individual currencies to different degrees.

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

The criterion on price stability

A majority of countries maintain relatively low inflation rates. Over the twelve-month period to the end of September 1995, the three best-performing countries were Finland, Belgium and France (with inflation rates of between 1.3 and 1.7%), and eleven Member States (Belgium, Denmark, Germany, France, Ireland, Luxembourg, the Netherlands, Austria, Finland, Sweden and the United Kingdom) would be seen as having inflation rates below the reference value of the price criterion.

Four countries had inflation rates above the reference value (Greece, Spain, Italy and Portugal). In Portugal, consumer price inflation tended to come closer to the reference value. In Spain, consumer price inflation accelerated in the spring up to around 5%, mainly due to an increase in indirect taxes; a correction took place in the summer, which brought inflation down to 4.4%. In Italy, the inflation rate increased in the first half of 1995 to 5.8%, again partly reflecting indirect tax increases, and stabilised thereafter. In Greece, the inflation rate continued to fall to stand at 8.4% in September 1995.

The criterion on the government budgetary position

Notwithstanding progress achieved over the past two years in reducing deficit ratios, outturns of fiscal policies are in general disappointing. In June 1995, the EU Council decided that twelve countries (of the fifteen Member States) had an excessive deficit. Either the deficit ratio was too high (in France and in the United Kingdom), or both the deficit and the debt ratio were excessive to varying degrees (in Belgium, Denmark, Greece, Spain, Italy, the Netherlands, Austria, Portugal, Finland and Sweden). Only Germany, Ireland and Luxembourg were not the subject of an EU Council decision that an excessive deficit exists. In the case of Ireland, which recorded a deficit ratio of 2.1% and a debt ratio of 91.1% in 1994, compared with 2.4% and 97.4% in 1993, account was taken in the procedure of the progress made in the reduction of the debt ratio. Germany and Luxembourg had deficit and debt ratios below the reference values of 3% and 60% of GDP. The EMI has not yet drawn definitive conclusions on these issues and reserves its judgement for future assessments. Even in countries which are not subject to an EU Council decision on excessive deficits, there are risks. In Germany, the deficit in 1995 is expected to stand at 2.9%, and the debt ratio is only slightly below the reference value of 60% of GDP, while in Ireland, though decreasing further, the debt ratio at 85.9% would still be well above 60%, and the deficit ratio is expected to rise to 2.7%, despite favourable cyclical conditions.

The criterion on exchange rate behaviour

Under current circumstances, it is not advisable to give a precise operational content to the Treaty provisions regarding exchange rates which could be mechanically applied also to forthcoming periods. Rather, a detailed record of recent developments has been provided and used as a contribution to an assessment.

Several currencies remained outside the ERM. ERM currencies followed different patterns of behaviour. In the ERM, a number of currencies have remained stable over the whole two-year time span under consideration. These include the Deutsche Mark, the Dutch guilder and the Austrian schilling (the latter joined the ERM in January 1995), and since the start of 1994 also the Belgian franc (as well as the Luxembourg franc, which forms a monetary association with the Belgian currency). Several other ERM currencies (Danish krone, French franc and Irish pound) have at times drifted away from their central parities. In late 1994 the Spanish peseta began to weaken. At the beginning of 1995, pressure on the peseta mounted and in March, following a request by the Spanish authorities, the currency underwent a realignment. Following the decision to change the central rate of the peseta the Ministers and central bank Governors also agreed on a downward adjustment of the central rate of the Portuguese escudo. After the adjustment, both currencies recovered to levels close to the new parities. By July the peseta had returned to its level of the beginning of 1995.

As regards non-ERM currencies, the Finnish markka appreciated vis-à-vis the strongest ERM currencies, the pound sterling and the Swedish krona experienced weakness in early 1995, while the Italian lira was often under substantial downward pressure from spring 1994 onwards. Over more recent months the pound, krona and lira have recovered against the strongest ERM currencies, albeit to different degrees. Finally, the Greek drachma depreciated at a decelerating pace, while appreciating in real terms.

The interest rate criterion

In the period October 1994-September 1995, ten countries had long-term interest rates below the reference value. These were the same Member States as in the case of the price criterion, with the exception of Sweden. Long-term interest rates in five countries (Spain, Greece, Italy, Portugal and Sweden) exceeded the reference value in the period under consideration to different degrees.

Interest rate differentials between the Member States with interest rate levels at the lower end of the spectrum (Belgium, Germany, Luxembourg, the Netherlands and Austria) have remained narrow. In other countries, like France, interest rate differentials against the above-mentioned Member States remained limited on average but at times displayed a tendency for a higher degree of volatility. Similar considerations apply to Denmark, Ireland and the United Kingdom, where some widening of interest rate differentials occurred. In Finland, interest rate levels have more recently approached those seen in Denmark, Ireland and the United Kingdom.

In Spain, Italy and Portugal some narrowing of differentials has been seen over recent months. In Sweden, a reversal of the earlier widening of differentials has been observed more recently. In Greece, long-term interest rates (which are indexed to the twelve-month Treasury bill rates) have come down continuously, but differentials remain quite wide.

Other factors

In addition to the above-mentioned convergence criteria reference is also made to other factors: unit labour costs, other price indices, the current account, the results of the integration of markets and the development of the ECU. While the latter two relate to the progress made towards Economic and Monetary Union in more general terms, the other three factors relate to issues covered under the convergence criteria. Accordingly, the assessment of unit labour costs, other price indices and current accounts is used to cast light on the assessments arrived at in other sections of the Report.

1.4 Paving the way for entering the European currency area

The period ahead will be of crucial importance for achieving a macroeconomic performance in compliance with the convergence criteria and with the essential requirement of sustainability. Three issues appear to merit particular emphasis.

Firstly, given past developments and current levels of structural deficits and government expenditure ratios, a successful rebalancing of public finances will require determined action over a sustained period. This is all the more important as the fiscal criteria will not only be examined for the purpose of convergence in Stage Two, but also applied in Stage Three. In other words, they are not merely entry conditions for EMU and guidelines for a sustainable fiscal strategy, but also a cornerstone for macroeconomic stability once the European currency area is in place.

It is important that favourable cyclical developments should not lead governments to postpone structural measures. Rather, the current cyclical environment should be seen as a major opportunity for undertaking or enhancing the consolidation of public finances. In order to act as a lasting disciplinary device, the reference value for fiscal deficits of 3% of GDP should be regarded as a ceiling which applies at all times over the entire economic cycle. Clearly, the higher the debt ratio, the more adjustment is required, i.e. the lower the current deficit has to be.

Beyond the aim of meeting the agreed fiscal convergence requirements, there are compelling economic reasons for further action in the Member States which are of direct interest to each of them. In particular, credible fiscal consolidation would over time more than offset possible short-term contractionary effects by leading to lower interest rates owing to a reduction in risk premia, releasing funds for productive investment, as well as bringing about an increase in confidence. In some cases, the favourable impact of fiscal consolidation on expectations could materialise rather swiftly. Conversely, not acting now in a determined manner could entail a further rise in debt ratios, a continued increase in interest payments and thereby risk a snowball effect, which would further add to the public deficit and thus to debt.

Secondly, the review of recent consumer price developments has highlighted the fact that there is, on the one hand, a majority of countries which maintain relatively low inflation rates, but, on the other hand, there are also some warning signals that the general downward momentum in inflation rates may not continue. Against this background, crucial elements in further preparation for Stage Three are that Member States should pursue a monetary policy conducive to stable exchange rates, that growth in labour costs should remain subdued and that fiscal deficits be reduced and kept under control.

Thirdly, low current and expected inflation rates across the Union, and a consistent pattern of progress in fiscal consolidation, would contribute to exchange rate stability and convergence of long-term interest rates. Erratic losses or gains in competitiveness would tend to be eliminated in the context of inflation convergence, and sound fiscal policies would generate confidence and reduce risk premia both in foreign exchange and capital markets.

2. PREPARATION FOR STAGE THREE

The issue as to how the European System of Central Banks (ESCB) should conduct the single monetary policy in Stage Three of EMU is to be tackled at two levels: on the one hand, in terms of the overall monetary policy strategy, and, on the other hand, in terms of the instruments and operational procedures to be employed. Related preparatory work is also being undertaken in the fields of foreign exchange, payment systems and statistics.

2.1 Monetary policy strategy

Three candidate strategies for Stage Three - exchange rate targeting, monetary targeting and inflation targeting - have been discussed. For the single currency area as a whole, exchange rate targeting would not be appropriate. Monetary targeting and inflation targeting strategies seem to be more relevant. However, both approaches require further economic study in order to prepare the basis for a judgement on their appropriateness for Stage Three. Work in this field currently involves the assessment of patterns of EU-wide money demand and the identification of the transmission mechanism of monetary policy in the EU.

2.2 Operational framework for monetary policy

A decision on the monetary policy strategy of the ESCB is not a prerequisite for the definition of its operational framework, provided that the framework made available to the ESCB is flexible enough to adjust to various situations.

The approach taken by the EMI in preparing the operational framework involves a number of steps. Firstly, monetary policy instruments, the evolution of which is monitored by the EMI, have been compared across member countries and examined individually. The monitoring shows that convergence of instruments in use at NCBs, although incomplete, is already occurring. This progress towards convergence has been evidenced, in particular, by the increasing weight of open market transactions in central bank operations and the widening use of repurchase agreements across the EU. Convergence can also be seen in the field of reserve requirements.

The main generic types of instruments have already been examined (i.e. open market operations, standing facilities and reserve requirements) to assess whether they should be employed and, if so, what precise features they should have if they are to contribute to fulfilling certain functions. A full assessment of the relative merits of these instruments will only be possible with reference to the main features of the operational framework to be adopted. However, some guiding principles for the selection of monetary policy instruments were agreed upon in the context of the EMI's 1994 Annual Report and, although no decision has yet been taken on this subject, some progress in the discussion on the general shape of an operational framework has been made. Open market operations, and among them repurchase agreements, could play a dominant role in the management of money market conditions, providing the main means of supplying/withdrawing liquidity and steering interest rates. Standing facilities could include a marginal lending facility and a deposit facility. The possibility of complementing them with facilities which involve the provision of liquidity at rates normally below market rates is also being studied. Some basic principles which could govern decisions in the area of reserve requirements have also been discussed. Reserve requirements could figure among the set of monetary policy instruments potentially available to the ESCB, even though the decision on the actual use of this instrument will have to be taken in view of the operational framework of the ESCB, as well as the economic and financial conditions prevailing in Stage Three. The next step, to which much effort is currently being devoted, is to examine how the instruments can be optimally combined to form an operational framework for the conduct of monetary policy in Stage Three.

The ECB will make the final decision on the operational framework, taking into account the economic and financial conditions prevailing in the countries participating in the single currency area. However, implementing changes to monetary policy instruments and procedures takes time; therefore, if the ECB's choice is not to be restricted, preparation of instruments and procedures has to start at an early stage. Detailed blueprints for the use of the various types of monetary policy instruments will be drafted by the EMI in 1996.

2.3 Operational framework for foreign exchange policy

Foreign exchange intervention will be an instrument at the disposal of the ESCB from the start of Stage Three. An assessment has been made of two basic options: a centralised arrangement, in which intervention operations will be carried out exclusively by the ECB; and a decentralised one, in which all NCBs will execute intervention decided by the ECB. To retain flexibility and the ability to make adjustments based on experience and prevailing conditions, it has been agreed that both basic options should be made available to the ESCB. Follow-up work has started in several areas, including specifying the features of the required information and communications systems and designing harmonised principles for selecting and monitoring counterparties.

In order to ensure the singleness of the monetary and exchange rate policies of the ESCB in Stage Three, the operations of the NCBs and Member States in those foreign reserve assets which will not be transferred to the ECB will be subject to guidelines. The EMI Council has decided that the guidelines should be based on reporting and prior approval procedures for operations exceeding certain limits to be established. Follow-up work is proceeding in the technical (information systems support) and legal areas.

2.4 Payment systems

At the start of Stage Three of EMU, a unified EMU-wide payment mechanism provided by the ESCB, based on real-time gross settlement (RTGS) systems, will be needed to ensure a secure implementation of the single monetary policy and to facilitate the settlement of large-value cross-border payments between Member States. In May 1995 the EMI Council agreed to set up the TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) system, which will incorporate domestic RTGS systems and their interlinkages. RTGS systems are already in operation in four Member States and are being implemented in all of the other EU countries. By the end of 1997 all national RTGS systems will be in operation. The EMI and EU central banks are completing the design of the mechanisms underlying the linkages of national RTGS systems (so called "Interlinking").

2.5 Statistics

The Treaty requires the EMI to make statistical preparations for the conduct of monetary policy in Stage Three. Further progress has been made in 1995 on harmonisation proposals in the areas of monetary and balance-of-payments statistics. A study is in progress to establish the time it will take to introduce the necessary statistical changes. Organisational issues, such as areas of competence in statistical matters, mentioned but not defined in the Treaty, have been resolved. Work on a means to transfer data within the ESCB is expected to begin shortly.

Close co-operation in statistical matters has been established with the Commission (EUROSTAT).

3. STATUTORY REQUIREMENTS TO BE FULFILLED BY NATIONAL CENTRAL BANKS TO BECOME AN INTEGRAL PART OF THE ESCB

Article 108 of the Treaty states that Member States shall ensure, at the latest at the date of the establishment of the ESCB, that their national legislation including the statutes of their NCBs is compatible with the Treaty and the Statute. This does not require harmonisation of NCBs' statutes, but merely implies that national legislation and statutes of NCBs need to be adjusted in order to eliminate inconsistencies with the Treaty. Timely adaptation requires the legislative process to be initiated during Stage Two, which would also allow the EMI and other Community institutions to assess the progress made towards the fulfilment of the requirements for Stage Three. For the purpose of identifying those areas where adaptation of statutes is necessary, a distinction may be made between independence of NCBs and integration of NCBs in the ESCB - the former, incidentally, being a particular feature of the latter.

The principle of central bank independence has been elaborated in different articles of the Treaty and the Statute, from which various features of central bank independence may be deduced. In particular, Article 107 of the Treaty prohibits the ECB, the NCBs and members of their decision-making bodies from seeking or taking instructions from Community institutions or bodies, from any government of a Member State or from any other body. It also prohibits Community institutions and bodies and the governments of the Member States from seeking to influence the members of the decision-making bodies of the ECB or of the NCBs. In addition to these institutional and personal features of independence, there are also functional features. For example, these would include appropriate adaptations of the statutes of NCBs which do not unambiguously reflect the primary objective of the ESCB (maintaining price stability).

The Treaty also requires that the necessary legislative measures be adopted in the Member States participating in the European currency area to enable their NCBs to be integrated within the ESCB. In particular, such measures may be necessary to enable NCBs to execute tasks as members of the ESCB and in accordance with decisions by the ECB. The nature and content of such adaptations will need to be elaborated further and will, in many cases, become clearer as preparatory work for Stage Three advances.

A description of the current institutional features of the NCBs of Member States of the European Union, together with an indication of prospective changes in the statutes of such NCBs, if any, is attached as Annex 1 to this report. By way of supplement, a table on institutional features of NCBs is attached as Annex 2. Since the signing of the Treaty in February 1992, the statutes of various NCBs have been changed with a view to ensuring compliance with the requirements of the Treaty. Some of these adaptations were designed to make national legislation consistent with Article 104 of the Treaty, which prohibits the provision of central bank credit to the public sector, as well as with Article 104a, which prohibits the granting of privileged access for governmental or public bodies to financial institutions. To this effect, legislative action was taken in Belgium, Germany, Greece, Spain, France, Italy, the Netherlands, Portugal and Sweden.

Further adaptations of central bank legislation have been made with a view to Stage Three of EMU. The three most important examples are the Banque de France, the Banco de España and the Banco de Portugal. Legislation regarding the National Bank of Belgium and the Banca d'Italia has also been amended.

In October 1995 amendments to the statutes of NCBs were pending in several Member States (Belgium and Luxembourg), whilst in other Member States (Ireland, the Netherlands, Finland and Sweden and, again, also in Belgium) preliminary or preparatory work on such amendments was being undertaken. The adaptation of the statutes of NCBs is a matter of continuing concern in all the Member States of the European Union. In many cases, the adaptation process is of a gradual nature, anticipating further changes to make statutes of NCBs compatible with the Treaty in accordance with Article 108. The EMI will monitor this process.

CHAPTER I

CONVERGENCE CRITERIA

1. INTRODUCTION

1.1 Range of the criteria

Before a decision may be reached as to whether a given country fulfils the necessary conditions for the adoption of the single currency, the achievement of a high degree of sustainable convergence will be examined. This examination will be made by reference to the fulfilment by each Member State of certain criteria relating to macroeconomic performance. As detailed in Article 109j (1) of the Treaty establishing the European Community (the Maastricht Treaty) these four criteria are as follows:

- "the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best-performing Member States in terms of price stability;
- the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104c (6);
- the observance of the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State;
- the durability of convergence achieved by the Member State and of its participation in the exchange rate mechanism of the European Monetary System being reflected in the long-term interest rate levels".

The assessment of convergence shall also take account of "the development of the ECU, the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices".

1.2 Role of the EMI in assessing progress towards convergence

The current Report may be seen as preparatory to the role the EMI, and in due course the European Central Bank, will play in the examination of the convergence process. The process will start in 1996 and only end when all Member States have adopted the single currency.

Three different periods can be distinguished. First, Article 109j of the Treaty establishing the European Community provides that the EMI and the Commission shall each prepare a report in 1996 to the EU Council, examining the convergence of individual countries. These reports will be taken into account by the Council meeting in the composition of Heads of State or of Government. The Council (not later than 31st December 1996) shall decide whether a majority of the Member States fulfil the necessary conditions for the adoption of a single currency, and whether it is appropriate for the Community to enter Stage Three. If so, the Council will set the date for the beginning of Stage Three. Second, if by the end of 1997 no date has been set for the beginning of Stage Three, it shall start on 1st January 1999. Before this date, new reports by the EMI and the Commission will have to be submitted to the EU Council, and will be taken into account by the Council meeting in the composition of Heads of State or of Government in order to confirm which Member States fulfil the necessary conditions for the adoption of a single currency. Third, after the start of Stage Three, at least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank shall report to the Council in accordance with the procedure laid down in Article 109j (1).

In its assessment of the degree of convergence achieved, the EMI Council intends to express its views independently. In approaching this reporting task, a number of general guiding principles are used by the EMI for the application of the convergence criteria. First, the individual criteria are interpreted and applied in a strict manner. The rationale behind this principle, as discussed below, is that the main purpose of the criteria is to ensure that only those Member States which have economic conditions that are conducive to the maintenance of price stability and the viability of the European currency area should participate in it. Second, the convergence criteria constitute a coherent and integrated package and they must all be satisfied; the Treaty lists the criteria on an equal footing and does not suggest a hierarchy. Third, the convergence criteria have to be met on the basis of current data. Fourth, the application of the convergence criteria should be consistent, transparent and simple.

Finally, other relevant factors have to be taken into account. They may cast further light on the degree of convergence and the assessment of its sustainability (see Section 6).

1.3 The role of the criteria

As is evident from Article 109j of the Treaty, the criteria cover a subset of macroeconomic variables - broadly speaking, those relating to nominal convergence (inflation and fiscal policy) and the markets' assessment of the success of such nominal convergence (exchange rates and long-term bond yields). They may be seen as crucial elements of sound economic management. Also those countries which have given notification that they will not participate in Stage Three (Denmark) or have the right not to participate (United Kingdom), consider the Maastricht criteria a benchmark for sound economic policy; however, references to these countries do not imply preparations for Stage Three.

Furthermore, the Treaty stresses the sustainability of convergence, a central issue which is addressed repeatedly in this Report. Basically, sustainability implies that the achievements made should not only hold at a specific point in time but should also be durable. Thus, while a successful process of convergence during Stage Two is clearly a prerequisite for a smooth start for monetary union, its durability is essential for a sustainable European currency area in Stage Three. Taking the example of the fiscal criteria, monetary policy risks becoming overburdened when other economic policies do not contribute sufficiently to the achievement of price stability over the medium term.

The criterion on price stability reflects the consensus that price stability is essential for the achievement of sustainable and balanced growth of economies, thereby creating the best conditions for fostering employment and improving standards of living. It is widely accepted that beyond the very short term there is no trade-off between inflation and unemployment to be exploited, and there is also growing awareness of the costly economic distortions that inflation creates, hampering the long-term growth prospects of economies.

Similar arguments may be derived for the fiscal criteria, with the 3% and 60% reference values for deficits and debt. (Note that simple calculations show that, assuming 5% nominal GDP growth, a net borrowing ratio of 3% would in the long run be compatible with reaching or maintaining a debt ratio of 60%.) These criteria will not only be examined for the purpose of convergence, but will also be applied in Stage Three, when fiscal policy will continue to be set in a decentralised manner. In other words, and reflecting the above-mentioned issue of sustainability, they are not merely entry conditions for EMU and guidelines for a sustainable fiscal strategy, but also a cornerstone for macroeconomic stability once the European currency area is in place. There are a number of reasons why fiscal discipline is essential in a monetary union. Respecting the debt criterion will safeguard the monetary union against the risk of a situation where an individual country is ultimately unable to service its debt within the parameters of its own fiscal revenues. Compliance with the debt criterion clearly reduces the chances of an unsustainable fiscal position emerging. The debt criterion is also included as a convergence requirement to prevent the risk of financial market instability.

Furthermore, turning to fiscal deficits, there may be important repercussions on monetary policy from large deficits, thereby unfavourably affecting the policy mix, while there may also be spillovers across borders affecting the monetary union as a whole from lax fiscal policies in individual Member States. This would penalise those members of the monetary union which had retained sound fiscal policies and would also complicate monetary policy for the monetary union as a whole. Finally, some disturbances to aggregate supply or demand affecting individual countries or the monetary union as a whole may occur: in this context fulfilment of the fiscal criteria will be essential to ensure that the automatic stabilisers of the fiscal system may operate in affected countries without generating an excessive deficit. Altogether, the fiscal criteria are not to be seen as constraints on the conduct of economic policy, but rather as a mechanism for preventing the recurrence of the experience of several countries in the past where fiscal developments have affected confidence, increased risk premia on interest rates, and thus hampered the achievement of long-term non-inflationary growth.

Exchange rate stability typically requires that markets should consider that current and expected inflation is sufficiently low to sustain competitiveness at current nominal exchange rates, and that monetary authorities have built up counter-inflationary credibility. Equally, a sound fiscal policy may generate confidence and thereby contribute to exchange rate stability.

Long-term interest rates are traditionally seen as closely related to domestic inflation expectations, as well as to the credibility of the authorities in maintaining price stability. There is also a tendency for risk premia in long-term rates to be linked with fiscal developments (with risk premia increasing as deficits and debt rise, and vice versa).

Other factors to be taken into account in the examination of sustainable convergence may shed further light on the four criteria mentioned in the Treaty as well as providing information in their own right. There is a link between unit labour costs and other price indices and the sustainability of low inflation; inter alia, a current account deficit may accompany an unbalanced fiscal position, or an overvalued exchange rate, or could be linked to an investment boom, while the combination of a fiscal deficit and a surplus on current account indicates that deficits are financed by national private saving. Furthermore, data on "the development of the ECU" and "the results of the integration of markets" may also provide useful information.

The rest of this chapter examines performance under each of the criteria outlined above. The main text of each section commences with a view of actual performance in relation to the criterion. Then an analysis is made of current developments in the perspective of past performance, and of important determinants of the relevant variables in order to highlight both developments over time and underlying economic factors. This analysis, combined with the data, makes it possible to arrive at an assessment of overall performance in relation to each criterion. For the sake of convenience, boxes are used to present each criterion as it appears in the Treaty, followed by a description of certain issues arising in its application, including statistical questions.

In a final section, an attempt is made to assess performance on a country-by-country basis.

2. THE CRITERION ON PRICE STABILITY

2.1 Consumer price developments in relation to the reference value

Consumer price inflation for the fifteen current Member States, as well as a range of reference values, are presented in Table 2.1. The data used are national, unharmonised indices. Details of the progress in statistical harmonisation, as well as the criterion itself and issues in calculating the reference value are provided in Box 2.1.

The Treaty states that the reference value should be based on "at most, the three best-performing Member States in terms of price stability". Price stability may in principle be best reflected by the country with the lowest inflation rate. However, the average of the three best-performing countries may provide a good starting-point for the assessment of compliance with the reference value if there are no outliers. Including the new entrants, the three countries with the lowest inflation rates, based on 1994 figures, would have comprised Finland (one of the new entrants), France and Denmark, with inflation rates ranging from 1.1 to 2.0%. These rates can be regarded as compatible with the objective of price stability. If the simple average of inflation rates in these three countries (plus 1½ percentage points) had been used as a starting-point for calculating the reference value (i.e. 3.1% in 1994), inflation in eleven Member States (Belgium, Denmark, Germany, France, Ireland, Luxembourg, the Netherlands, Austria, Finland, Sweden and the United Kingdom) would have been below the reference value of the price criterion.

Table 2.1 **Consumer price inflation and alternative reference values for the price criterion**

(annual percentage rates)

	Medium-term developments						
	1990	1991	1992	1993	1994	1995 [(a)]	Oct 94-Sep 95
Belgium	3.5	3.2	2.4	2.8	2.4	1.5	1.6
Denmark	2.6	2.4	2.1	1.3	2.0	2.2	2.1
Germany[(b)]	2.7	3.6	4.0	3.6	2.7	1.9	2.1
Greece	20.3	19.6	15.9	14.5	10.9	9.7	9.9
Spain	6.7	5.9	5.9	4.6	4.7	4.8	4.7
France	3.4	3.2	2.4	2.1	1.7	1.7	1.7
Ireland[(c)]	3.4	3.2	3.0	1.5	2.4	2.6	2.5
Italy[(d)]	6.1	6.4	5.4	4.2	3.9	5.2	4.9
Luxembourg	3.7	3.1	3.2	3.6	2.2	2.1	2.1
Netherlands	2.4	3.1	3.2	2.6	2.8	2.1	2.2
Austria	3.3	3.3	4.0	3.6	3.0	2.4	2.5
Portugal	13.4	11.4	8.9	6.5	5.2	4.3	4.2
Finland	6.2	4.3	2.9	2.2	1.1	1.2	1.3
Sweden	10.4	9.7	2.6	4.7	2.3	2.9	2.8
United Kingdom [(e)]	8.1	6.8	4.7	3.0	2.4	2.8	2.7
Memo item: EU-15	5.4	5.3	4.4	3.6	3.0	3.0	3.0
Standard deviation[(f)]	5.0	4.6	3.6	3.2	2.4	2.2	2.2
Reference value[(g)] of:							
Best performer	3.9	3.9	3.6	2.8	2.6	2.7	2.8
Mean of best two rates	4.0	4.3	3.7	2.9	2.9	2.9	3.0
Mean of best three rates	4.1	4.4	3.8	3.1	3.1	3.0	3.0
2nd best performer	4.1	4.6	3.9	3.0	3.2	3.0	3.1
Mean of 2nd and 3rd best	4.2	4.6	3.9	3.3	3.3	3.1	3.2
3rd best performer	4.2	4.6	3.9	3.6	3.5	3.2	3.2

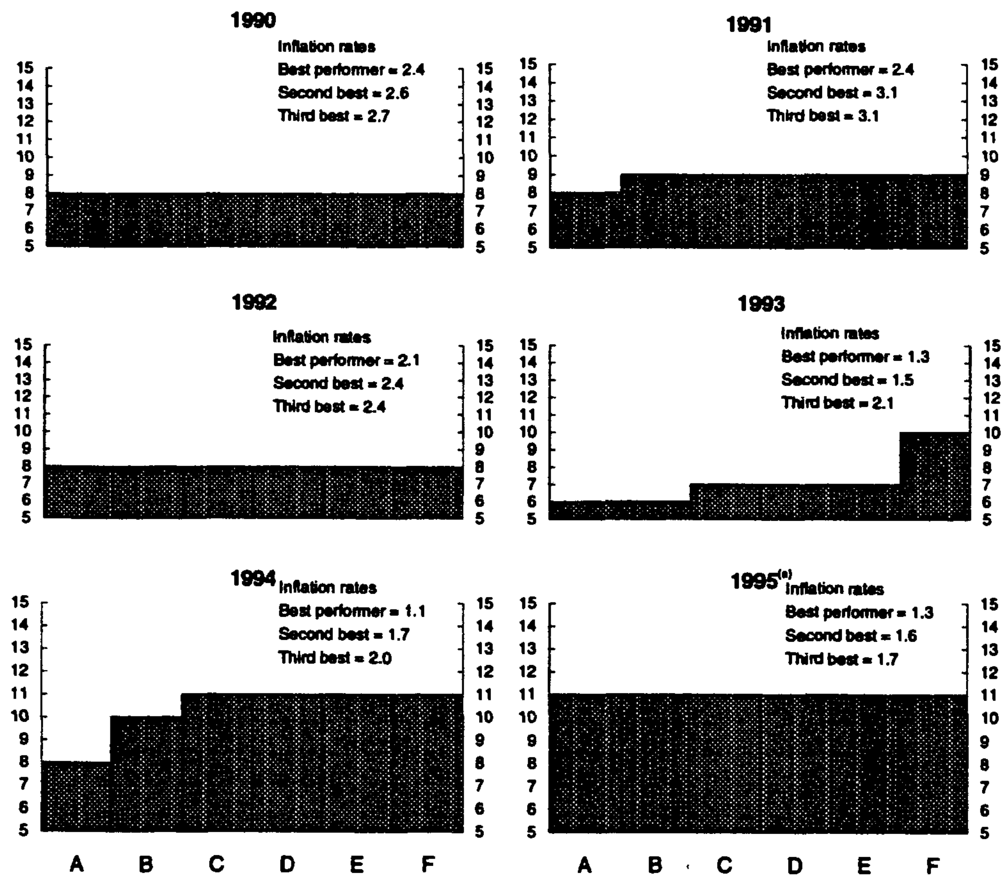
	Short-term developments						
	Q4 94	Q1 95	Q2 95	Q3 95	Jul 95	Aug 95	Sep 95
Belgium	2.0	1.8	1.5	1.2	1.2	1.3	1.2
Denmark	2.1	2.4	2.3	1.8	1.8	1.6	2.1
Germany[(b)]	2.6	2.0	1.9	1.8	1.8	1.7	1.8
Greece	10.8	10.6	9.8	8.6	8.9	8.7	8.4
Spain	4.4	4.8	5.1	4.4	4.7	4.3	4.4
France	1.6	1.7	1.6	1.8	1.5	1.9	2.0
Ireland[(c)]	2.4	2.5	2.8	2.4	2.4	2.4	2.4
Italy[(d)]	3.8	4.4	5.5	5.7	5.6	5.8	5.8
Luxembourg	2.0	2.3	2.2	1.8	1.9	1.8	1.6
Netherlands	2.7	2.4	2.2	1.6	1.8	1.5	1.5
Austria	2.8	2.5	2.5	2.1	2.2	2.1	2.1
Portugal	4.2	4.6	4.2	3.9	3.7	4.0	4.0
Finland	1.7	1.8	1.4	0.5	0.8	0.4	0.3
Sweden	2.5	2.9	3.2	2.7	2.9	2.7	2.5
United Kingdom [(e)]	2.2	2.7	2.7	2.9	2.8	2.9	3.1
Memo item: EU-15	2.9	3.0	3.1	3.0	3.0	3.0	3.1
Standard deviation[(f)]	2.2	2.2	2.1	2.0	2.0	2.0	2.0
Reference value[(g)] of:							
Best performer	3.1	3.2	2.9	2.0	2.3	1.9	1.8
Mean of best two rates	3.2	3.3	2.9	2.4	2.5	2.4	2.2
Mean of best three rates	3.3	3.3	3.0	2.6	2.7	2.6	2.5
2nd best performer	3.2	3.3	3.0	2.7	2.7	2.8	2.7
Mean of 2nd and 3rd best	3.4	3.3	3.0	2.9	2.8	2.9	2.8
3rd best performer	3.5	3.3	3.1	3.1	3.0	3.0	3.0

Source: National data. For further explanation of the inflation data used see Box 2.1.
(a) Data for 1995 are the average of the first nine months of the year.
(b) Western Germany up to end 1993, unified Germany thereafter.
(c) Based upon quarterly data. Data given in the Oct 94-Sep 95 column refer to the annual average inflation rate in the year to the third quarter of 1995.
(d) Cost-of-living index.
(e) CPI excluding mortgage interest payments (RPIX).
(f) Unweighted standard deviation.
(g) Reference values are based on all fifteen current EU Member States.

Over the last twelve months for which data are available compared with the same twelve in the previous year (October 1994 to September 1995 compared with October 1993 to September 1994), the three best-performing countries have been Finland, Belgium and France (with inflation rates of between 1.3-1.7%), and the same eleven Member States would be seen as having inflation below the reference value of the price criterion.

As is illustrated for the fifteen current member countries in Chart 2.1, the application of other means of calculating reference values may lead to identical results (for a discussion of the issues involved in calculating the reference value see Box 2.1). This was the case in 1990, 1992 and in the latest twelve-month period covered. In the same vein, Chart 2.2 illustrates the area-wide inflation rate of the group of countries which would have had inflation rates below the reference value for price stability in each year. Reflecting the general tendency towards lower consumer price inflation in the Member States in the 1990s, this rate has decreased to levels in the range of 2-2.5%.

Chart 2.1 Number of countries with inflation rates not exceeding reference values according to alternative methods



A. Best performer + 1.5 percentage points.
B. Average of best two rates + 1.5 percentage points.
C. Average of best three rates + 1.5 percentage points.
D. Second best + 1.5 percentage points.
E. Average of second best and third best rates + 1.5 percentage points.
F. Third best + 1.5 percentage points.

Source: National data. For further explanation of the inflation data used see Table 2.1.
(a) Data for 1995 are the average of the twelve months to September 1995.

Box 2.1 **Price Stability**

1. The criterion

The Treaty establishing the European Community, Article 109j (1) requires:

the price criterion to be judged on the basis of the relative inflation performance, which is "close to that of, at most, the three best-performing Member States in terms of price stability";

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

"The criterion on price stability referred to in the first indent of Article 109j (1) of this Treaty shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1½ percentage points that of, at most, the three best-performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index (CPI) on a comparable basis, taking into account differences in national definitions".

2. Issues relating to the calculation of the reference value

The wording of Protocol No. 6, Article 1, does not unambiguously define to which reference value the inflation criterion should apply, as it mentions the notion of "at most, the three best-performing countries". Furthermore, several technical issues arise, concerning the "average inflation rate observed over a period of one year" before the examination, and the calculation of averages of several countries' inflation rates in cases where more than one country's performance is used when calculating the reference value.

As to the technical issues when calculating averages among best-performing countries, preference is given to unweighted, arithmetic averages, as opposed to geometric and/or weighted averages. The inflation rate is calculated using the increase in the (arithmetic) average of the latest available twelve monthly indices over the average of the preceding twelve monthly indices. However, the information available from comparisons of other reference periods, including the latest available annual rate, is not excluded.

Regarding the definition of the reference value, the EMI has analysed the range of possible options and concluded that it is not appropriate to determine ex ante which option should be applied under all circumstances. Two examples may highlight potential complications of such an ex ante clarification. Firstly, it may not be appropriate to focus on the inflation performance of, say, the best-performing country only, if, for example, that country's inflation rate is considered to be distorted by exceptional circumstances. Secondly, choosing the simple average of the three best-performing countries, for example, would not be appropriate as a reference value if inflation rates among the best performers differ significantly, either because there are outliers due to high inflation on the one hand or to a situation of deflation on the other.

To the extent, however, that there are no strong indications of severely distorted price developments in the Member States over the most recent period considered, and as the price performance of the countries with low inflation rates is broadly similar, the average of the three best-performing countries could serve as a starting-point for the calculation of the reference value, while other reference values may also be taken into consideration.

3. Presentation of work on harmonisation of CPIs

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

Box 2.1 (Cont'd)

similar general principles, there are considerable differences of detail concerning the definitions of the items and the prices covered, the procedures used to obtain the basic price data and the methods employed to derive the weights for the index calculation. These differences affect the comparability of the national results.

The EU Council adopted in October 1995 a Regulation concerning Harmonised Indices of Consumer Prices. The conceptual work started in 1993 and is carried out by the European Commission (EUROSTAT) in close liaison with the National Statistical Institutes. As a key user, the EMI is closely involved in this work.

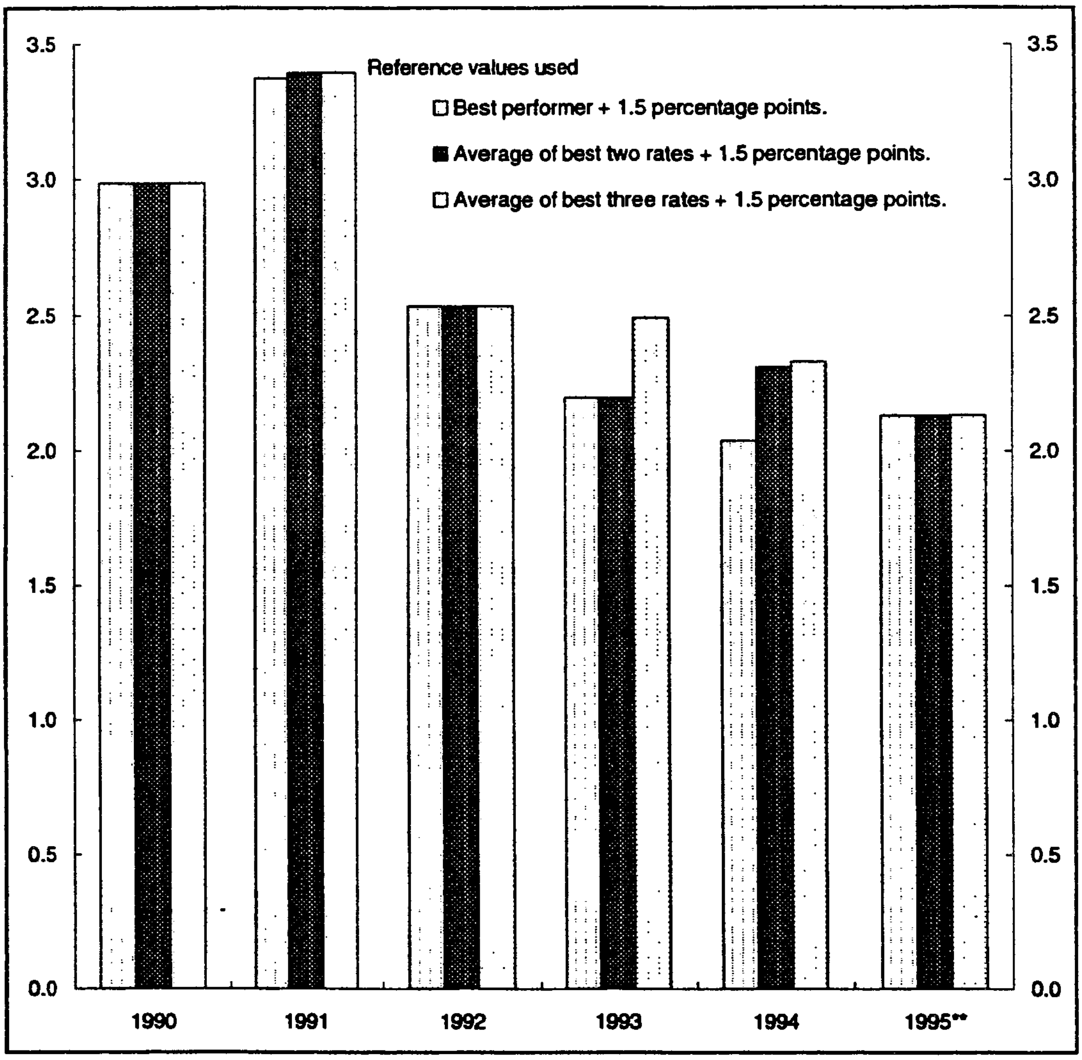
The Council Regulation serves as the framework for detailed future harmonisation measures. It sets out a step-wise approach for harmonising consumer price indices to provide both the necessary data for the analysis of convergence and for the conduct of a single monetary policy in Stage Three.

In a first step, beginning in January 1996, Interim Indices of Consumer Prices (IICP) will be calculated in order to facilitate comparisons across the European Union, until fully harmonised indices can be produced. These interim indices will be based on existing national indices, adjusted only by excluding major items for which national practices differ significantly (owner-occupied housing costs, expenditures for education, health and insurance) and by including certain items which are not currently covered in all countries (alcoholic beverages and tobacco). They will not be fully comparable since considerable differences in concepts and practices will remain. However, they are more comparable than present national indices and thus would provide a better basis for assessing convergence, although the exclusion of major items from the indices is an important drawback. The EMI expects that IICPs will be the basis for measuring price convergence in its convergence report prepared under Article 109j in 1996. The interim indices will, nevertheless, not be a substitute for existing indices in the Member States.

In a second step, beginning in January 1997, Harmonised Indices of Consumer Prices (HICP) will be calculated. They will be the basis for the report on convergence in 1997/98. Furthermore, HICPs will serve as the main indicator for consumer price developments under a single monetary policy in Stage Three. Work on these indices is already under way. Amongst the various fields for harmonisation, three will be particularly important in order to develop both comparable and meaningful consumer price statistics in the Member States. First, a wide coverage of expenditures undertaken for private consumption is indispensable. Therefore, common rules, particularly concerning the items excluded from the interim indices in 1996, need to be considered and, in due course, enacted. Second, an agreed means of adjusting for changes in the quality of goods and services is needed. Finally, the required frequency of the updating of the index weights will also need to be considered as a matter of priority.

Questions which cannot be resolved in the time remaining before the introduction of the HICPs will make further harmonisation measures after January 1997 necessary. The EMI has emphasised the need to make highly comparable data available by 1997 and to limit the number of stages and the delays in the harmonisation process to a strictly unavoidable minimum, in order to ensure sufficient consistency and stability in consumer price statistics. Further efforts will be required from Member States, if the tight timetable set by the Treaty for the provision of data to assess price convergence on a fully comparable basis is to be met.

Chart 2.2 **Alternative reference values and average inflation***
(annual percentage rates)



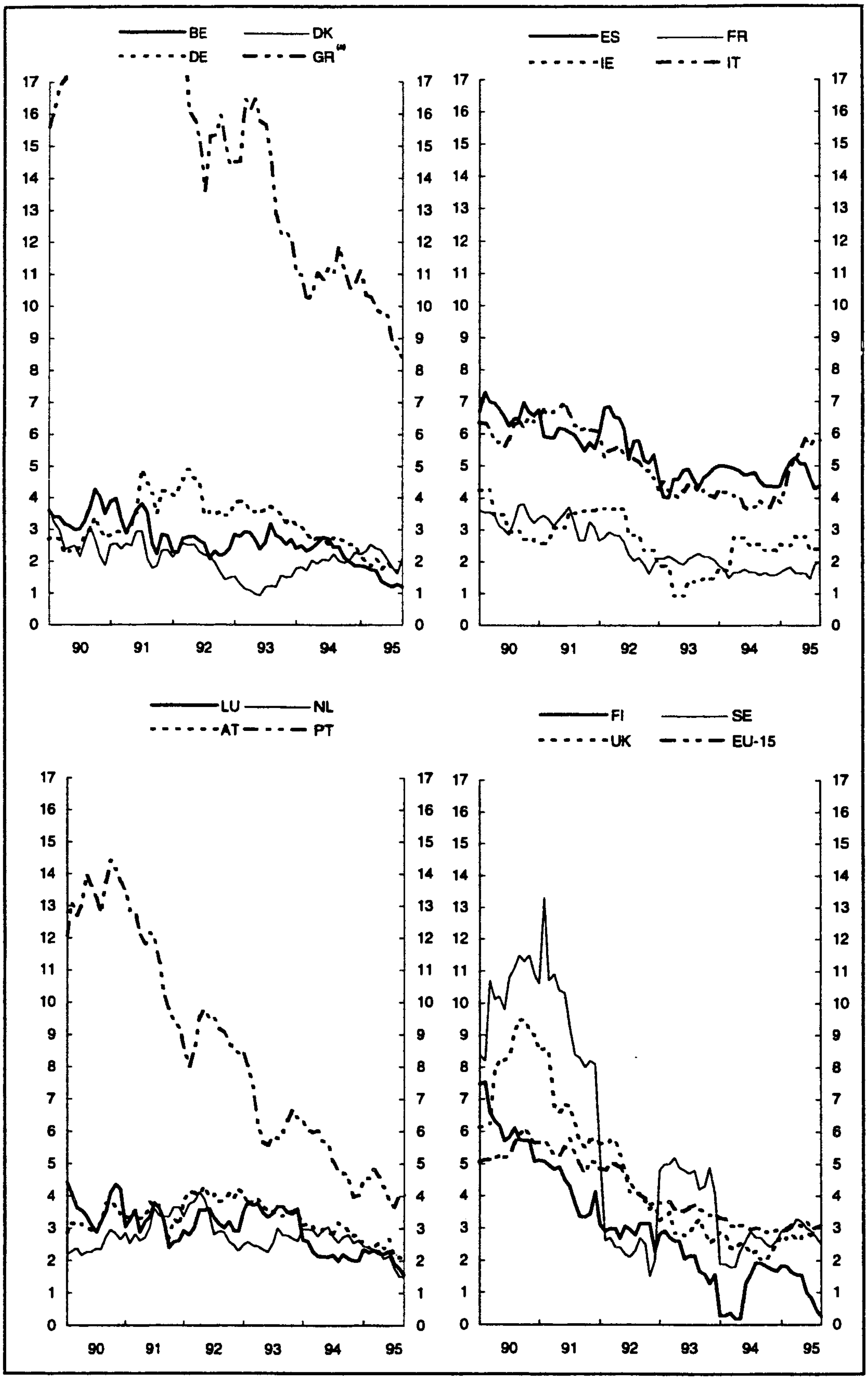
Source: National data. For further explanation on the inflation data used see Table 2.1.
* Average rate of inflation in the countries complying with the reference values in each year based on alternative methods in calculating the reference values (weighted area aggregates are based upon consumer price index (CPI) using renormalised 1993 consumer spending weights).
** Data for 1995 are the average of the twelve months to September 1995.

2.2 Recent consumer price developments in perspective

As the Treaty requires price developments to be sustainable, it is relevant to trace past developments and assess underlying economic factors. During the mid-to-late 1980s, a number of Member States had already experienced a decline in inflation. During the 1990s, a general tendency towards lower inflation in Member States has prevailed and CPI inflation according to national indices has shown marked convergence (see Chart 2.3).

Chart 2.3 **Consumer price inflation rates**

(monthly data; percentage change on the same period of the previous year)



Source: National data. For further explanation on the inflation data used see Table 2.1.
(a) The Greek series is not continuous for reasons of scaling.

All Member States, including the three new entrants, displayed lower CPI inflation in the course of 1995 than in the early 1990s. Consumer price inflation in Belgium, Denmark, Germany, France, Ireland, Luxembourg, the Netherlands and Austria has come down from around 2.5-3.5% in 1990 to, in most cases, around or below 2% in January-September 1995, while several countries have joined this group by achieving considerable decelerations from higher levels. Most notably, inflation fell in Finland from 6% to around 1%, in Sweden from above 10% to below 3% and in the United Kingdom from 8% to below 3%. Marked disinflation also took place in Portugal from a level of around 13% in 1990 to around 4%. Furthermore, Spain has reduced its CPI inflation rate from below 7% in 1990 to below 5% in the first nine months of 1995. In Italy CPI inflation fell from around 6% in 1990 to 4% in 1994, but increased thereafter to around 5% in the first nine months of 1995. Inflation in Greece fell from over 20% in 1990 to below 10% in the first three quarters of 1995. As a result of these patterns, consumer price inflation in the EU as a whole has declined markedly (from 5.4% in 1990 to around 3% at the time of writing). This general tendency partly reflects the impact of the recession witnessed in most Member States, particularly in 1993. It may also be related to structural factors such as increased political emphasis on the goal of price stability, a greater degree of independence of some central banks, increased competition stemming partly from the completion of the Single Market, and in some countries from the deregulation of labour and product markets.

Developments in the course of 1995, however, have raised the question of whether the downward convergence of inflation rates across the EU may have come to a halt. Whereas several EU countries continue to enjoy low or falling inflation rates, there have been increases in the first half of 1995 in some Member States. For example, the inflation rate has picked up since late 1994 in Italy, with an increase of 2 percentage points to 5.8% in June 1995. Since then the inflation rate has remained at that level. In early 1995 inflation rates also rose in Spain, Sweden and the United Kingdom, although inflation has since eased in Spain and Sweden to 4.4% and 2.5%, respectively. In the United Kingdom, it has remained at around 3%. A recurrence of contrasting developments would be regarded as a serious matter.

Monetary authorities in the EU should aim at rates of inflation which are generally regarded as price stability. Against this background, it is important to analyse the factors underlying recent developments, focusing both on countries which continue to display broadly favourable developments and those which have experienced higher inflationary pressures. This is the subject of the following section.

2.3 Underlying factors

In the long term, inflation is a 'monetary phenomenon', i.e. it correlates closely with developments in the supply of money and is related more generally to the longer-term stringency of monetary policy; however, in the short term, other factors may play an important role. Among these are (i) commodity price and exchange rate changes affecting import prices; (ii) international and domestic demand trends affecting production and capacity utilisation, as well as autonomous cost pressures particularly influencing unit labour costs and profit margins; and (iii) effects of fiscal policy.

The usual measure of external pressure on inflation is import prices. Clearly, this measure is determined by a host of further underlying factors, such as developments in world oil and non-oil commodity prices (which are traded mainly in US dollars), currency movements against the US dollar and overall exchange rate trends. However, profit margins of importers may vary over time, and prices of imported goods and services may therefore not directly respond to changes in prices quoted in foreign currency or to fluctuations in exchange rates. Thus, a deeper analysis of the determinants of import prices and their impact on final prices in the importing countries is in itself a subject which requires detailed consideration. For the purpose of the examination of the convergence criterion on price stability it may, however, be a useful starting-point to identify the broad trends in import prices observed over the past few years. One may thereby highlight the extent to which overall external developments may have influenced consumer price developments in individual countries, both in themselves and in relation to other factors such as the development of unit labour costs and fiscal developments.

The following patterns have prevailed over the past few years: in a number of Member States showing broadly favourable CPI inflation rates in the course of the 1990s (namely Belgium, Denmark, Germany, France, Luxembourg, the Netherlands and Austria), increases in import prices have generally been low or even negative (see Chart 2.4). This is partly due to the behaviour of exchange rates. Ireland also conforms to this pattern, except in 1993, when import prices rose after the devaluation of the Irish pound. In 1994, when world oil and non-oil commodity prices rose significantly, the potential inflationary impulse in these countries was alleviated by the decline of the US dollar vis-à-vis their currencies.

In Spain and Italy, import prices had a moderating impact on overall consumer price developments over the period 1990-92. But import prices rose sharply in both 1993 and 1994 following the earlier depreciation of the respective currencies. Since these increases only fed through into consumer prices to a limited extent, inflation tendencies over 1993-94 may only be partly attributed to changes in exchange rates. Likewise, import price inflation was low or negative in Finland, Sweden and the United Kingdom in the early 1990s, while in 1992 and 1993 the effect of the devaluation of the Finnish markka, and in 1993 the weakening of the Swedish krona and the pound sterling, led to substantial increases in import prices. In these countries, only a small part of import price rises was passed on to consumer prices, however, due to weak pressure of demand in the domestic economy and a non-accommodating stance of monetary policy. Finally, in Greece and Portugal, which had shown a sharp reduction in inflation over the early 1990s, aggregate import price inflation was less than consumer price inflation over the whole period.

Data for 1995 suggest that import price increases in the EU will on average be higher in 1995 than in any of the previous four years. This development can be ascribed largely to increases in Italy and the United Kingdom, in particular, and in Greece, Spain and Sweden, to a lesser extent, whereas import price inflation is expected to remain low in the rest of the EU.

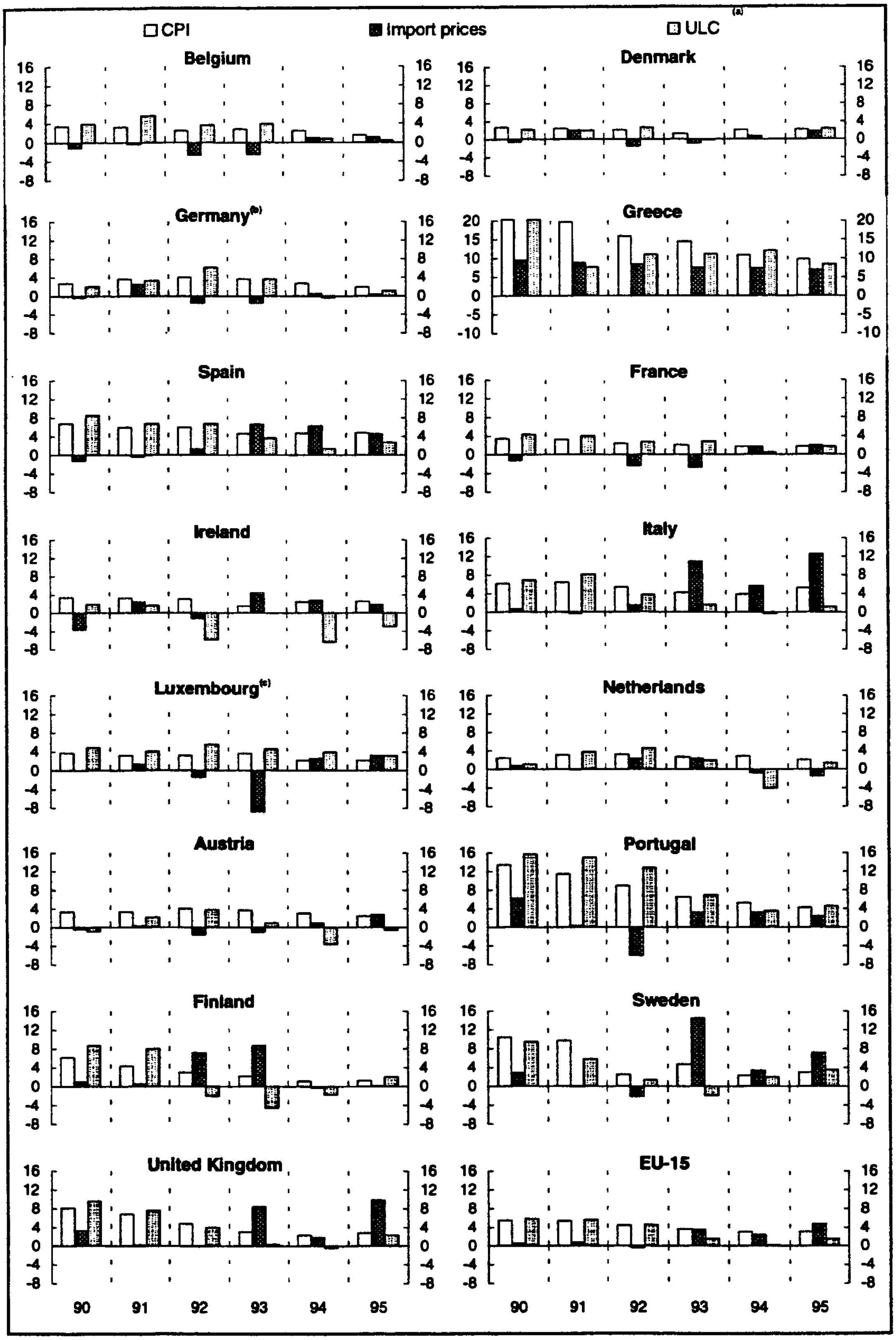
Unit labour costs - total labour costs divided by output - provide an important measure of domestic cost pressures. Unit labour costs are determined by a host of factors, in particular by the actual state of the business cycle, changes in employment, capacity utilisation and the existence of output gaps, as well as the development of profit margins, the negotiating power of unions and employers in the framework of specific institutional arrangements and the evolution of non-wage labour costs. All of these factors may influence both components of unit labour costs - labour costs per employee and productivity (see also Section 6.2.1).

The pattern which emerges from Chart 2.4 suggests unit labour cost pressures decelerated between 1990 and 1994. While the rate of increase of unit labour costs in the early 1990s was quite high or accelerating in most countries, increases in 1994 were considerably more limited or even negative. This can be observed in Member States that typically had lower inflation rates (Belgium, Germany, the Netherlands and Austria), and in countries that started at considerably higher levels (Spain, Italy, Portugal and the United Kingdom). In France, wage moderation and low inflation prevailed over the whole period. Unit labour costs actually decreased in countries such as Finland (over 1992-94) and Sweden (in 1993) and they contributed to the deceleration in the overall inflation rate in 1994. In contrast, in Greece, nominal unit labour costs have continued to increase by around 10% per annum throughout the period since 1991.

It is evident that the downturn in economic activity in most EU economies in 1993, together with the subsequent recovery, had a significant impact on developments in unit labour costs. Since the economies in Europe are now in a process of recovery, the question arises as to whether the more favourable development of unit labour costs over recent years can be sustained, or alternatively, whether risks are emerging in terms of upward pressures on wages and lower gains in productivity.

Data for 1995 suggest that unit labour costs across the EU are not rising strongly at present. One underlying reason may be that Member States are still benefiting from cyclical improvements in productivity as increases in output outstrip growth in employment. Furthermore, labour market reforms carried out in a number of Member States during the last few years may be helping to contain wages. Enhanced monetary policy credibility may also be a factor. On the other hand, there is evidence of renewed wage pressure in some countries, while scope for further productivity gains is becoming more limited. Thus in 1995, growth of unit labour costs has been edging upwards in a number of Member States, although mostly from low or even negative rates. This development is quite widespread. As the economic recovery in Europe continues to gather pace, these developments have to be seen against the likelihood that the amount of spare capacity will decline, and potential upward pressures on prices may emerge. Furthermore, price indices for intermediate products (dealt with in greater detail in Section 6), such as producer or wholesale price indices, rose strongly during 1994 in almost all countries, and available evidence for 1995 suggests that producer price inflation this year will be higher than consumer price inflation in several Member States.

Chart 2.4 **Consumer price inflation and important determinants**
(annual percentage rates)



Source: National data. For further explanatory notes on consumer prices see Table 2.1. Data for 1995 are the average of the first nine months of the year. Data for import prices and ULC for 1995 are projections.
(a) ULC = Nominal unit labour costs.
(b) Western Germany up to 1991, unified Germany thereafter.
(c) For reasons of scaling the import price growth series extends beyond the range of the graph. In 1993 it stood at -9.0%.

A final factor which may be considered is the course of fiscal policy. Large structural fiscal deficits (defined as the deficit that an economy would exhibit if its GDP were on its potential growth path, after eliminating cyclical factors) may have an adverse impact on agents' inflation expectations because they tend to be associated with rapid increases in public debt ratios which may cast doubt on sustainability. A rapid rise in government spending not matched by increased revenues will also increase the demand pressure on prices. A case in point may be the period following unification in Germany, but also developments in the early 1990s in countries like Spain and Portugal as well as Greece. More recently, the general reduction in structural deficits (see also Table 3.2) has reduced the pressure of demand from fiscal policy.

Measures to increase indirect taxes may have at least a temporary impact on the price level, to the extent that producers are able to maintain their margins, by passing on price increases to consumers. Fiscal consolidation has been associated with increases in indirect taxes in all member countries in 1994 and further increases have been widely observed in 1995. An important issue is whether such increases will be accepted as a one-off change in prices, or whether they will feed, via wage increases, into a more general inflationary process. The general macroeconomic situation, the credibility and, in particular, the stance of monetary policy, are likely to have an impact on such second-round effects. It is therefore critical that monetary policy should remain vigilant and counter emerging price and cost pressures at an early date.

2.4 Assessment

2.4.1 Sustainability of price developments

The requirement of sustainability implies that price stability has to be maintained over the long term (see also Section 5 on long-term interest rates, which according to the Treaty are a measure of the durability of convergence). More specifically, the question is whether or not there are reasons to judge that a low (or even negative) current inflation rate is due to particular circumstances which will only prevail temporarily. If this were the case, it would not be appropriate to consider the country concerned as necessarily eligible for monetary union.

In principle, three considerations may play a role when assessing the sustainability of price developments. Firstly, price developments may be analysed with a view to identifying temporary factors that lead to one-off price changes. The most obvious of these is a reduction in indirect taxes, which would lead to a lower increase in consumer prices in the year in question, ceteris paribus. Such factors are often excluded from measures of underlying inflation. Secondly, there may be some situations, such as a debt deflation, where falling prices at a macroeconomic level are a sign of unsustainability. Indicators of such a situation would include a high rate of bankruptcies, a banking crisis, a sharp contraction of money and credit, and rapidly declining commercial or residential property prices. Thirdly, there is the more general issue of whether the current rate of inflation is sustainable, given the macroeconomic situation. For example, inflation often tends to decline during a recession. Therefore, the rate of inflation viewed over the one-year reference period could be judged in the light of performance over a given period in the past or, alternatively, a number of indicators of inflation could be considered.

It is clear that these considerations in the assessment of the sustainability of price developments cannot be easily captured in simple models. Therefore, it is not appropriate to determine ex ante how they should be applied under all circumstances. Rather, there has to be room for a qualitative assessment at the time when the criterion needs to be applied.

Overall, there is no evidence of recent net reductions in indirect taxes in Member States, and the macroeconomic situation in the Union is broadly balanced. Those countries which displayed some elements of debt deflation in the early 1990s (such as Finland and Sweden) appear to have experienced recovery more recently. Therefore, in this Report it may be judged that for the period under consideration (October 1994 to September 1995) no country clearly displays an unsustainable price performance in the above sense, although in some Member States price performance remains unsatisfactory. A more explicit examination, however, would require deeper analysis which took into account past developments.

2.4.2 Inflation performance

The review of recent consumer price developments has highlighted the fact that there is, on the one hand, a majority of countries which maintains relatively low inflation rates, but on the other hand, there are also some warning signals that the general downward momentum in inflation rates may not continue.

Among the four countries that do not comply with the reference value (Greece, Spain, Italy and Portugal), consumer price inflation in Portugal tended to come closer to the reference value. In Spain, consumer price inflation accelerated in the spring up to around 5% mainly due to an increase in indirect taxes; a correction took place in the summer, which brought inflation down to 4.4%. In Italy, the inflation rate increased to 5.8% in the first half of 1995 again partly reflecting indirect tax increases, and stabilised thereafter. In Greece, the inflation rate continued to fall and stood at 8.4% in September 1995. Among those eleven Member States which comply with the price criterion, the inflation rate in Sweden edged upwards during the first half of 1995 to a level above the reference value, but has recently fallen back to around 2.5%. In the United Kingdom, too, the inflation rate picked up in early 1995 and reached 3.1% in September, a development which needs to be monitored closely.

The above analysis has highlighted a number of factors which may underlie these patterns. One is the divergence of exchange rate developments in recent years, feeding through into import prices in countries whose currencies have depreciated (as is the case in Spain, Italy, Sweden and the United Kingdom). A further factor is a certain pick-up in unit labour costs across much of the Union related to slowing productivity growth and in some cases renewed wage pressures, particularly in countries where the export sectors have grown very dynamically in contrast to domestic sectors (in Sweden and Finland), or where output gaps as a result of the recovery are now comparatively small (according to OECD estimates in Denmark, Ireland and Austria, and to a lesser extent in Germany and the Netherlands). Indirect taxes have also boosted prices in a one-off manner in several countries. Against this background, crucial elements in further preparation for Stage Three are that Member States should pursue a monetary policy conducive to stable exchange rates, that growth in labour costs should remain subdued and that fiscal deficits be reduced and kept under control.

3. THE CRITERION ON THE GOVERNMENT BUDGETARY POSITION

3.1 Fiscal positions in relation to the reference values

Fiscal data presented by the European Commission in autumn 1995 are shown in Table 3.1. Figures for 1995 are Commission projections, and are sometimes referred to as 'planned', 'projected' or 'expected'. Further details on the fiscal criteria, issues relating to the reference values and statistical issues are provided in Box 3.1. Box 3.2 provides an overview of the Excessive Deficit Procedure.

The data show that deficit-to-GDP ratios declined in 1994 and 1995 in most Member States, but remained worryingly high. Debt ratios, moreover, continued to rise in most countries between 1993 and 1995. Measured against the reference value of a deficit-to-GDP ratio of 3%, three countries were below this level in 1994 - Germany, Ireland and Luxembourg - while for 1995 Commission projections suggest that Denmark will join this group. As regards the performance against the reference value of the debt-to-GDP ratio, four countries (Germany, France, Luxembourg and the United Kingdom) have maintained levels of below 60%.

In 1994, of the then twelve member countries only Ireland and Luxembourg were not the subject of an EU Council decision under Article 104c (6) of the Treaty that an excessive deficit exists. In the case of Ireland, although the debt ratio was above 90% at the time and thus well above 60% of GDP, account was taken in the procedure of the progress made in the reduction of the debt ratio. In Luxembourg, fiscal balances were in surplus and the debt ratio was low. Also in 1995, Ireland and Luxembourg were not the subject of an EU Council decision. In addition, the Council decision that an excessive deficit exists was abrogated for Germany in view of the progress achieved in the reduction of the deficit to below 3% in 1994 (and a debt ratio which remained below 60%). Thus, at present, twelve of the fifteen member countries are subject to an EU Council decision that an excessive deficit exists (see Box 3.2). The following sections examine the development of the government budgetary position of Member States in more detail, both with a view to highlighting underlying factors of continuing imbalances and to promoting corrective action.

Box 3.1 **Public Finances**

1. Treaty provisions

The Treaty establishing the European Community, Article 109j (1) requires that the government financial position be sustainable. This will be apparent from having achieved a government budgetary position without a deficit that is "excessive" (see Box 3.2). Article 104(c) defines the criteria for deciding whether an excessive deficit exists, requiring the Commission to prepare a report if one or both of the following conditions are fulfilled:

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

- *either the ratio has declined substantially and continuously and reached a level that comes close to the reference value;*

- *or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;*

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

In addition, the report prepared by the Commission should take into account "whether the government deficit exceeds government investment expenditure" and "all other relevant factors, including the medium-term economic and budgetary position of the Member State". The Commission may also prepare a report if, notwithstanding the fulfilment of the requirements under the criterion, it is of the opinion that there is a risk of an excessive deficit in a Member State. The Monetary Committee (or its successor in Stage Three, the Economic and Financial Committee) shall formulate an opinion on the report of the Commission. Finally, on the basis of the recommendation of the Commission, the EU Council shall, acting by qualified majority, decide whether an excessive deficit exists in a Member State (see also Box 3.2).

2. Issues in the application of reference values

The fiscal developments analysed below show that even strong economic recoveries may not by themselves bring about fundamental improvements. Although actual deficits may decline during periods of buoyant economic activity, possibly falling to just below 3% of GDP, structural deficits persist, and, thus, in the event of an economic slowdown, increases in actual deficits are to be anticipated. In order to show clear evidence of a reduction in debt ratios and to ensure that the ratio referred to in the Treaty is sufficiently diminishing and approaching the reference value at a satisfactory pace, in some cases this will imply high primary surpluses (that is, the balance net of interest rate payments), if not a sustained low deficit or overall surplus.

3. Statistical issues

The Protocol on the Excessive Deficit Procedure defines "government", "deficit" and "investment" by reference to the European System of Integrated Economic Accounts (ESA). The ESA is a coherent and detailed set of national account tables agreed for the European Community in order to facilitate comparative analyses between Member States. Furthermore, the definitions of "debt" and "gross domestic product" as well as the rules and coverage of reporting by the Member States to the European Commission are laid down in a Council Regulation. The Protocol on the Excessive Deficit Procedure assigns to the European Commission the ultimate responsibility for providing the statistical data to be used.

Box 3.1 (Cont'd)

"Government" comprises central government, regional or local government and social security funds. It does not include public enterprises and is therefore to be distinguished from a more broadly defined public sector. The application of the ESA definition of government is in the process of being further clarified, in particular as far as certain pension funds are concerned.

"Government deficit" is defined as the difference between government gross saving and the sum of government investment, net capital transfers payable by government, the change in stocks and net purchases of land and intangible assets by government. Furthermore, "government debt" is defined as the sum of the liabilities of government classified in the ESA categories currency and deposits, bills and bonds, and other loans. The definitions of government deficit and government debt imply that the change in government debt outstanding at the end of two consecutive years may differ substantially from the size of the government deficit for the year under consideration. For example, government debt could be reduced by privatising public enterprises or by selling other financial assets. This, however, would not affect the deficit.

3.2 Government deficits

3.2.1 Recent developments in general government deficits in perspective

After a period of falling fiscal deficits in the context of rapid economic growth in the late 1980s, imbalances in the government budgetary position increased sharply from 1990 onwards (see Table 3.1). Of the nine countries which had a surplus or a deficit ratio of below 3% in 1990, only two countries continued to do so in 1993. During the same period, average fiscal deficits rose from 3.5% to 6.3% of GDP for the Union as a whole. This was the highest level observed since the EEC was founded in 1957, and was considerably higher than in the economic downturns that followed the two oil price shocks when deficit-to-GDP ratios peaked at 4½% in 1975 and above 5% in 1982.

During 1994 and 1995 some improvements in government balances were observed in almost all Member States - a pattern which is reflected in the reduction of the deficit in the Union from 6.3% in 1993 to 5.5% in 1994 and to 4.7% in 1995.

Luxembourg has experienced a decline in its surplus since 1993, while of those three countries which are expected to record deficits of below 3% in 1995, the deficit reduction since 1993 has been substantial in Denmark (2.5 percentage points). In Germany, although the deficit is expected to decrease by only 0.6 percentage point of GDP, the underlying improvement is substantial when the burden of reunification is taken into account. Meanwhile, in Ireland the deficit is projected to increase from 2.4% to 2.7%. Among countries which are expected to run deficits in the range of 3-6% in 1995 (Belgium, Spain, France, the Netherlands, Austria, Portugal, Finland and the United Kingdom), improvements over 1993-95 are expected to be in the range of 2 to 3 percentage points of GDP in Belgium, Finland and the United Kingdom and less (1 to 2 percentage points) in Spain, France and Portugal. In the Netherlands, the fiscal deficit for 1995 is likely to improve marginally (by 0.1 percentage point). However, in Austria, the deficit is expected to increase by 1.4 percentage points. Those countries with the highest

Table 3.1 **Government budgetary positions**

(as a percentage of GDP)

	General government net lending (+) / net borrowing (-)					
	1990	1991	1992	1993	1994	1995[a]
Belgium	-5.8	-6.7	-7.1	-6.7	-5.3	-4.5
Denmark	-1.5	-2.1	-2.9	-4.5	-3.8	-2.0
Germany[b]	-2.1	-3.3	-2.8	-3.5	-2.6	-2.9
Greece	-14.0	-11.4	-11.7	-12.1	-11.4	-9.3
Spain	-4.1	-4.9	-4.2	-7.5	-6.6	-5.9
France	-1.6	-2.2	-4.0	-6.1	-6.0	-5.0
Ireland	-2.3	-2.2	-2.4	-2.4	-2.1	-2.7
Italy	-10.9	-10.2	-9.5	-9.6	-9.0	-7.4
Luxembourg	4.9	1.9	0.8	1.8	2.2	0.4
Netherlands	-5.1	-2.9	-3.9	-3.2	-3.2	-3.1
Austria	-2.2	-2.4	-2.0	-4.1	-4.4	-5.5
Portugal	-5.5	-6.6	-3.3	-7.1	-5.8	-5.4
Finland	5.4	-1.5	-5.9	-8.0	-5.8	-5.4
Sweden	4.2	-1.1	-7.8	-13.4	-10.4	-7.0
United Kingdom	-1.5	-2.6	-6.1	-7.8	-6.8	-5.1
EU-15	-3.5	-4.3	-5.1	-6.3	-5.5	-4.7
	General government gross debt					
	1990	1991	1992	1993	1994	1995[a]
Belgium	130.9	130.3	131.1	137.5	135.0	134.4
Denmark[c]	59.6	64.6	69.0	80.3	75.6	73.6
Germany[b]	43.8	41.5	44.1	48.2	50.2	58.8
Greece	82.6	85.4	91.6	114.5	113.0	114.4
Spain	45.1	45.8	48.4	60.4	63.0	64.8
France	35.4	35.8	39.6	45.3	48.4	51.5
Ireland	96.5	96.7	94.3	97.4	91.1	85.9
Italy	97.9	101.3	108.4	119.4	125.4	124.9
Luxembourg	4.6	4.1	5.1	6.3	5.9	6.3
Netherlands	78.8	78.8	79.6	81.3	78.0	78.4
Austria	58.3	58.6	58.3	63.0	65.2	68.0
Portugal	68.6	70.2	62.4	67.2	69.4	70.5
Finland	14.5	23.0	41.5	57.3	59.8	63.2
Sweden	43.5	53.0	67.1	76.2	79.7	81.4
United Kingdom	...	35.7	41.9	48.6	50.1	52.5
EU-15	...	56.0	60.3	66.2	68.1	71.0

Source: European Commission forecasts (Autumn 1995)

(a) European Commission projections.

(b) Western Germany up to 1990, unified Germany thereafter.

(c) General government gross debt figures are not adjusted for the assets held by the Danish Social Pension Fund against sectors outside general government, and for government deposits at the central bank for the management of foreign exchange reserves. In accordance with the Council's and Commission's statements covering Article 1(4) of Council Regulation No.3605/93 of 22nd November 1993, for Denmark these items shall be stated separately. They totalled 20.8% of GDP in 1993, 16.3% of GDP in 1994 and are expected to be 13.3% of GDP in 1995. In addition, the data are not adjusted for the amounts outstanding in the government debt for the financing of public undertakings, which according to the aforementioned Regulation will be subject to a separate presentation for the Member States. In Denmark, this item amounted to 7.2% of GDP in 1993, 6.8% of GDP in 1994, and is expected to be 6.6% of GDP in 1995. If corrected by these items, the debt level at end-year would stand at 52.3% of GDP in 1993, 52.5% of GDP in 1994 and an expected 53.7% in 1995.

deficits (Greece, Italy and Sweden) also experienced a reduction in recent years. In particular, the deficit in Sweden is expected to fall by more than 6 percentage points between 1993 and 1995 to reach an estimated 7%, while the reduction in Italy is estimated at 2.2 percentage points to bring the deficit to 7.4% of GDP. In Greece, the recorded deficit fell from 12.1% of GDP in 1993 to 9.3% in 1995. At first glance, recent developments might be regarded as a sign of a reversal of negative trends. However, analysis suggests that these trends are relatively deep-seated, and a closer examination of factors underlying fiscal developments in the short and medium term suggests that there is still a considerable need for adjustment. This will continue to pose a major challenge to economic policy-makers far beyond the present cycle.

3.2.2 Underlying factors

The evolution of fiscal positions in individual EU countries is the combined result of structural fiscal balances and cyclical factors. There is a clear risk that data for individual years or shorter periods of time may mask underlying trends and make judgements regarding sustainability difficult. Considering longer periods of time can help to put recent developments in perspective.

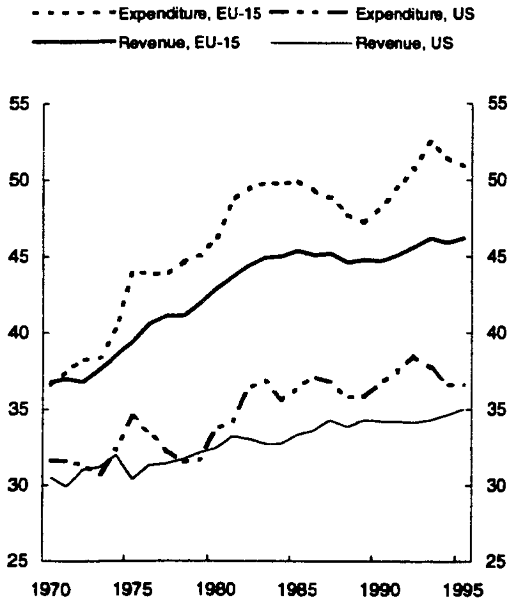
In this respect, attention is drawn to Charts 3.1 and 3.2 which, for illustrative purposes, focus on averages for the Union as a whole.

First, as can be seen, there has been a trend increase in the ratio of public expenditure to GDP. While the expenditure ratio typically increased sharply during times of economic slowdown (as in the mid-1970s, early 1980s and early 1990s), only partial corrections took place during periods of recovery owing to the adjustment of discretionary fiscal policy. Although the revenue ratio typically also increased over time, this could not fully offset the impact of expenditure growth on deficits.

Second, the tendency for inadequate adjustment measures during times of economic growth is also shown by a comparison of actual and structural deficits (defined as the deficit that an economy would exhibit if its GDP were on its potential growth path, after eliminating cyclical factors). Since there are severe methodological and measurement problems associated with the estimation of structural deficits, the focus should be less on levels than on developments over time. Also, measures of structural deficits not only contain structural elements, but also certain items of a non-recurrent nature. Chart 3.2 highlights the reduction of actual deficits in the late 1980s, but also suggests that there was insufficient correction of underlying imbalances. Structural imbalances quickly reappeared in actual deficits when EU economies slowed down in the early 1990s.

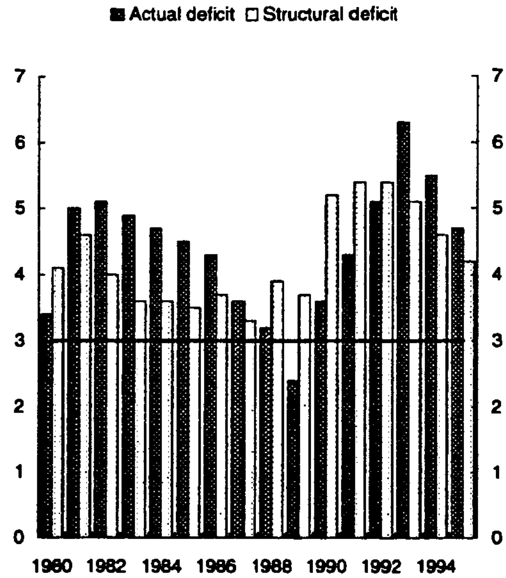
Focusing in more detail on recent developments in structural balances, the estimates available from the European Commission suggest that, for the EU, a deterioration took place until 1992, after which a process of correction began. Slightly less than 1 percentage point of the decrease in actual deficits since 1993 (out of 1.6 percentage points) can be associated with government consolidation efforts aimed at reducing structural imbalances (see Table 3.2). However, differences appear at the national level.

Chart 3.1 EU-15* and US general government expenditures and revenues
(as a percentage of GDP)



Source: European Commission.
For further explanation of the data used see Table 3.1
* From 1970 to 1978 EU-15 excluding Greece, Luxembourg, Portugal and Sweden. From 1979 to 1992 excluding Luxembourg. Western Germany up to 1991, unified Germany thereafter.

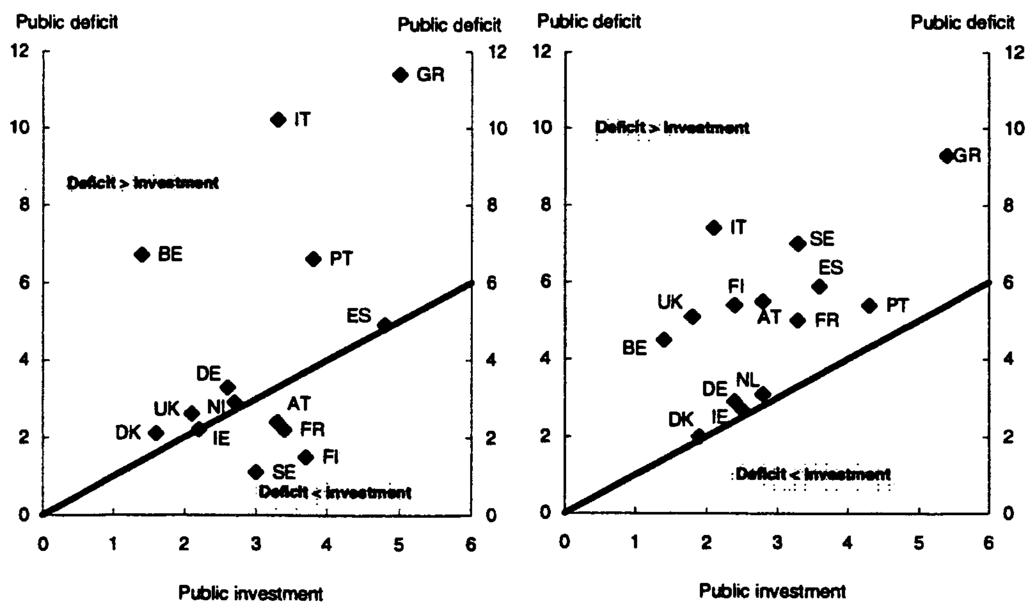
Chart 3.2 EU-15* actual and structural deficits
(as a percentage of GDP)



Source: European Commission.
For further explanation of the data used see Table 3.1.
* EU-15 excluding Luxembourg. Western Germany up to 1991, unified Germany thereafter.

Chart 3.3 Public investment and deficits*
(as a percentage of GDP)

a) 1991 **b) 1995**



Source: European Commission. For further explanation of the data used see Table 3.1.
* For reasons of scaling no data are shown for Luxembourg; the public surplus in 1991 was 1.9% and is estimated to be 0.4% in 1995. For public investment there is no data available in 1991 and is estimated to be 5.2% in 1995.

Among those countries with relatively low and/or falling deficit ratios, Germany and Denmark have experienced limited reductions in structural imbalances, while the structural position of Ireland deteriorated. In countries with projected deficit ratios for 1995 of between 3% and 6% of GDP, improvements in actual balances are generally accompanied by corresponding reductions in structural deficits. This is the case in Belgium, Spain, Portugal and the United Kingdom, and to a lesser extent in France. In contrast, structural deficits increased in Austria and Finland (where certain items of a non-recurrent nature affected the changes for 1994 and 1995), and, to some degree, in the Netherlands. Finally, the reduction in actual borrowing requirements in Greece is matched by equivalent structural improvements, while in Italy and Sweden structural factors account for more than half of the deficit reduction.

As regards levels, methodological difficulties are even more pronounced and any inferences must hence be made with extreme caution. However, international organisations such as the OECD and IMF show some consensus in the assessment that in the bulk of Member States structural deficits in 1995 are estimated to fall in the range 2-5%: Luxembourg retains a structural surplus, Germany and Denmark have deficits of around 2%, while Greece, Italy and Sweden have structural deficits in excess of 5%. If such magnitudes were to persist over the medium term, they would highlight the risk that actual deficit ratios may quickly increase if economic activity slows down, and therefore would further deviate from the reference values of the Maastricht Treaty.

In summary, the indicators considered suggest that although in a large number of member countries progress in reducing fiscal imbalances has been achieved over the past two years, major reasons for concern remain. In particular, structural improvements in the last two years only account for a fraction of overall reductions in deficits in a number of countries, while other countries even displayed a deterioration. Structural deficits themselves remained high in many Member States.

3.2.3 Fiscal deficits and public investment

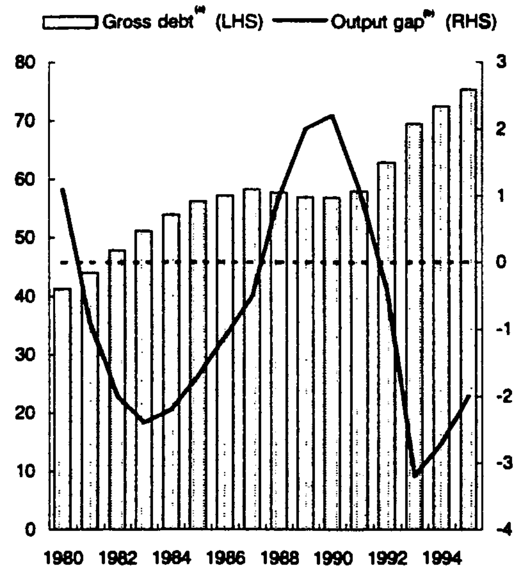
An increase in public deficits, if accompanied by an equivalent increase in public investment, may be considered as "self-financing" for the economy as a whole to the extent that the higher interest burden on debt is financed by the return on investment. A matching of fiscal deficits and public investment is often referred to as the "golden rule". These considerations are also reflected in the Excessive Deficit Procedure according to the Treaty (see Box 3.1). As shown in Chart 3.3, however, only a few Member States (namely France, Ireland, Austria, Finland and Sweden) had deficits below public investment in 1991, while Luxembourg had a fiscal surplus. In 1995 no EU country (except Luxembourg) is expected to meet this condition.

3.3 Developments in public debt

3.3.1 Recent developments in public debt in perspective

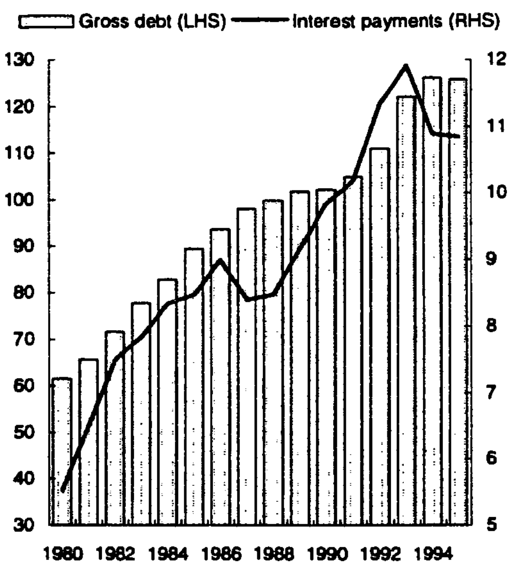
The majority of Member States have experienced a persistent trend towards rising debt ratios. For illustrative purposes, this trend may be highlighted by the average debt ratio for the Union as a whole (see Chart 3.4), which in 1995 is expected to reach a level almost twice that prevailing fifteen years ago. It is notable that, over the past five years,

Chart 3.4 Business cycle developments and general government debt-to-GDP ratio*



Source: OECD. Data for 1995 are forecasts.
* EU-15 excluding Luxembourg. Western Germany up to 1991, unified Germany thereafter.
(a) Gross financial liabilities, OECD definition, as a percentage of GDP.
(b) Deviations of actual from potential GDP, as a percentage of potential GDP.

Chart 3.5 General government debt and interest payments in EU-15 countries with debt ratios exceeding 90% in 1995*
(as a percentage of GDP)



Source: European Commission. For further explanation of the data used see Table 3.1. Data for 1995 are European Commission projections.
* Weighted average of Belgium, Greece and Italy. Data for Greece not available prior to 1990.

the average debt ratio of the EU has increased markedly. As in the case of public deficits, developments over the economic cycle were asymmetric in that a deceleration in economic activity usually triggered a significant rise in the debt ratio, while during times of economic recovery the debt ratio only tended to stabilise. With rising debt ratios, the interaction between debt levels and interest payments may become increasingly powerful, a mechanism often referred to as the "snowball effect". This effect is illustrated in Chart 3.5 for the three EU countries with the highest current debt ratios (Belgium, Greece and Italy). Interest payments represent an ever-increasing share of expenditure, revenues and GDP, which ultimately requires high and persistent surpluses in the primarybalance in order to prevent the debt position from becoming financially unsustainable.

At the level of individual countries, starting positions in 1990 differed markedly. Nine EU countries had debt levels below the 60% reference value (Denmark, Germany, Spain, France, Luxembourg, Austria, Finland, Sweden and the United Kingdom), but all (except Luxembourg) experienced rapid increases in debt ratios. Nevertheless, in Germany, France, Luxembourg and the United Kingdom, debt ratios are expected to remain below the reference value in 1995. Two Member States (the Netherlands and Portugal) already had high ratios (60-80%) and only succeeded to a limited extent in containing debt growth over the 1990s. Among the countries with very high ratios in 1990, debt ratios increased significantly in Greece and Italy from 82.6% and 97.9% respectively, to 114.5% in Greece and 124.9% in Italy in 1995, while in Belgium the rise was from 130.9% to 134.4%. In contrast, Ireland achieved a significant reduction from 96.5% to 85.9%.

Table 3.2 **Changes in general government net borrowing and structural balance ratios***

(changes over the previous year; as a percentage of GDP)

	Actual net borrowing requirement						Structural balance					
	1991	1992	1993	1994	1995	90-95	1991	1992	1993	1994	1995	90-95
BE	-0.9	-0.4	0.4	1.4	0.8	1.3	-1.0	-0.2	2.5	1.3	0.6	3.2
DK	-0.6	-0.8	-1.6	0.7	1.8	-0.5	-0.2	0.0	-1.0	-0.8	1.0	-1.0
DE[(a)]	-1.2	0.5	-0.7	0.9	-0.3	-0.8	-2.0	0.8	1.1	0.8	-0.1	0.6
GR	2.6	-0.3	-0.4	0.7	2.1	4.7	2.0	0.0	0.3	0.7	2.1	5.1
ES	-0.8	0.7	-3.3	0.9	0.7	-1.8	-0.6	1.8	-0.9	1.1	0.4	1.8
FR	-0.6	-1.8	-2.1	0.1	1.0	-3.4	0.0	-1.5	-0.4	-0.1	0.6	-1.4
IE	0.1	-0.2	0.0	0.3	-0.6	-0.4	1.4	0.2	1.0	-0.7	-1.5	0.4
IT	0.7	0.7	-0.1	0.6	1.6	3.5	1.0	1.2	1.4	0.4	1.1	5.1
LU	-3.0	-1.1	1.0	0.4	-1.8	-4.5	...	...	...	-0.3	-1.9	...
NL	2.2	-1.0	0.7	0.0	0.1	2.0	2.2	-0.6	2.4	-0.1	-0.2	3.7
AT	-0.2	0.4	-2.1	-0.3	-1.1	-3.3	-0.4	0.6	-0.8	-0.7	-1.1	-2.4
PT	-1.1	3.3	-3.8	1.3	0.4	0.1	-1.0	3.8	-2.2	1.8	0.3	2.7
FI	-6.9	-4.4	-2.1	2.2	0.4	-10.8	-1.5	-1.2	-0.5	0.6	-1.7	-4.3
SE	-5.3	-6.7	-5.6	3.0	3.4	-11.2	-3.3	-4.5	-2.4	2.3	1.6	-6.3
UK	-1.1	-3.5	-1.7	1.0	1.7	-3.6	1.2	-1.7	-1.5	0.0	1.3	-0.7
EU-15[(b)]	-0.8	-0.8	-1.2	0.8	0.8	-1.2	-0.2	0.0	0.3	0.5	0.4	1.0

Source: European Commission forecasts (Autumn 1995). For further explanation of the data used see Table 3.1.

* A negative sign indicates a worsening in terms of lower surpluses or higher deficits.

(a) Western Germany up to 1990, unified Germany thereafter.

(b) EU-15 data include, in 1990, western Germany and, for the structural balance, exclude, in 1991, 1992 and 1993, Luxembourg.

In most countries, the bulk of this disappointing trend took place in the period up to 1993, in the course of which four of the above-mentioned nine Member States exceeded the threshold of 60% for gross debt (Denmark (see the footnote to Table 3.1), Spain, Austria and Sweden), while those countries with initially high or very high ratios deviated further from the reference value. A more differentiated picture emerged in 1994. While a further rise in the debt ratio occurred in the majority of Member States, the debt ratio in two countries declined considerably (in Denmark from 80.3% to 75.6% of GDP and in Ireland from 97.4% to 91.1%), and smaller reductions were recorded in Belgium, Greece and the Netherlands. These contrasting trends are expected to continue in 1995. A further reduction in the debt ratio of more than 5 percentage points of GDP is expected in Ireland, while debt ratios are expected to fall by 2 percentage points in Denmark, and by around 0.5 percentage point in Belgium and Italy. In contrast, debt ratios are expected to rise by more than 8 percentage points in Germany, to a level of almost 60% of GDP, owing to the takeover of the liabilities of the Treuhandanstalt and part of the old debt of the eastern German housing sector. Increases of more than 3 percentage points are expected in Finland (taking the debt ratio to 63.2% of GDP, thereby also exceeding the reference value) and France (to 51.5%). With the exception of the Netherlands and Luxembourg, where the debt ratio is projected to remain broadly unchanged, debt ratios are expected to increase by 1 to 3 percentage points in the remaining Member States.

Box 3.2 The excessive deficit procedure

1. In Article 104c (1), the Treaty establishes that in Stage Three of EMU *"Member States shall avoid excessive government deficits"*. In addition, Article 109e (4) says that *"in the second stage, Member States shall endeavour to avoid excessive government deficits"*. The Excessive Deficit Procedure (EDP) is defined in Article 104c and in an annexed Protocol to the Maastricht Treaty. The Commission (Article 104c (2)) is the body in charge of supervising the fulfilment of this mandate, *"with a view to identifying gross errors"*. The phases of the EDP are as follows:

2. The Commission monitors the development of the budgetary situation in the Member States (Article 104c (2)).

3. If the conditions are not fulfilled, the **Commission prepares a report** (Article 104c (3)).

4. The **Monetary Committee** formulates an **opinion on this report** (Article 104c (4)).

5. If the **Commission** judges that an *Excessive Deficit exists*, it addresses an **opinion to the Council** (Article 104c (5)).

6. The **Council decides** by a qualified majority on a recommendation of the Commission whether an Excessive Deficit exists (Article 104c (6)). Also, if the *Excessive Deficit ceases to exist*, the **Council** shall **abrogate** the decision (Article 104c (12)).

7. If an *Excessive Deficit exists*, the **Council** makes **recommendations** to the Member State, which are not made public (Article 104c (7)).

8. If *no effective action* is taken by the Member State, the **Council** may make the **recommendations public** (Article 104c (8)).

9. If the *Excessive Deficit is not corrected*, the **Council** may propose **precise measures** to be undertaken by the Member State, and **monitors** their implementation (Article 104c (9)).

10. If the situation of *Excessive Deficit persists*, the **Council** applies or intensifies one or more of these **measures**: requiring the Member State to publish additional information before issuing bonds, inviting the European Investment Bank to reconsider its lending policy towards the Member State, requiring a non-interest bearing deposit or imposing fines of an appropriate size (Article 104c (11)).

During Stage Two of EMU steps 9 to 10 (describing the penalties associated with the absence of compliance) do not hold. In other words, the EDP is extended once countries enter the European currency area (see also Article 109k (1) and (3)).

3.3.2 Underlying factors

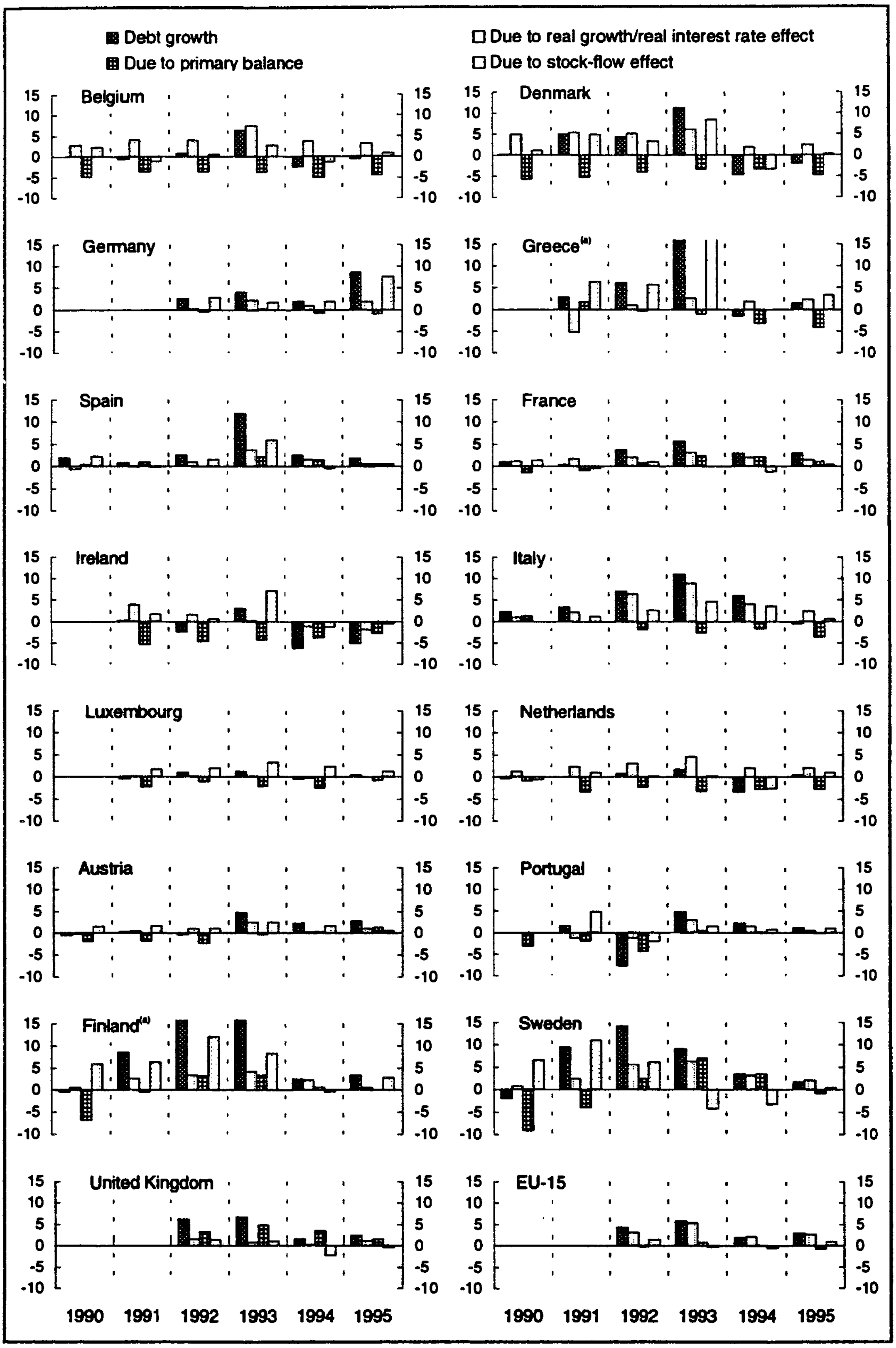
Chart 3.6 shows the factors affecting the evolution of debt ratios over time. They are expressed in percentage points of GDP, and their sum should be equal to the growth of the debt-to-GDP ratio.

Focusing on the Union as a whole for illustrative purposes, the primary balance highlights the consolidation efforts of governments, as it reflects the actual deficits excluding interest payments (interest payments, though influenced by fiscal policy, are not under the direct control of the government in the short run, whereas the other expenditure categories can be adjusted to some degree). As can be seen in Chart 3.6, the rapid rise in the debt ratio in 1992 and 1993 can be partly attributed to a deteriorating primary balance, while in 1994 and 1995 some - although insufficient - improvements were seen or are expected. The second factor examined is the difference between the interest rate paid on debt and GDP growth. When interest rates exceed GDP growth this contributes to the rise in the debt-to-GDP ratio. Due to the economic downturn this factor contributed to debt growth in 1993, while recent developments are more favourable. In addition, a set of special factors, often referred to as the "stock-flow adjustment", also affect debt growth and therefore the debt-to-GDP ratio; for example, debt takeovers or the revaluation of foreign currency debt in the event of a depreciation of the home currency.

This overall pattern is seen in many individual countries, although the average masks considerable country-specific differences. After the significant deterioration of primary balances in many EU countries over 1990-93, most Member States have experienced an improvement over 1994-95, with the exceptions of Ireland, Luxembourg, the Netherlands and Austria. Either primary surpluses increased (as was the case in countries with a high debt ratio like Belgium, Greece and Italy, but also in Denmark as well as Germany), or primary deficits decreased (as in Spain, France, Sweden and the United Kingdom). In Finland, the sizable primary deficit in 1993 is expected to return to balance in 1995. When attention is focused on the differential between interest rates and GDP growth, two extreme cases can be distinguished. On the one hand, in Ireland high economic growth and relatively low financing costs of the government tended to reduce debt ratios, while the severe recession in Finland and Sweden in 1991-93, as well as an increase in risk premia, pushed up debt ratios considerably.

Finally, a number of specific factors have in some years and in some countries played a significant role for debt dynamics in the recent period, summarised above as "stock-flow adjustments". To mention some, in 1993 these were the effects of currency realignments on debt denominated in foreign currency (Ireland), debt issuance with the purpose of building up assets of the government at central banks in advance of the prohibition of monetary financing according to the Maastricht Treaty (Greece and Italy), and the replenishing of foreign exchange reserves (Denmark). In the Nordic countries, the sizable stock-flow adjustments observed resulted from the accumulation of assets by social security funds, as well as from debt takeovers associated with the banking crises of the early 1990s (Finland and Sweden).

Chart 3.6 **Determinants of debt evolution**
(as a percentage of GDP)

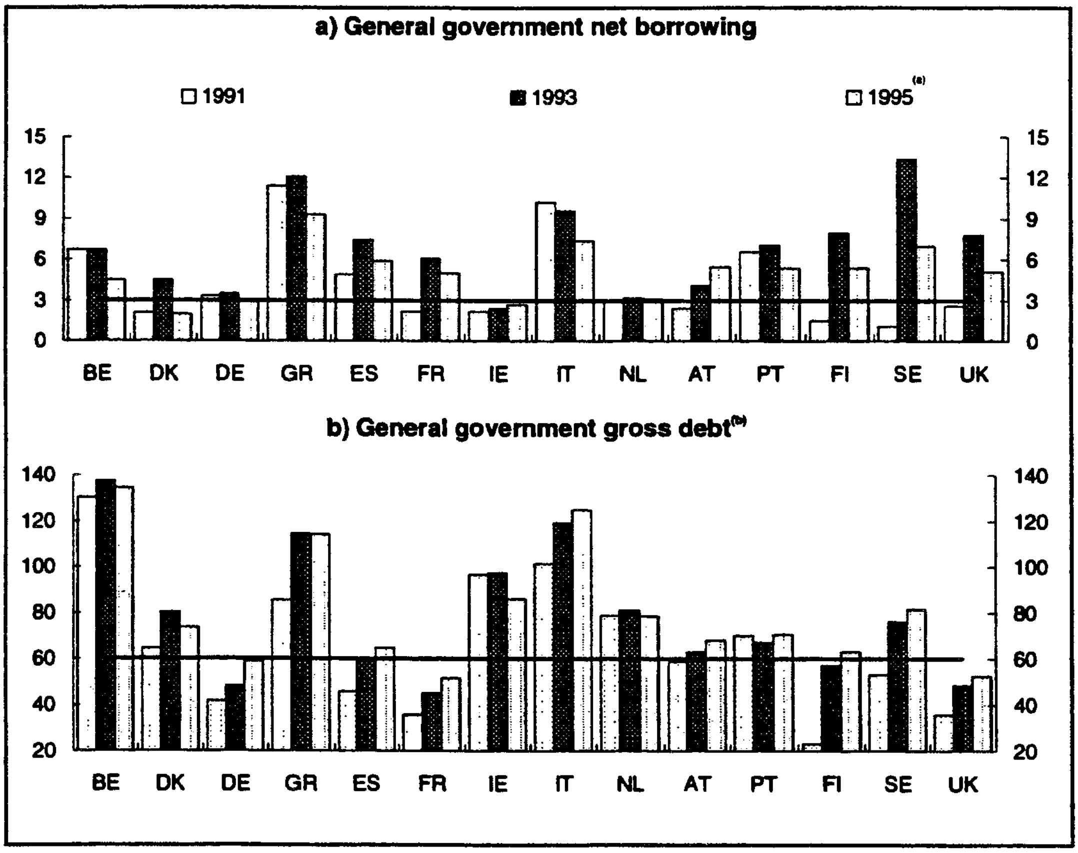


Source: European Commission and EMI calculations. Data for 1995 are European Commission estimates.
(a) For reasons of scaling both Greek and Finnish series extend beyond the range of the graph. In 1992 Finnish debt growth totalled 18.5% of GDP. In 1993 debt growth totalled 22.9% of GDP in Greece, and the change in debt due to the stock-flow effect in Greece in 1993 was 21.4% of GDP.

3.4 Assessment

Notwithstanding progress achieved over the past two years in reducing deficit ratios, outturns of fiscal policies are in general disappointing. Over the medium term, the main characteristic is one of divergence from the 60% and 3% reference values (see Chart 3.7). Recent efforts made are insufficient to ensure a return to sustainable levels of deficits. As a consequence, the evolution is even more disappointing on the debt side.

Chart 3.7 Performance in relation to Maastricht fiscal reference values
(as a percentage of GDP)



Source: European Commission. For further explanatory notes see Table 3.1.
For reasons of scaling no data are shown for Luxembourg; the public surplus in 1991 was 1.9%, in 1993 stood at 1.8% and is estimated to be 0.4% in 1995. Public debt was 4.1% in 1991, 6.3% in 1993 and is estimated to be 6.3% in 1995.
(a) European Commission projections.
(b) For Denmark see footnote (c) in Table 3.1.

The Excessive Deficit Procedure provides for the monitoring of budgetary developments in Member States by the Commission with a view to identifying gross errors. The decision by the EU Council that an excessive deficit exists implies non-compliance with the fiscal criteria (see also Box 3.2). In June 1995, the EU Council decided that twelve countries (of the fifteen Member States) had an excessive deficit. Only Germany, Ireland and Luxembourg were not the subject of an EU Council decision under Article 104c (6) of the Treaty that an excessive deficit exists. In the case of Ireland, which recorded a deficit ratio of 2.1% and a debt ratio of 91.1% in 1994 compared with 2.4% and 97.4% in 1993, account was taken in the procedure of the progress made in the reduction of the debt ratio. Germany and Luxembourg had deficit and debt ratios below the reference values of 3% and 60% of GDP. The EMI has not yet drawn definitive conclusions on these issues and reserves its judgement for future assessments. Even in countries which are not subject to an EU Council decision on excessive deficits, there are risks. In Germany, the deficit ratio in 1995 is expected to stand at 2.9%, and the debt ratio at only slightly below the reference value of 60% of GDP, while in Ireland, though decreasing further, the debt ratio at 85.9% would still be well above 60% and the deficit ratio is expected to rise to 2.7%, despite favourable cyclical conditions.

Among the remaining countries, two have debt ratios below 60% of GDP, seven have debt ratios of between 60% and 90% and three are above 90%. In the first group, comprising France and the United Kingdom, the projected deficit ratio has declined to around 5%, but remains some way from the reference value. Among the second group, on the basis of 1995 Commission projections, Denmark is expected to reduce the deficit ratio to well below 3%, and the debt ratio is declining. In the Netherlands, despite a deficit close to the reference value, the debt is expected to stabilise at a high level and the deficit reduction seems to have lost momentum. In Spain, Portugal and Finland, where the deficit ratio is 5-6% of GDP, some reduction in deficits has taken place from the very high levels recorded in 1993, but the progress achieved is insufficient and the debt ratios are continuing to drift away from the reference value. In Austria, the deficit is drifting away from the 3% ceiling and is expected to reach 5.5%; the debt ratio, after overshooting the 60% reference value in recent years, is still growing. Finally, in Sweden, the deficit ratio has so far only been reduced to 7%, while the debt ratio has jumped above 80%.

Among the countries with debt ratios above 90% of GDP, some progress has been made in Belgium in reducing the debt ratio, and the planned deficit has come down to 4.5%, although this is still far from the reference value. In Italy, the expected deficit is down to 7.4%, and the rise in the debt ratio is expected to come to a halt. Greece shows a decline in measured deficits to 9.3% from very high starting levels, and the debt ratio is expected to increase by 1.4 percentage points.

In the view of the EMI, it is important that favourable cyclical developments should not lead governments to postpone structural measures. Rather, the current cyclical environment should be seen as a major opportunity for undertaking or enhancing the consolidation of public finances. Given past developments and current levels of structural deficits and expenditure ratios, a successful rebalancing of public finances will, however, require determined action over a sustained period. Beyond the aim of meeting the agreed fiscal convergence requirements, there are compelling economic reasons for further action in the Member States which are of direct interest to each of them. In particular, credible fiscal consolidation would over time more than offset possible short-term contractionary effects by leading to lower interest rates owing to a reduction in risk premia, releasing funds for productive investment, as well as bringing about an increase in business and consumer confidence. In some cases, the favourable impact of fiscal consolidation on expectations could be strong enough for positive growth effects to materialise rather swiftly. Furthermore, sound fiscal balances would ensure that, in the future, fiscal policy could accommodate an economic slowdown through the working of automatic stabilisers. In order to act as a lasting disciplinary device, the reference value for fiscal deficits of 3% of GDP should be regarded as a ceiling which applies at all times over the entire economic cycle.

In the same context, attention has to be drawn to the high debt ratios, which represent a burden on future generations in the form of higher future taxes. Today's unsolved problems in the field of public finances would compound other longer-term problems, such as the existence of large unfunded liabilities in public pension systems and the impact of ageing populations on the financing of social security and health systems in general. Respecting the reference value of 3% as a ceiling on government deficits also helps to control the evolution of the ratio of gross debt to GDP. Clearly, the higher the debt ratio, the more adjustment is required; that is, the lower the current deficit has to be. In the absence of determined measures there is a major risk that debt positions will become financially unsustainable, an issue often disregarded in public debate. In many Member States, not acting now in a determined manner could entail a further rise in debt ratios, a continued increase in interest payments and thereby risk a snowball effect, which would add further to the public deficit and thus to the debt. In contrast, reducing deficit and debt-to-GDP ratios in line with the requirements of the Treaty would limit such risks, and would inspire a virtuous circle of greater confidence, lower interest rate payments and positive effects on growth. While fiscal consolidation is paramount, as higher taxation may diminish incentives and distort decisions, constraining overall public spending may have more favourable macroeconomic effects.

4. THE CRITERION ON EXCHANGE RATE BEHAVIOUR

4.1 Exchange rate developments since October 1993

This section describes exchange rate developments in the EMS, without prejudging the precise interpretation of the Treaty requirements concerning exchange rate stability. According to the Treaty, the focus is on developments over the two years preceding the examination, i.e. the current Report covers the period from October 1993 to September 1995. Three broad periods can be distinguished (see Charts 4.1 to 4.3).

Box 4.1 — Exchange rate stability

1. Treaty Provisions

The Treaty establishing the European Community, Article 109j (1) requires *"the observance of the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State"*. In addition, the Protocol to the Treaty (No. 6, Art. 3) specifies that the above requirement should be fulfilled *"... 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"*.

2. Issues related to the widening of the ERM fluctuation bands

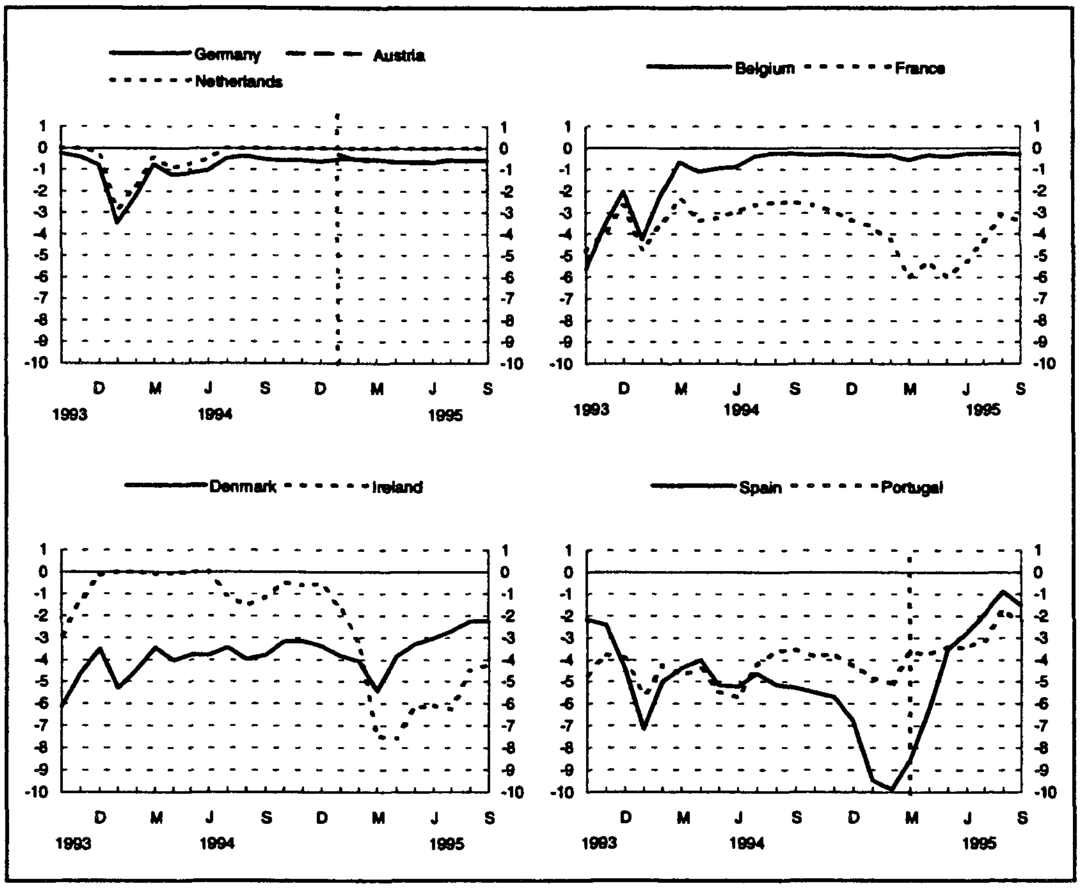
In 1991, when the Treaty was conceived, the "normal fluctuation margins" were ±2.25% around bilateral central rates, whereas a ±6% band was a derogation from the rule. In August 1993 the decision was taken to widen the fluctuation margins to ±15%, and the interpretation of the criterion, in particular of the concept of "normal fluctuation margins", became less straightforward. On the other hand, the central parities remained unchanged and the requirement to be a member of the ERM remains an element of the Treaty. The widening of the ERM bands created a new market environment, so that experience of these changes had to be gained in a learning process. Moreover, external factors as well as domestic developments imposed particular strains on the system. Account needs to be taken of the particular evolution of exchange rates in the EMS since 1993 in forming an ex post judgement; a detailed record of recent developments is provided in this Report as a contribution to this assessment.

On the issue of the widening of the bands, a formal Opinion was put forward by the EMI Council in October 1994 (later endorsed by the ECOFIN Council; see EMI Annual Report 1994). In the Opinion it was stated that *"on 2nd August 1993 the Ministers of Finance and central bank Governors jointly took the decision to widen the ERM fluctuation bands for compulsory intervention to 15% while leaving central parities unchanged. Experience since then indicates that the wider band has helped to achieve a sustainable degree of exchange rate stability in the ERM. It has done so by deterring speculative attacks on ERM currencies, thereby preventing large exchange rate depreciation or excessive exchange market intervention and their potentially inflationary consequences. In the light of this experience and in the current circumstances, the EMI Council considers it advisable to maintain the present arrangements"*. At the same time, the EMI Council recommended *"that member countries should continue to aim at avoiding significant exchange rate fluctuations by gearing their policies to the achievement of price stability and the reduction of fiscal deficits, thereby contributing to fulfilment of the requirements set out in Article 109j (1) of the Treaty and the relevant Protocol"*.

October 1993. In the ERM, after the widening of the band, the exchange rates of almost all the former narrow band currencies moved outside their former narrow limits vis-à-vis the strongest currencies (see Chart 4.1). The exceptions were the Deutsche Mark and the Dutch guilder; the latter, in line with a bilateral agreement to maintain a ±2.25% band vis-à-vis the Deutsche Mark, was relatively stable and over this period turned out to be the strongest currency in the system. In October the Irish currency was, on average, around 3% below its central parity vis-à-vis the strongest currencies, while the Belgian, Danish and French currencies showed deviations of around 5-6%. In the case of former wide band currencies (the Spanish peseta and the Portuguese escudo), the phenomenon was less pronounced in that they remained within their former ±6% margins. The rise and subsequent decline of pressures on some of these currencies was mirrored in the parallel widening and then narrowing of short-term interest rate differentials vis-à-vis the strongest currencies (see Table 4.1), which by October 1993 had declined to monthly averages of 0.3% in France, 2% in Denmark, and 2.5% in Belgium.

Chart 4.1 **Deviations from ERM central parities**

(monthly averages; in percentages; measured against the strongest currencies)
(October 1993 to September 1995)



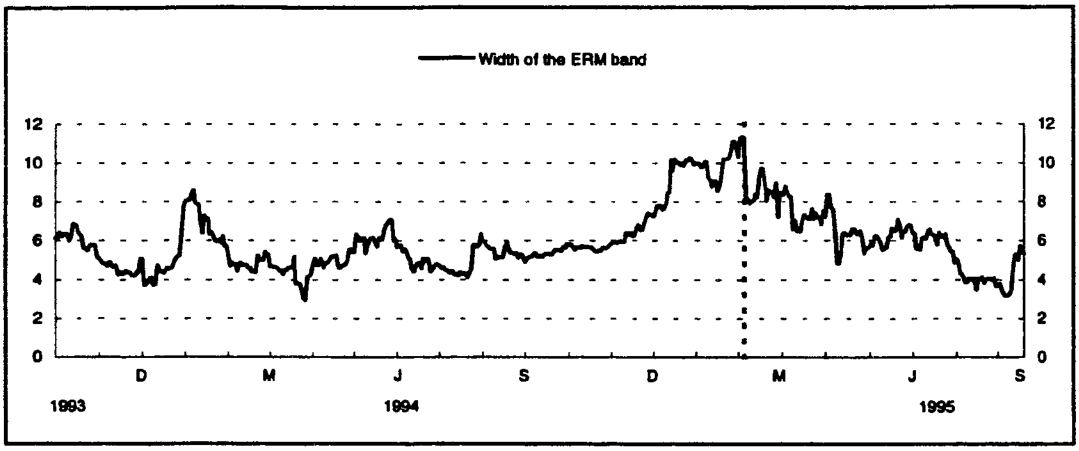
Source: National data.
Vertical lines indicate the Austrian schilling's entry into the ERM (9th January 1995) and realignments of the Spanish peseta and Portuguese escudo (5th March 1995).

Outside the ERM, the Greek drachma, the Italian lira, the Finnish markka, the Swedish krona and the pound sterling began to regain ground lost over the summer (see Chart 4.3). The Austrian schilling, which did not join the ERM until Austria's EU entry in January 1995, was tightly pegged to the Deutsche Mark.

November 1993 to December 1994. In the ERM, this was a period of relatively smooth functioning of the system and the maximum width of the band was generally less than 6% (see Charts 4.1 and 4.2). This relative calm was reflected in short-term interest rate differentials, which returned to previous levels during the period. Some episodes of tension emerged in January and in the second quarter of 1994, the first one involving the Spanish peseta and the second the Portuguese escudo.

Chart 4.2 **Maximum deviation from ERM central parities***

(daily data; in percentages)



Source: National data.

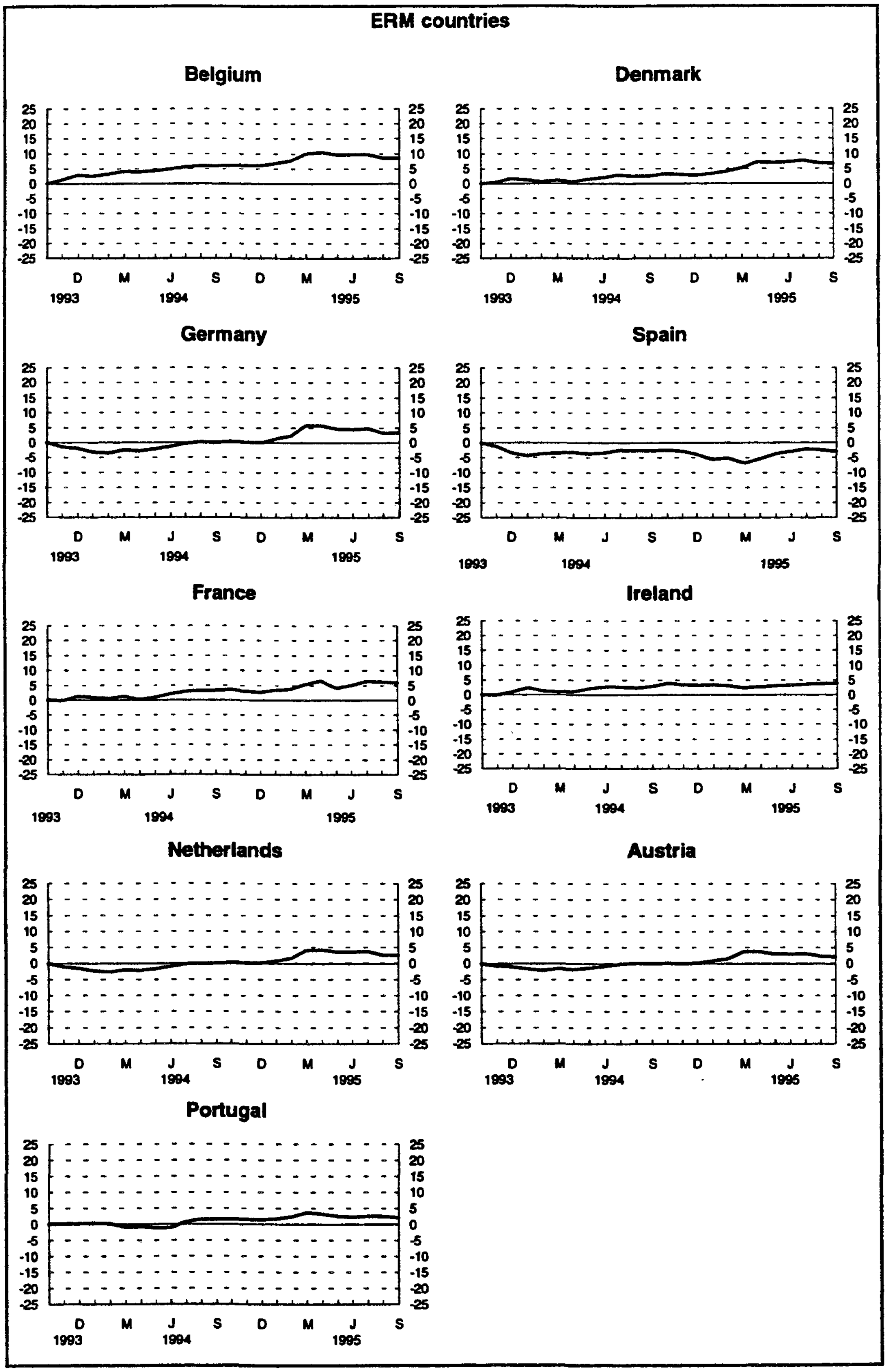
* Deviation between the strongest and weakest currencies of the ERM, measured as the percentage difference between their market exchange rate and their bilateral central parity. The vertical line indicates the realignments of the Spanish peseta and Portuguese escudo on 5th March 1995.

Among non-ERM currencies, the Austrian schilling remained firmly pegged to the Deutsche Mark, the Swedish krona and the pound sterling oscillated around November 1993 levels, and the Finnish markka appreciated steadily (see Chart 4.3). In contrast, the Italian lira depreciated significantly from May 1994 onwards, and the Greek drachma underwent pressures in May and June, before the lifting of the country's remaining capital controls.

January to September 1995. In the first quarter of 1995 tensions grew significantly in the ERM. With the exception of the Portuguese escudo, which remained in a median position, member currencies clustered in two groups: the Belgian franc, the Deutsche Mark, the Dutch guilder (as the strongest currency) and the Austrian schilling (which joined the ERM on 9th January) remained firmly pegged to each other, while the Spanish peseta, the Irish pound, the French franc and the Danish krone underwent considerable pressure, with the deviation from their central parity vis-à-vis the strongest currencies peaking in March and averaging 5-10%. Short-term interest rate differentials vis-à-vis the strongest currencies rose, although by smaller amounts than in the second half of 1993. In early March, a realignment of the peseta and the escudo took place (with a devaluation of central rates of 7% and 3.5%, respectively), but provided no immediate relief for the system as a whole. Between April and June tensions eased somewhat, as indicated by

Chart 4.3 **Nominal effective exchange rates**

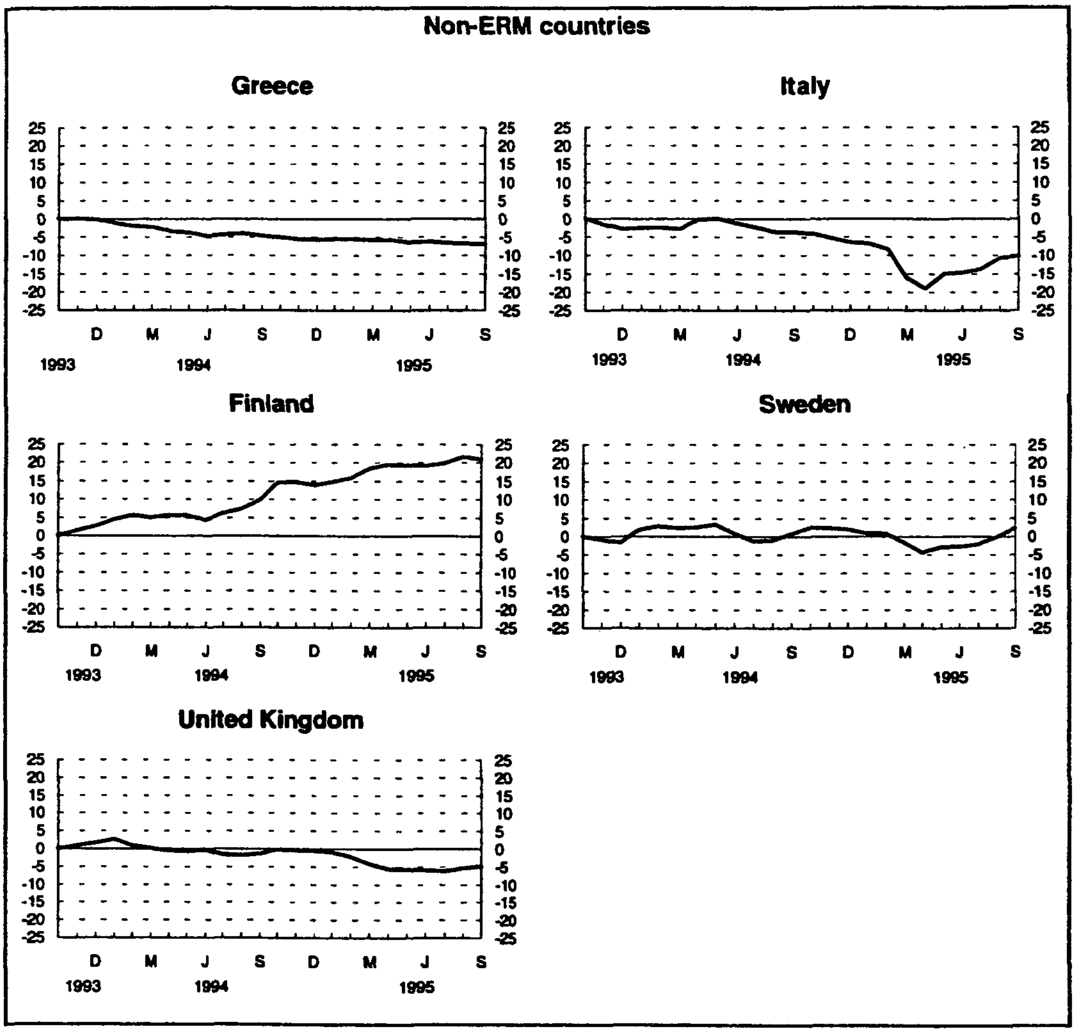
(monthly averages; in percentages; deviation since October 1993)



Source: BIS.

Chart 4.3 **Nominal effective exchange rates**

(monthly averages; in percentages; deviation since October 1993)



Source: BIS.

the reduced deviations of ERM currencies from central parities vis-à-vis the strongest currencies, although short-term interest rate differentials vis-à-vis the strongest currencies remained high for Denmark, Spain, France, Ireland and Portugal. With the ebbing of tensions, currencies initially followed different paths: the Danish, Spanish and Portuguese currencies recovered significantly, whereas the French and Irish currencies remained relatively weak. From the beginning of July onwards, conditions in the ERM eased considerably, with the Danish krone, the Spanish peseta and the Portuguese escudo moving within a range of 1-2% below their respective central rates, followed in mid-August by the French franc, which subsequently settled around 3% below its central parity; the Irish pound remained around 4% below its central parity. Likewise, interest rate differentials vis-à-vis the strongest currencies declined significantly. Some tensions re-emerged in September.

Among non-ERM currencies, the Italian lira, the Swedish krona and the pound sterling underwent pressure in early 1995; interest rate differentials vis-à-vis the strongest currencies also increased. The currencies subsequently recovered somewhat (see Chart 4.3). In contrast, the exchange rate of the Finnish markka was remarkably strong, and interest rate differentials widened to a lesser extent than in Italy, Sweden and the United Kingdom.

Table 4.1 **Short-term interest rate differentials and volatility of exchange rates and short-term interest rates***

		ERM countries							
		93Q4	94Q1	94Q2	94Q3	94Q4	95Q1	95Q2	95Q3
BE	Int. rate differentials	1.8	0.7	0.3	0.6	0.0	0.7	0.5	0.1
	Exch. rate volatility	0.3	0.1	0.0	0.1	0.0	0.1	0.1	0.0
	Int. rate volatility	15.8	6.2	4.3	24.4	3.6	13.2	39.2	2.9
DK	Int. rate differentials	1.8	0.4	0.8	1.4	1.0	1.4	2.2	1.7
	Exch. rate volatility	0.2	0.1	0.1	0.1	0.1	0.3	0.1	0.1
	Int. rate volatility	14.7	7.1	7.5	14.2	5.1	15.9	4.7	4.5
DE	Int. rate differentials	-	-	-	-	-	-	-	-
	Exch. rate volatility	-	-	-	-	-	-	-	-
	Int. rate volatility	3.3	1.9	2.6	2.0	2.3	2.6	1.4	1.7
ES	Int. rate differentials	2.9	2.7	2.5	2.8	2.7	4.0	4.9	5.2
	Exch. rate volatility	0.3	0.3	0.2	0.2	0.1	0.6	0.4	0.2
	Int. rate volatility	6.9	4.8	3.7	4.2	3.1	9.6	4.2	2.3
FR	Int. rate differentials	0.4	0.5	0.5	0.7	0.5	1.6	2.9	1.7
	Exch. rate volatility	0.2	0.1	0.1	0.1	0.1	0.3	0.3	0.2
	Int. rate volatility	5.6	2.5	3.9	2.7	3.8	19.2	11.9	4.8
IE	Int. rate differentials	0.1	0.2	0.6	0.9	0.6	1.4	2.2	2.0
	Exch. rate volatility	0.2	0.3	0.3	0.3	0.2	0.5	0.5	0.3
	Int. rate volatility	6.9	8.6	7.4	7.6	5.1	15.5	15.5	4.1
NL	Int. rate differentials	-0.3	-0.6	-0.1	0.0	0.1	0.1	-0.1	-0.3
	Exch. rate volatility	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	Int. rate volatility	2.8	2.6	2.2	1.7	2.6	2.2	1.9	1.7
AT	Int. rate differentials	0.0	-0.4	0.0	-0.2	-0.2	0.2	0.2	0.1
	Exch. rate volatility	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	Int. rate volatility	..	1.2	1.6	1.1	1.2	1.4	1.1	1.0
PT	Int. rate differentials	4.9	4.5	7.2	6.8	5.0	5.5	5.7	5.0
	Exch. rate volatility	0.2	0.3	0.2	0.2	0.1	0.3	0.2	0.1
	Int. rate volatility	15.1	15.9	54.7	23.0	28.1	27.7	18.1	18.0

		Non-ERM countries							
		93Q4	94Q1	94Q2	94Q3	94Q4	95Q1	95Q2	95Q3
GR	Int. rate differentials	12.6	12.8	15.1	19.7	14.2	12.8	11.9	11.1
	Exch. rate volatility	0.2	0.1	0.3	0.1	0.1	0.3	0.2	0.1
	Int. rate volatility	2.1	5.5	65.9	18.4	53.7	25.7	10.8	4.2
IT	Int. rate differentials	2.5	2.6	2.8	3.7	3.7	4.7	6.2	6.3
	Exch. rate volatility	0.4	0.4	0.3	0.4	0.2	1.1	0.7	0.5
	Int. rate volatility	7.0	5.3	6.4	13.5	7.6	16.4	8.8	6.2
FI	Int. rate differentials	0.2	-0.9	0.1	0.7	0.3	0.9	1.4	1.7
	Exch. rate volatility	0.4	0.4	0.3	0.3	0.4	0.4	0.3	0.2
	Int. rate volatility	4.2	5.0	7.0	9.2	5.4	3.8	3.1	1.6
SE	Int. rate differentials	0.9	1.2	1.8	2.6	2.8	3.2	4.4	4.8
	Exch. rate volatility	0.4	0.5	0.4	0.5	0.4	0.7	0.6	0.4
	Int. rate volatility	5.4	3.6	4.5	10.3	5.4	6.0	4.6	2.3
UK	Int. rate differentials	-0.7	-0.6	-0.1	0.5	0.9	1.6	2.1	2.3
	Exch. rate volatility	0.3	0.3	0.3	0.4	0.2	0.6	0.6	0.4
	Int. rate volatility	4.0	3.3	3.5	6.8	4.5	4.8	6.5	3.1

Source: National data

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

The alternation of phases of calm and of tension in foreign exchange markets during the three periods described above was reflected in the evolution of the volatility of exchange and interest rates (see Table 4.1). In general, volatility in 1993-95 was higher than in the years preceding the 1992 ERM crisis. More specifically, for some currencies exchange rate variability in 1995 was as high as, or sometimes higher, than in the second part of 1993. In contrast, interest rate levels and differentials were in general less volatile; this may have reflected the tendency of some monetary authorities to rely less on the interest rate instrument to stabilise exchange rates and have more intensive recourse to other instruments, in particular allowing a greater degree of exchange rate flexibility within the widened ERM bands. As regards foreign exchange intervention, with the exception of a few ERM members which made significant use of this instrument, the amounts involved in 1995 were generally smaller than in the second half of 1993.

4.2 Underlying factors

After the widening of the ERM fluctuation bands in August 1993, significant pressures were exerted on exchange rates and money market interest rates, triggered by market expectations of some degree of monetary easing in the context of the greater scope for policy differentiation within the wider bands; subsequently, pressures eased when the awareness emerged among market participants that the room for policy differentiation would be used only very cautiously and that the widening of the bands was largely viewed by monetary authorities as a means of increasing two-way risk.

Indeed, from November 1993 until December 1994, the EMS operated smoothly and without major tensions in an environment characterised by a prudent easing of monetary conditions in the Union and a stronger-than-expected pick-up in economic activity. Nonetheless, markets remained cautious and wary, as shown by the short-lived pressure on the Spanish peseta in early 1994 and the turbulence which affected the Portuguese escudo in mid-1994.

The first half of 1995 was characterised by severe strains in the system, which later subsided but re-emerged in September. An important factor underlying the widespread unrest in world currency markets in the first half of this year was a reassessment of the prospects for the US economy against the background of an increasing external imbalance; a non-negligible role in generating worldwide turbulence was played by the Mexican crisis. These factors altered market expectations of developments in short-term interest rate differentials and contributed to a sharp fall in the value of the dollar, underpinning capital flows towards the Japanese yen and stronger European currencies.

However, the fact that the recent unrest within the ERM was related to factors from outside the Union should not be interpreted as implying that internal factors were unimportant. On the contrary, increased general uncertainty in the financial markets seems to have prompted a renewed focus on certain economic fundamentals and domestic imbalances prevailing in several Member States. Political uncertainty has also contributed to the unrest. There was perceived to be a link in several countries - but not in others - with the current and prospective state of public finances. Furthermore, currencies of countries with a less favourable record of price stability have appeared more vulnerable. This relationship between exchange rates and previous economic performance bears some resemblance to the bond market tensions of 1994, when increases in yields were differentiated across countries and seemed to follow a certain pattern. However, in contrast with previous episodes of tension within the ERM, the link between exchange rate movements and the need to correct imbalances in the competitive positions of individual countries seems to have been weak (see Box 4.2).

Box 4.2 The evolution of real effective exchange rates in the EU in perspective

The measurement of the competitive position of an economy is fraught with methodological problems. One widely used approach relies on estimates of the real effective exchange rate (REER) and the comparison of their current levels with a base or "reference" year. Table 4.2 summarises the evolution of some indicators of real effective exchange rates (vis-à-vis twenty-six trading partners), measured with consumer prices, producer prices, unit labour costs and export prices, over the short, medium and long run. Currencies are grouped according to their overall real effective exchange rate trends; current levels (September 1995) are compared with December 1994 (a relatively quiet month, before the recent turbulence), with April 1992 (a quiet month before the 1992-93 crises), and 1987 (a period in which most EU members appeared to be broadly in both internal and external balance). The methodology underlying the construction of such measures is described in P. Turner and J. Van't dack, "Measuring international price and cost competitiveness", BIS Economic Papers No. 39, November 1993.

In the short run (between December 1994 and September 1995), due to limited inflation differentials, real effective exchange rate developments closely mirrored fluctuations in nominal effective exchange rates. During this period, all ERM currencies appreciated in real effective terms; also non-ERM currencies, with the exception of the Italian lira and the British pound appreciated. Over the medium and long run, a group of six ERM currencies (the Belgian franc, Danish krone, Deutsche Mark, French franc, Dutch guilder and Austrian schilling) may be identified, which, over time, displayed relatively consistent nominal and real appreciations. Within this group of currencies, the Deutsche Mark tended to record the highest appreciation and the French franc the lowest.

A second group of currencies (inside the ERM the Portuguese escudo and outside the ERM the Greek drachma) has appreciated strongly in real terms since 1987. In both cases, the real appreciation occurred in spite of a significant nominal depreciation, which was, however, smaller than the unfavourable price/cost differentials with trading partners, for the period as a whole. However, developments in the escudo's external value followed a specific time pattern, since its real effective exchange rate stands currently at its mid-1992 level, while its nominal effective rate has been roughly stable since 1993.

A third group of currencies has strongly depreciated in real effective terms since 1987 (the Italian lira and the Swedish krona). The depreciation has been even more pronounced since April 1992, given the earlier real appreciation.

The Irish pound and the Finnish markka registered some gains in price and cost competitiveness over the medium and long run, though during the first three quarters of 1995 the Irish pound's real exchange rate was relatively stable.

Finally, the Spanish peseta and, to some extent, the pound sterling now exhibit real effective exchange rate indices close to their levels of 1987, suggesting that the sharp depreciations since April 1992 may be seen as a correction of previous losses in price and cost competitiveness. In the case of sterling and the peseta, the exchange rate adjustment also reflected a rebalancing of monetary and fiscal policies.

With hindsight, tensions among EU currencies may have been a consequence of markets' changing assessment of the credibility and sustainability of Member States' present and expected future policies, especially fiscal policies. A number of long-term structural factors seem to have contributed to the fact that foreign exchange markets' behaviour increasingly reflects such perceptions and expectations. Among the most important are the full liberalisation of capital movements among OECD countries combined with continued advances in information technology, which have enabled agents to shift the currency composition of international portfolios quickly. Some commentators would also cite the increasing importance of highly leveraged financial instruments, the reduction in market participants' profit margins and the greater role of institutional investors.

Table 4.2 Summary of changes in real effective exchange rates of EU-15 currencies up to September 1995*

(monthly data; in percentages)

	Since 1987				Since April 1992				Since December 1994			
	CPI(a)	ULC(b)	XPI(c)	PPI(d)	CPI(a)	ULC(b)	XPI(c)	PPI(d)	CPI(a)	ULC(b)	XPI(c)	PPI(d)
BEF	+2.9	+4.7	-6.3	+0.8	+6.7	+8.1	-11.6	+3.3	+1.5	+2.6	-1.3	+0.6
DKK	+1.8	+9.9	+2.5	+5.9	+6.3	+13.6	+5.2	+7.5	+2.7	+4.9	+2.5	+3.1
DEM	+4.9	+16.2	-1.5	+7.3	+9.9	+15.0	+1.2	+7.4	+2.4	+2.8	+1.9	+2.8
FRF	+0.2	-2.8	+13.0	+1.2	+5.4	+4.1	+9.1	+5.1	+2.5	+2.0	+3.6	+2.8
NLG	+0.5	-0.2	-0.2	+3.3	+7.9	+4.9	+4.0	+5.2	+2.4	+1.8	+2.4	+1.4
ATS	+5.1	-3.3	-12.1	+0.8	+7.8	+4.8	-2.8	+1.6	+2.4	+2.2	+2.9	-3.8
GRD	+20.3	+21.3	-10.1	+6.3	+5.8	+6.1	-14.8	+1.6	+2.0	+6.2	+2.0	-1.3
PTE	+25.9	-(e)	-0.2	-(e)	-0.8	-(e)	+1.7	-(e)	+1.5	-(e)	+4.6	-(e)
ITL	-18.3	-20.9	-6.6	-15.2	-23.5	-27.9	-10.7	-18.1	-1.7	-3.3	+0.5	+1.4
SEK	-7.1	-21.4	-4.6	-0.2	-18.5	-28.3	-8.4	-6.2	+1.0	+0.3	+2.9	+8.0
IEP	-7.6	-24.5	-0.8	-3.8	-2.7	-11.8	+2.1	-1.3	+0.7	-2.4	+4.0	+0.3
FIM	-8.6	-27.0	+11.0	-5.3	-3.3	-17.3	+11.9	+3.7	+4.7	+2.8	+11.4	+5.7
ESP	+3.6	-5.0	+1.8	+0.0	-14.3	-21.8	-10.9	-13.2	+2.2	+1.1	+4.1	+2.7
GBP	-5.1	-5.7	+3.6	+0.7	-16.5	-13.2	-2.9	-10.4	-3.8	-3.5	-3.4	-3.4

Source: BIS.

*Effective exchange rates against 26 trading partners; a positive sign indicates an appreciation of the real effective exchange rate.

(a) Deflated by consumer prices.

(b) Deflated by unit labour costs.

(c) Deflated by export prices.

(d) Deflated by producer price indices.

(e) ULC and PPI indicators are not presented because of methodological problems: first, since producer prices series are not available for Portugal, the BIS uses the CPI for estimating the former; second, the ULC indicator used by the BIS tends to overstate the extent of the appreciation of this real effective exchange rate, compared with the Banco de Portugal's series.

4.3 Assessment

Under current circumstances, it is not advisable to give a precise operational content either to the exchange rate convergence criterion set out in the Treaty or to the concept of the absence of severe tensions which could mechanically be applied also to forthcoming periods. Rather, a detailed record of recent developments has been provided in this section and will be used as a contribution to an assessment.

Several currencies remained outside the ERM. As can be seen from Chart 4.1 ERM currencies followed different patterns of behaviour. When measured in terms of bilateral rates against the strongest currencies in the ERM, a number of currencies have remained stable over the whole two-year time span under consideration. These include the Deutsche Mark, the Dutch guilder and the Austrian schilling (the latter joined the ERM in January 1995), and since the start of 1994, also the Belgian franc, which shifted out of the former narrow band for a few months after the widening of margins in August 1993. Several other ERM currencies (Danish krone, French franc and Irish pound) have at times drifted away from their central parities. The French franc and the Irish currency moved close to their central parities and within the former narrow band for almost all of 1994, but in early 1995 both currencies weakened and until July 1995 remained in a range of 4-6% below the central parity. The Danish krone remained around 3-4% below its central parity with the strongest currencies almost uninterruptedly after the widening of the bands in August 1993. However, by mid-August 1995 the Danish krone and the French franc were back within, or close to, the former narrow band. From October 1993 to mid-1994 the Spanish peseta and the Portuguese escudo were relatively stable, while remaining rather distant from central parities. In late 1994 the Spanish peseta began to weaken. At the beginning of 1995, the pressure on the peseta mounted and in March, following a request by the Spanish authorities, the currency underwent a realignment. Following the decision to change the central rate of the peseta the Ministers and central bank Governors also agreed on a downward adjustment of the central rate of the Portuguese escudo. After the adjustment, both currencies recovered to levels close to the new central parities. By July the peseta had returned to its level of the beginning of 1995.

As regards non-ERM currencies, the Finnish markka appreciated vis-à-vis the strongest ERM currencies over the period under consideration. The pound sterling and the Swedish krona experienced weakness in early 1995, while the lira was often under substantial downward pressure from spring 1994 onwards. Over more recent months the pound, krona and lira have recovered against the strongest ERM currencies, albeit to different degrees. Finally, the Greek drachma depreciated at a decelerating pace, while appreciating in real terms.

5. THE INTEREST RATE CRITERION

5.1 Recent performance against the reference value

Long-term interest rate developments for the fifteen current Member States as well as a range of reference values are presented in Table 5.1. The data used are partly harmonised interest rates. Details of the progress in statistical harmonisation, the criterion itself, as well as issues related to the calculation of the reference values are provided in Box 5.1.

Among the Member States including the new entrants, the three countries with the lowest inflation rates in 1994 were Finland, France and Denmark, and their respective long-term interest rates ranged between 7.2% and 9.1%. Using the average of the three best-performing countries (plus 2 percentage points) as a starting-point, the reference value in 1994 would have been a long-term interest rate of 10.0%. Twelve countries would have had rates at or below the reference value, i.e. all Member States except for Greece, Italy and Portugal. In the latest twelve months considered in this Report the equivalent reference value would have been 10.4% and yields for five countries (Spain, Greece, Italy, Portugal and Sweden) would have exceeded the reference value[1].

As is illustrated for the present fifteen EU countries in Chart 5.1, the application of other reference values may at times lead to different results. In particular, fourteen countries would have had rates at or below the reference value in 1994 if Finland's bond yield (the country with the lowest inflation rate but not the lowest bond yield) had been used as the reference value, but only twelve had rates at or below the reference value on the basis of the average rate of the three best-performing countries in terms of price stability. However, as pointed out in Box 5.1, a situation as in 1994 would raise the issue of the treatment of outliers in the determination of the reference value. For the other years considered, differences on the basis of alternative reference values remained limited.

Box 5.1 — Long-term interest rates

1. Treaty Provisions

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

"The criterion on the convergence of interest rates referred to in the fourth indent of Article 109j (1) of this Treaty shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best-performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions".

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[1] In Greece, long-term interest rates are indexed to the twelve-month Treasury bill rate.

Box 5.1 (Cont'd)

2. Issues in calculation of the reference values

In applying the criterion, it is important to note that the Treaty provides for the use of the long-term interest rates of those, at most three, countries with the lowest inflation rates as reference values.

As the same wording is used in the Treaty for the choice of the reference values for both the price and interest rate criterion, the same procedure should be followed in both areas. Thus, under present circumstances, choosing the average of the three best performers in terms of inflation as a starting-point in the price section (see Box 2.1) would suggest using the respective long-term interest rates as a reference value for measuring interest rate convergence. As for the reference value for the price stability criterion, however, due regard should also be given to possible outliers for the interest rate level, which may be affected by the degree of credibility of the policy mix. In particular, if a country, while having a low inflation rate, has a high long-term interest rate, this country's situation should be closely monitored to assess whether the long-term interest rate should determine the criterion. Furthermore, when calculating averages among best-performing countries, preference should be given to unweighted arithmetic averages, and the long-term interest rate should be calculated as a simple average over the last twelve months. However, information available from other reference periods, including the latest long-term interest rates, should not be excluded.

3. Defining data for the long-term interest rate criterion

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

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

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

The harmonisation principles were that the issuer of bonds should be the central government, with securities of close to ten years to maturity and that yields should be measured gross of tax. To ensure that the depth of the market is taken into account, and that no liquidity premium is carried into the yield, the representative securities should be chosen on the basis of their high liquidity. The responsibility for this choice is a matter for the Member States. Countries may choose either a benchmark or a sample of bonds, using the liquidity of the market at the ten-year point as the determining factor. Special-feature bonds (e.g. embedded option, zero coupon) are excluded from the assessment. The selection of highly liquid bonds is also seen as an effective indirect means to minimise the effects of different coupon values. Finally, a uniform formula was chosen using existing international standards. (Namely, formula 6.3 "Formulae for Yield and other Calculations", International Securities Market Association.) Where there is more than one bond in the sample, the liquidity of the selected bonds warrants the use of a simple average of the yields to produce the representative rate. The production of the harmonised representative long-term interest rates defined above is being implemented by the central banks at present, and it is envisaged that provisional harmonised data will be produced by the end of the year, and a preliminary version is used in this Report.

Table 5.1 **Long-term interest rates and alternative reference values for the interest rate criterion**

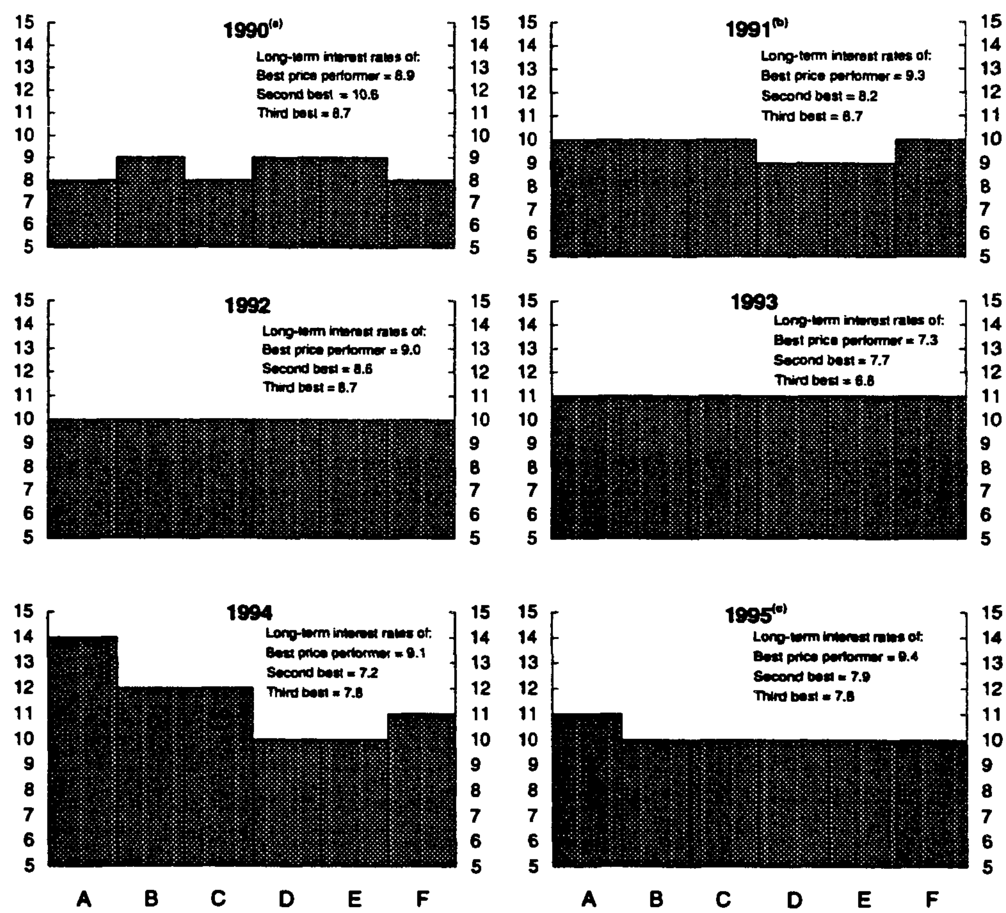
(period averages; in percentages)

	Medium-term developments						
	1990	1991	1992	1993	1994	1995[a]	Oct 94 - Sep 95
Belgium	10.1	9.3	8.7	7.2	7.8	7.7	7.9
Denmark	10.6	9.3	9.0	7.3	7.8	8.5	8.6
Germany	8.7	8.5	7.9	6.5	6.9	7.0	7.1
Greece[b]	...	...	26.3	23.4	20.8	17.9	18.8
Spain	14.7	12.4	11.7	10.2	10.0	11.5	11.5
France	9.9	9.0	8.6	6.8	7.2	7.7	7.8
Ireland	10.1	9.2	9.1	7.7	7.9	8.4	8.5
Italy	13.5	13.3	13.3	11.3	10.6	12.4	12.3
Luxembourg	8.5	8.2	7.9	6.9	6.4	6.1	6.2
Netherlands	8.9	8.7	8.1	6.4	6.9	7.1	7.2
Austria	8.8	8.6	8.2	6.8	7.0	7.3	7.4
Portugal[c]	...	17.2	13.8	11.1	10.4	11.7	11.7
Finland	13.5	11.8	12.0	8.8	9.1	9.2	9.4
Sweden	13.2	10.7	10.0	8.5	9.7	10.7	10.8
United Kingdom	11.6	10.1	9.1	7.4	8.0	8.3	8.4
Memo item: EU-15	11.4	10.6	10.0	8.3	8.5	9.0	9.1
Standard deviation[d]	4.3	5.1	4.7	4.3	3.5	3.0	3.2
Reference value[e] of:							
Best performer	10.9	11.3	11.0	9.3	11.1	11.2	11.4
Mean of best two rates	11.8	10.8	10.8	9.5	10.2	10.5	10.7
Mean of best three rates	11.4	10.7	10.8	9.3	10.0	10.2	10.4
2nd best performer	12.6	10.2	10.6	9.7	9.2	9.7	9.9
Mean of 2nd and 3rd best	11.7	10.5	10.7	9.3	9.5	9.7	9.9
3rd best performer	10.7	10.7	10.7	8.8	9.8	9.7	9.8

	Short-term developments						
	94 Q4	95 Q1	95 Q2	95 Q3	Jul 95	Aug 95	Sep 95
Belgium	8.4	8.3	7.6	7.2	7.3	7.2	7.0
Denmark	8.8	9.0	8.4	8.1	8.3	8.1	7.8
Germany	7.5	7.4	6.9	6.7	6.9	6.7	6.6
Greece[b]	21.4	18.8	17.9	16.9	17.3	17.2	16.3
Spain	11.2	11.9	11.7	11.0	11.4	11.0	10.8
France	8.1	8.1	7.6	7.4	7.4	7.3	7.4
Ireland	8.6	8.7	8.4	8.2	8.4	8.2	8.0
Italy	12.0	12.7	12.7	11.8	12.2	11.6	11.6
Luxembourg	6.4	6.1	6.2	6.1	6.2	6.1	6.0
Netherlands	7.6	7.6	7.0	6.7	6.9	6.7	6.6
Austria	7.7	7.6	7.2	7.0	7.1	7.0	6.9
Portugal	11.5	11.8	12.0	11.4	11.7	11.3	11.2
Finland	10.2	10.2	9.0	8.4	8.7	8.3	8.0
Sweden	11.0	11.0	10.9	10.1	10.6	10.2	9.6
United Kingdom	8.6	8.6	8.2	8.1	8.2	8.1	7.9
Memo item: EU-15	9.4	9.5	9.1	8.7	8.9	8.7	8.5
Standard deviation[d]	3.5	3.0	3.0	2.7	2.8	2.8	2.6
Reference value[e] of:							
Best performer	10.1	10.1	11.0	10.4	10.7	10.3	10.0
Mean of best two rates	11.2	11.2	10.3	9.8	10.0	9.8	9.5
Mean of best three rates	10.9	10.9	10.1	9.4	9.8	9.4	9.2
2nd best performer	12.2	12.2	9.6	9.2	9.3	9.2	9.0
Mean of 2nd and 3rd best	11.3	11.3	9.6	9.0	9.4	9.0	8.8
3rd best performer	10.4	10.3	9.6	8.7	9.4	8.7	8.6

Source: National data. For further explanation on the interest rate data used see Box 5.1.
(a) 1995 data are the average of the first nine months of the year.
(b) Data are only available from 30th September 1992. Precise data on long-term interest rates are not available. The data refer to variable coupon rates adjusted annually. As such, they cannot be used for comparisons with other countries, but only as a rough guide for intertemporal comparisons.
(c) Data are available only from January 1991.
(d) Unweighted standard deviation.
(e) According to the Treaty, the best-performing interest rates are to be chosen on the basis of the best-performing countries according to the price criterion (see Table 2.1).

Chart 5.1 Number of countries with long-term interest rates not exceeding reference values according to alternative methods



A. Best performer + 2.0 percentage points.
B. Average of best two rates + 2.0 percentage points.
C. Average of best three rates + 2.0 percentage points.
D. Second best + 2.0 percentage points.
E. Average of second best and third best rates + 2.0 percentage points.
F. Third best + 2.0 percentage points.

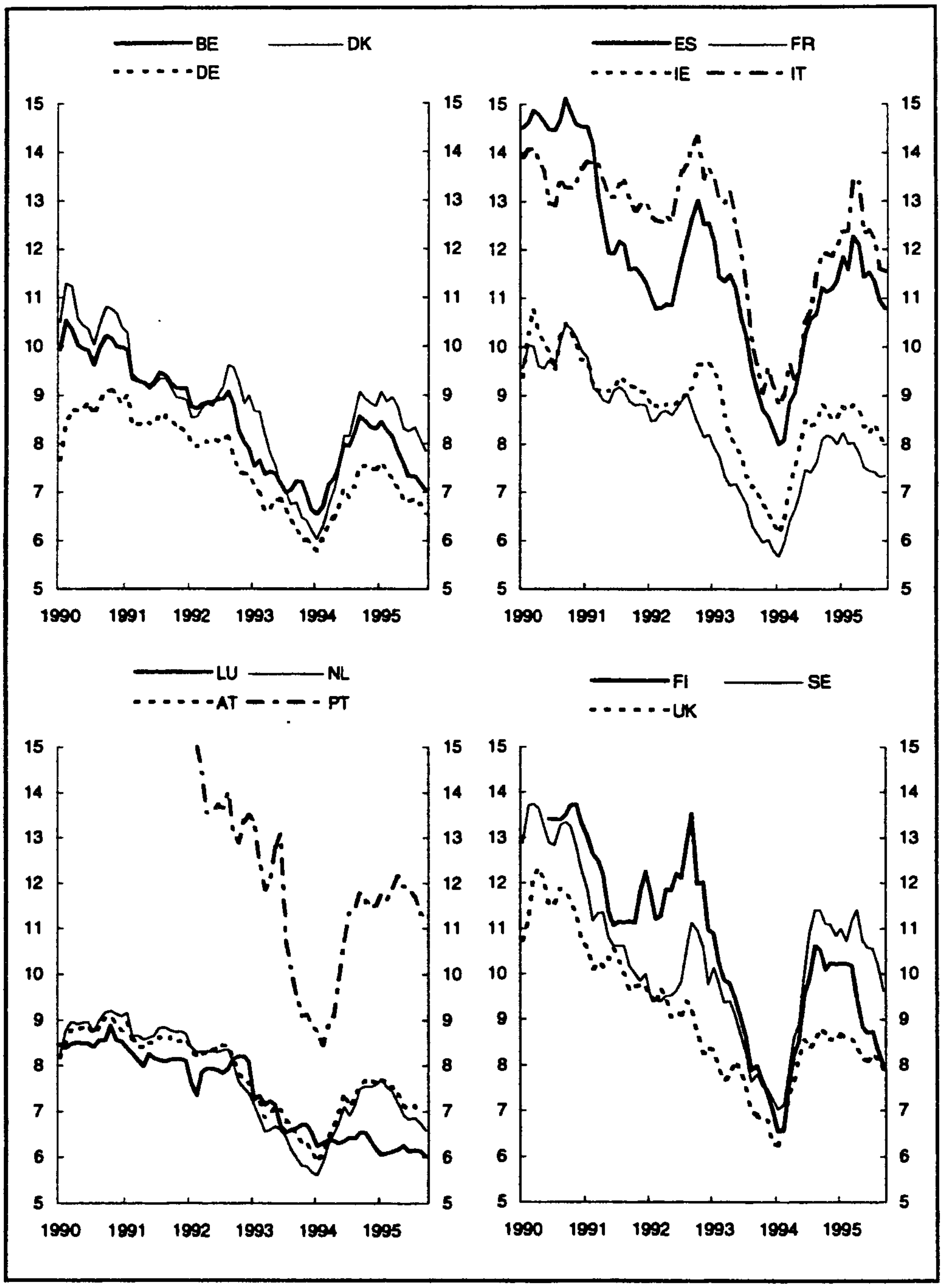
Source: National data. For further explanatory notes see Table 5.1.
(a) Greece and Portugal are not included. See footnotes (b) and (c) in Table 5.1.
(b) Greece is not included. See footnote (b) in Table 5.1.
(c) Data refer to the best inflation performers as determined by the average inflation rate in the twelve months to September 1995.

5.2 Recent developments in long-term interest rates in perspective

As may be seen from Chart 5.2, long-term bond yields of Member States declined over the period 1990-93, in conjunction with which a significant convergence of long-term bond yields took place. As a consequence of this, almost all EU countries would have met the long-term interest rate convergence criterion by the end of 1993 and during the first months of 1994. Most notably, long-term interest rates in Spain, Italy, Portugal, Finland, Sweden and the United Kingdom had fallen substantially by that time.

Chart 5.2 **Long-term interest rates**

(monthly averages; in percentages)

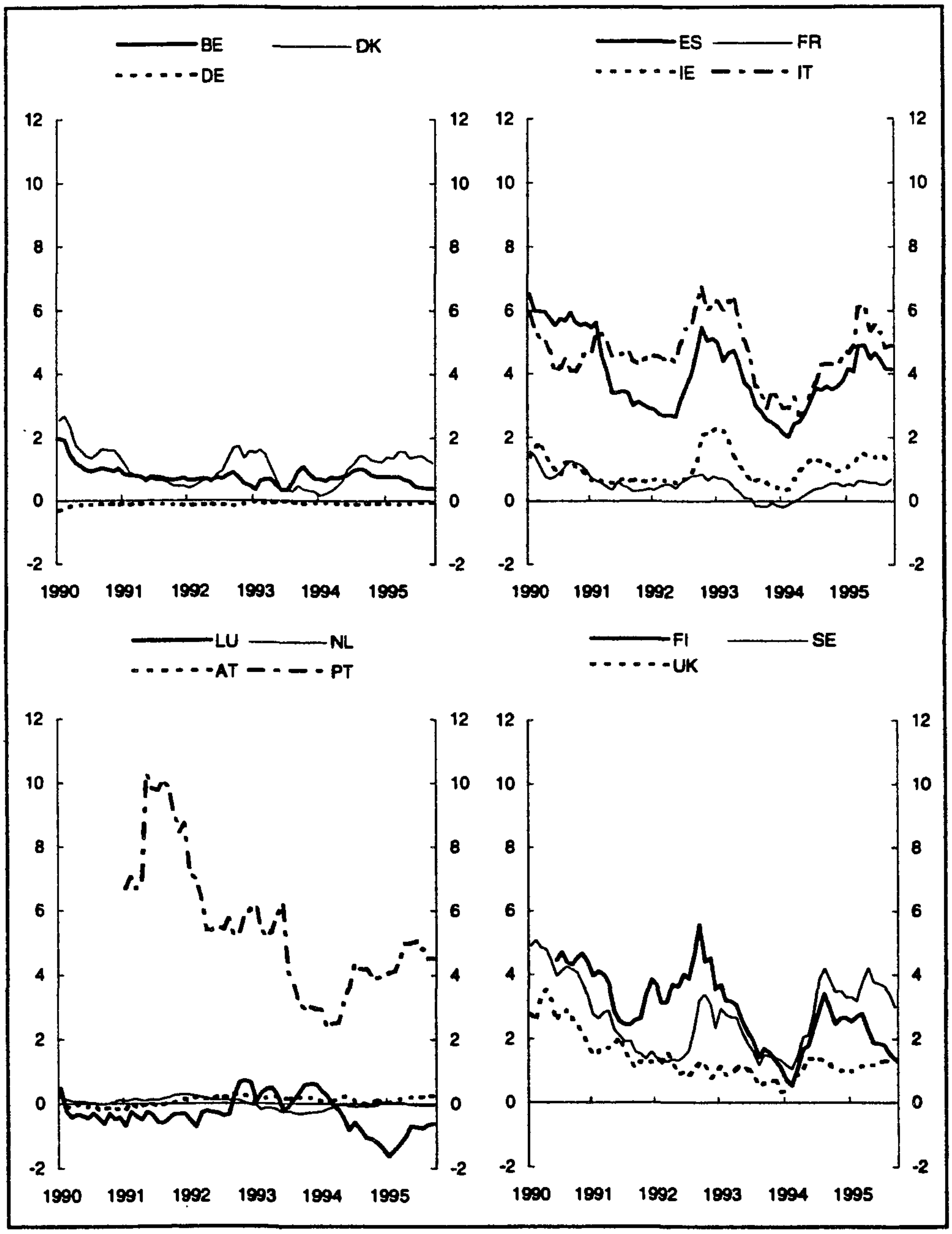


Source: National data. For further explanatory notes see Table 5.1.
No Greek data are shown. See footnote (b) in Table 5.1. For reasons of scaling the Portuguese series is not continuous.

The general downward trend in long-term interest rates was interrupted during 1994. Reflecting a strong correlation with yields on the US bond market, comparable long-term interest rates in the EU rose steeply. While international trends clearly played a role, country-specific factors were also of major significance. This is highlighted by the tendency for long-term interest rate differentials to widen within the EU after the beginning of 1994 (see Chart 5.3).

Chart 5.3 Long-term interest rate differentials against countries with lowest long-term interest rates*

(monthly averages; percentage points)



Source: National data. For further explanatory notes see Table 5.1.
No Greek data are shown. See footnote (b) in Table 5.1.
* Weighted average of Belgium, Germany, Luxembourg, Netherlands and Austria.

Yields in Belgium, Germany, Luxembourg, the Netherlands and Austria have moved in parallel since the beginning of 1994. Other countries' experiences differed. While the interest rate differential against countries with the lowest yields did widen in France, this increase was limited. In Denmark, Ireland and the United Kingdom, increases in differentials did not exceed 1½%. In the case of Spain, Italy, Portugal, Finland and Sweden, differentials increased by considerably more.

From a market perspective, two major events may account for developments in international bond markets during 1995. First, a revision of expectations regarding economic activity, particularly in the United States, reduced inflationary fears in that country. This factor contributed to renewed downward pressures on long-term interest rates on global bond markets. Second, a substantial currency shock, which was triggered by events in Mexico at the end of 1994 and early 1995, led to capital flows from high-yielding countries and subsequently gave rise to a further widening of long-term interest rate differentials. The general rise in risk aversion following developments in Mexico may, in part, account for the fact that German bonds have out-performed those of most other Member States since the beginning of 1995. In addition, by focusing market participants' attention on country-specific risks, it prevented the high-yielding countries from participating fully in the rally during the first few months of the year. Over the past few months there appears to have been some reversal of this tendency. Reflecting this, long-term interest rate differentials in high-yielding countries narrowed in September 1995.

5.3 Factors underlying the evolution of interest rate differentials

The divergence of long-term interest rates which took place during the bond market correction of 1994, and which continued over most of 1995, indicates that although the explanation for the international trend in bond yields may have been global, country-specific factors also played an important role. In particular, differentials against countries with the lowest yields tended to widen. Against this background, it is important to consider the factors underlying recent divergences, looking both at countries which continue to display broadly similar developments and at those with a tendency over the more recent past towards increasing differentials in long-term interest rates.

Both levels and changes in long-term interest rate differentials can be considered to be determined by three factors: expected inflation differentials, differentials in the real rate of interest and differentials in risk premia. Long-term interest rates may also be influenced by the liquidity of markets. If countries are fully integrated into world capital markets, real interest rate levels would tend to equalise so that long-term interest rate differentials would primarily reflect expected inflation differentials and differentials in risk premia associated with inflation. In addition, expectations concerning EMU may play a role in determining long-term interest rates across EU countries.

Regarding financial market expectations of future inflation, the slope of the term structure of interest rates can provide useful information. During 1994, yield curve slopes in the EU displayed a significant turnaround, moving from an inverted to a more normal upward slope. This turnaround initially reflected the gradual easing of monetary conditions in many Member States before the sharp rise in long-term interest rates took over as the dominant factor. In 1995 patterns were more differentiated, largely reflecting monetary policy actions.

However, as is suggested by the pattern of bond yield volatility across the EU, differential risk premia may also have accounted for the divergence in long-term interest rates which took place during 1994. In particular, countries which had relatively high historical inflation rates and/or large past devaluations or depreciations, and had relatively high fiscal deficits at that time may have been perceived by markets to have had greater inflation risks than countries with better inflation track records, more stable exchange rates and lower current fiscal deficits. Reversing the pattern of 1993, the greatest widening of differentials occurred in countries such as Spain, Italy, Finland and Sweden. In addition, country-specific factors relating to political, fiscal and exchange rate problems - and thus risk premia - may also have played a role.

In summary, a combination of factors appears to account for the divergence that has taken place in EU bond yields since the beginning of 1994. In some countries, inflation expectations may have increased, while an important factor also seems to have been an increase in risk premia. The increase in risk premia may be attributed to a change in financial market perceptions of longer-term convergence towards price stability, related to factors such as progress towards fiscal consolidation, devaluations of the currency and political uncertainty.

5.4 Assessment

Chart 5.3 confirms that the previous process of convergence of long-term interest rates, which came to a halt in 1994, has not resumed over the twelve-month period from October 1994 to September 1995. Interest rate differentials between the Member States with interest rate levels at the lower end of the spectrum (Belgium, Germany, Luxembourg, the Netherlands and Austria) have remained narrow. In other countries, like France, interest rate differentials against the above-mentioned Member States remained limited on average but at times displayed a tendency for a higher degree of volatility. Similar considerations apply to Denmark, Ireland and the United Kingdom, where some widening of interest rate differentials occurred. Larger fluctuations in interest rate differentials took place in Finland, but more recently interest rate levels in that country have approached those seen in Denmark, Ireland and the United Kingdom. These ten countries mentioned form the group which by autumn 1995 had long-term interest rates below the reference value of the interest rate criterion, using the average long-term interest rate of the three best-performing countries in terms of price stability. The scale of remaining differences indicates that progress towards overall convergence still needs to be strengthened.

Among those countries currently exceeding the reference value of the interest rate criterion, in Spain, Italy and Portugal inflation expectations and/or risk premia still appear sizable, although other factors may also have played a role and over the very recent period some narrowing of differentials has been seen. In Sweden, a reversal of the earlier widening of differentials has been observed more recently. In Greece, long-term interest rates (which are indexed to the twelve-month Treasury bill rate) have come down continuously, but differentials remain quite wide.

6. OTHER FACTORS IN THE ASSESSMENT OF CONVERGENCE

6.1 Introduction

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

"The reports of the Commission and the EMI shall also take account of the development of the ECU, the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices".

In contrast to the previously-discussed Treaty criteria, these "other factors" are mentioned in the Treaty in a more general way. While some of the factors bear an analytical relation to the convergence criteria, others may be considered more as topics in their own right. As noted in Section 1, unit labour costs and other price indices relate closely to the issues of price stability and sustainability, while current accounts may be assessed with a view to the exchange rate, inflation rate or fiscal criteria. Accordingly, rather than being outlined descriptively for all Member States, the macroeconomic indicators employed in this section are used to cast light on the assessments arrived at in the earlier sections on the degree and sustainability of convergence. Meanwhile, the integration of markets and the development of the private ECU relate to the progress made towards Economic and Monetary Union in more general terms.

6.2 Developments of unit labour costs and other price indices

In assessing prices it is important to recall that, at the time of writing, the rates of inflation in Greece, Spain, Italy and Portugal stand some distance from the reference value defined in the price criterion. Inflation rose in Spain and Italy in early 1995, but has since eased in Spain and has been stable since June in Italy. Among the countries currently displaying inflation rates below the reference value, inflation in Sweden rose during the spring but fell back again during the summer of 1995 and has risen in the United Kingdom. Elsewhere inflation has been broadly stable or declining. This section seeks to cast light on these judgements using alternative indicators.

6.2.1 Unit labour costs

An overview of recent developments of unit labour costs was provided in Section 2. They are a particularly important component of the overall cost structure of the corporate sector and may provide information on trends in national competitiveness; in the long run changes in unit labour costs and final consumer prices have a strong tendency to move in line with one another.Ceteris paribus, excessive unit labour cost growth tends to squeeze

Table 6.1 **Unit labour costs, wages and productivity**

(annual percentage change)

		1990	1991	1992	1993	1994	1995[a]
Belgium	Nominal unit labour costs	3.9	5.6	3.7	3.9	0.8	0.4
	Compensation per employee	5.9	8.1	6.2	3.9	4.2	2.3
	Productivity	1.9	2.3	2.4	0.0	3.4	1.8
Denmark	Nominal unit labour costs	2.2	1.9	2.7	-0.1	0.1	2.4
	Compensation per employee	4.6	4.3	3.8	1.9	3.2	3.4
	Productivity	2.4	2.4	1.1	2.1	3.1	1.0
Germany[b]	Nominal unit labour costs	2.0	3.3	6.2	3.6	-0.4	1.1
	Compensation per employee	4.7	5.9	10.5	4.3	3.2	3.4
	Productivity	2.6	2.5	4.1	0.6	3.6	2.3
Greece	Nominal unit labour costs	20.3	7.7	11.0	11.1	12.0	8.4
	Compensation per employee	17.5	13.8	10.3	9.4	12.3	10.0
	Productivity	-2.3	5.6	-0.6	-1.5	0.2	1.0
Spain	Nominal unit labour costs	8.6	6.7	6.7	3.7	1.4	2.8
	Compensation per employee	8.8	8.4	8.7	6.8	4.4	3.5
	Productivity	0.1	1.6	1.9	3.0	2.9	0.7
France	Nominal unit labour costs	4.4	4.0	2.8	2.9	0.5	1.7
	Compensation per employee	5.0	4.6	4.0	1.7	2.0	3.1
	Productivity	0.6	0.4	1.6	-1.0	1.6	1.3
Ireland	Nominal unit labour costs	1.9	1.6	-5.9	0.0	-6.4	-3.0
	Compensation per employee	4.5	5.6	4.6	5.8	2.0	2.8
	Productivity	2.6	4.0	10.5	5.8	8.4	5.8
Italy	Nominal unit labour costs	7.0	8.1	3.8	1.6	-0.3	1.2
	Compensation per employee	8.5	8.7	6.4	4.0	3.9	4.7
	Productivity	1.4	0.6	2.6	2.4	4.2	3.5
Luxembourg	Nominal unit labour costs	4.8	4.1	5.5	4.6	4.0	3.1
	Compensation per employee	5.8	4.5	4.9	5.4	4.2	4.3
	Productivity	1.0	0.4	-0.6	0.8	0.2	1.2
Netherlands	Nominal unit labour costs	1.2	3.8	4.6	1.9	-4.1	1.4
	Compensation per employee	2.7	4.6	4.9	3.0	3.7	3.0
	Productivity	1.4	0.7	0.2	1.2	8.1	1.6
Austria	Nominal unit labour costs	-0.9	2.2	3.8	0.9	-3.6	-0.4
	Compensation per employee	7.5	5.8	6.1	5.0	4.0	4.6
	Productivity	6.4	4.3	2.9	4.4	8.1	5.0
Portugal	Nominal unit labour costs	15.7	15.0	12.8	7.0	3.6	4.6
	Compensation per employee	17.7	14.2	13.7	7.9	4.7	6.6
	Productivity	1.7	-0.7	0.8	0.9	1.1	1.9
Finland	Nominal unit labour costs	8.7	8.0	-2.1	-4.6	-1.8	2.0
	Compensation per employee	11.7	7.6	1.2	0.2	2.5	5.5
	Productivity	3.5	-0.3	3.8	5.8	4.6	3.5
Sweden	Nominal unit labour costs	9.5	5.8	1.4	-1.9	1.9	3.6
	Compensation per employee	9.9	7.1	3.5	0.1	2.8	5.0
	Productivity	0.4	1.2	2.1	2.0	0.9	1.4
United Kingdom	Nominal unit labour costs	9.6	7.6	3.9	0.4	-0.4	2.3
	Compensation per employee	9.8	8.0	6.1	3.4	4.0	3.8
	Productivity	-0.2	0.6	1.9	3.3	3.6	1.5
EU-15	Nominal unit labour costs	5.7	5.6	4.6	2.4	0.0	1.7
	Compensation per employee	7.2	7.0	7.0	3.8	3.6	3.8
	Productivity	1.3	1.4	2.5	1.5	3.5	2.1

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

profit margins, putting upward pressure on prices. Complementing the data provided for recent years in Section 2, Table 6.1 shows unit labour costs over the period 1990-95 for each country broken down by compensation per employee and productivity.

The breakdown of unit labour costs into their component parts shows that the slight pick-up in most EU countries expected in 1995 is widely associated with a slowdown in productivity growth, principally related to cyclical developments. In a number of cases, however, this is compounded by an acceleration in the growth rate of compensation, which is of potentially greater relevance to judgements concerning price stability. Compensation growth is expected to increase in 1995 in Denmark, Germany, France, Ireland, Italy, Luxembourg, Austria, Portugal, Finland and Sweden. However, productivity improvements continued to more than offset the increase in compensation in Ireland and Austria. On balance, these results underline the risks to inflation in countries such as Italy and highlight the dangers from accelerating wage inflation in several others.

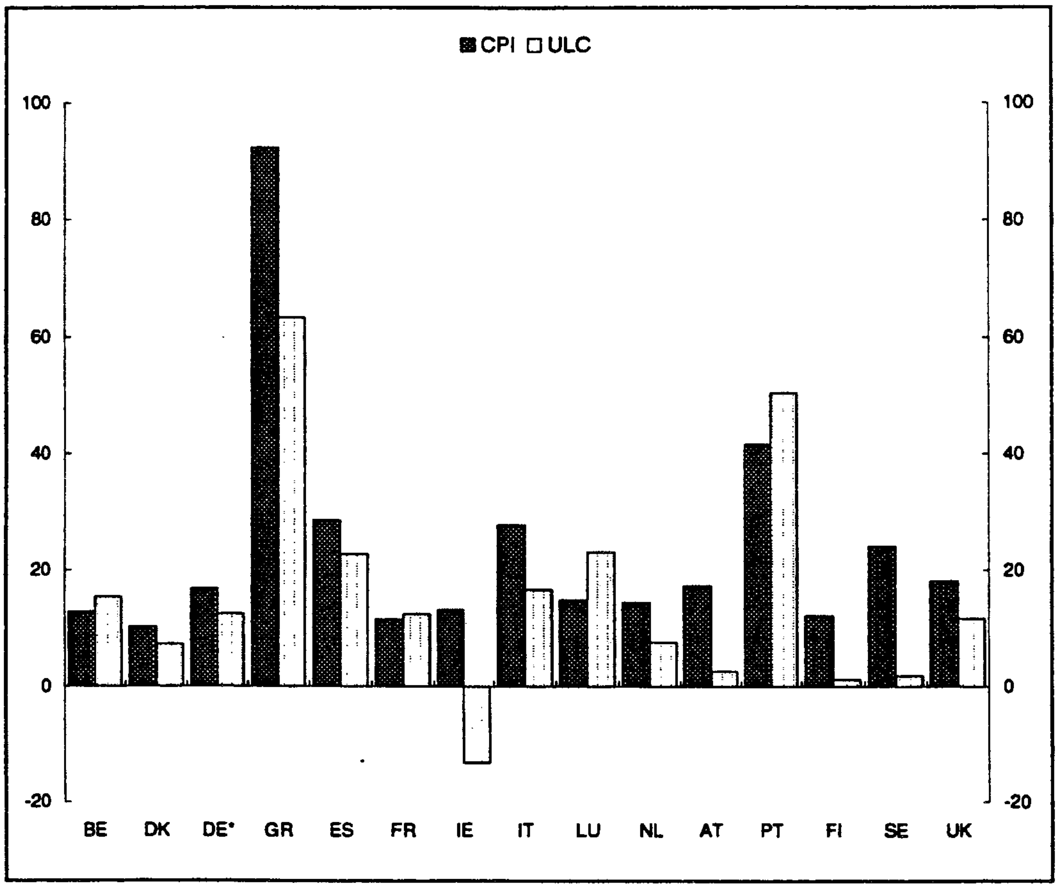
The structure of the labour market varies across Member States, and the likely response of wages to labour scarcities and the level of unemployment differs. Moreover, labour market reforms carried out in recent years may lead to different responses relative to past experience. Nevertheless, it is notable that compared with the average unemployment rate recorded over the period 1987-92, unemployment rates are currently lower in only two countries, Greece and Ireland. In the remaining EU countries unemployment rates are either close to, or above, the average. Unemployment in the EU as a whole was 10.5% in September 1995, down only slightly from its peak in 1994. Considerable differences remain in the level of unemployment among individual countries, but a common factor appears to be the existence of substantial structural labour market problems. A wide range of measures have already been implemented in Member States since the late 1980s which may have lowered equilibrium unemployment rates, but further supply-side measures are needed. As noted in the first Annual Report of the EMI, convergence is more likely to be sustainable if further progress is made to improve the structural performance of labour markets.

In the near term, levels of unemployment above their equilibrium rates suggest that, for most countries, labour market factors are unlikely to put strong upward pressure on prices. But, on the other hand, the uneven nature of the recovery in some countries may result in bottlenecks in certain sectors, which could lead to pressure for higher wages. This pressure might ultimately spread to the economy as a whole.

Some evidence as to the sustainability of price developments may also be derived from looking at cumulative changes in unit labour costs and consumer price indices (CPI) over 1990-95 (see Chart 6.1). Although for many EU countries the two series are comparatively close to one another, in Portugal and Luxembourg, and to a lesser degree in Belgium and France, the series for cumulative unit labour costs currently stands slightly above that for the consumer price index, a result which could be indicative of some, albeit limited, upward pressure on consumer prices. In contrast, in Greece, Ireland and Sweden the cumulative CPI exceeds unit labour costs over the period 1990-95 by a considerable margin, suggesting that corporate margins are likely to have increased somewhat. However, in some cases these patterns may arise from import price

Chart 6.1 **Unit labour costs and consumer prices**

(cumulative percentage changes in indices, 1990-95)



Source: National data. For further explanation of the inflation data used see Table 2.1.
Consumer price data for 1995 are the average of the first nine months. Data for unit labour costs for 1995 are projections.
* Western Germany up to 1991, unified Germany thereafter.

developments or from country-specific factors, such as the predominance of multinational enterprises with different pricing strategies in countries such as Ireland.

6.2.2 Producer prices

An indication of the strength of inflationary pressures may also be seen in price rises for finished and unfinished goods at intermediate stages of production, although the relationship is by no means clear cut. Table 6.2 shows the latest (unharmonised) producer price data for EU countries, together with CPI inflation. In a large number of countries, producer price inflation has picked up in 1995 compared with 1994, partly reflecting developments in oil and commodity markets, but also in some cases the effects of recent exchange rate depreciations. In Belgium, Denmark and France, as well as in countries where inflation has been under upward pressure, such as Spain, Italy, Sweden and the United Kingdom, the pace of increase in the producer prices index (PPI) has recently outstripped that of the CPI. Although the correlation between PPI and CPI developments has been weak in recent years, one cannot exclude that CPI inflation could rise if these price pressures are passed on down the production chain. In almost all cases, however, there is some evidence that PPI growth has recently either levelled off or even begun to decline, suggesting that such pressures are likely to be limited. In addition, monetary policy has been tightened to counter the inflationary threat.

Table 6.2 **Producer prices (PPI) and consumer prices (CPI)**
(annual percentage change)

		Annual						Monthly		
		1990	1991	1992	1993	1994	1995[a]	Jul 95	Aug 95	Sep 95
Belgium	CPI	3.5	3.2	2.4	2.8	2.4	1.5	1.2	1.3	1.2
	PPI	0.6	-1.1	0.2	-1.0	1.4	2.4	1.3	2.0	-
Denmark	CPI	2.6	2.4	2.1	1.3	2.0	2.2	1.8	1.6	2.1
	PPI	1.0	1.0	-1.1	-0.5	1.3	3.4	2.9	2.8	-
Germany	CPI	2.7	3.6	4.0	3.6	2.7	1.9	1.8	1.7	1.8
	PPI[b]	1.7	2.4	1.4	0.0	0.6	1.9	-	-	-
Greece	CPI	20.3	19.6	15.9	14.5	10.9	9.7	8.9	8.7	8.4
	PPI	18.2	18.0	14.7	13.6	7.4	8.4	7.2	7.2	-
Spain	CPI	6.7	5.9	5.9	4.6	4.7	4.8	4.7	4.3	4.4
	PPI	2.2	1.5	1.4	2.4	4.3	6.9	6.9	-	-
France	CPI	3.4	3.2	2.4	2.1	1.7	1.7	1.5	1.9	2.0
	PPI	2.3	2.3	1.1	2.0	1.9	2.3	-	-	-
Ireland	CPI	3.4	3.2	3.0	1.5	2.4	2.6	2.4	2.4	2.4
	PPI	-1.6	0.9	1.6	4.6	1.1	1.6	-	-	-
Italy	CPI	6.1	6.4	5.4	4.2	3.9	5.2	5.6	5.8	5.8
	PPI	4.5	3.5	2.2	4.0	3.6	7.5	-	-	-
Luxembourg	CPI	3.7	3.1	3.2	3.6	2.2	2.1	1.9	1.8	1.6
	PPI	-	-2.6	-2.7	-1.3	1.4	-	-	-	-
Netherlands	CPI	2.4	3.1	3.2	2.6	2.8	2.1	1.8	1.5	1.5
	PPI	1.1	1.9	1.8	0.1	0.5	1.8	1.3	1.4	-
Austria	CPI	3.3	3.3	4.0	3.6	3.0	2.4	2.2	2.1	2.1
	PPI	2.9	0.8	-0.2	-0.4	1.3	1.7	0.7	-0.6	-
Finland	CPI	6.2	4.3	2.9	2.2	1.1	1.2	0.8	0.4	0.3
	PPI	3.3	-0.3	1.3	2.8	1.9	2.4	1.2	1.2	-
Sweden	CPI	10.4	9.7	2.6	4.7	2.3	2.9	2.9	2.7	2.5
	PPI	4.3	1.8	-1.0	5.5	4.2	-	-	-	-
United Kingdom	CPI	8.1	6.8	4.7	3.0	2.4	2.8	2.8	2.9	3.1
	PPI	6.2	5.4	3.1	4.0	2.5	4.0	4.5	4.4	4.5

Source: National data. For further explanatory notes on consumer price indices see Table 2.1.
(a) Data for 1995 are the average of the available monthly data to September.
(b) Western Germany.
For Portugal there are no data available on producer prices.

6.2.3 Alternative price indices

Being derived from National Accounts, the consumer expenditure deflator (CED) and GDP deflator are generally more harmonised than national CPI. The CPI and CED indices both measure prices paid by consumers and are likely to be closely linked; the CED may therefore yield useful complementary information. The GDP deflator covers a much broader range of goods and services, including export prices, but may provide an indicator of the sustainability of inflation performance. In 1995 there were four countries in which inflation measured by the CPI data was expected to be below that recorded by the CED or the GDP deflator. These countries were Spain, Luxembourg, Finland and Sweden. The shortfall with the CED highlights the need for care in judgements based on the CPI, while the GDP deflator gives grounds for caution regarding the sustainability of current inflation in these countries.

A further distinction which may be of particular interest is that between traded and non-traded goods and services. One concern is that significant divergences between the two may lead to upward pressures, generally via spillover effects between sectors, such as wage demands in the exports sector. In addition, there has been some suggestion that, at least historically, "inflation cycles" follow a regular pattern in which during the expansionary phase of activity commodity and other goods prices begin to rise first, followed by an upturn in inflation in the services sector. Thus, goods prices may provide something of a leading indicator of inflationary upturns. Since goods prices are closely associated with the traded sector in many countries, this may provide a useful proxy. In this context, the available information suggests that changes in inflation in the traded sector have generally been downwards, suggesting little cause for concern of the type outlined above.

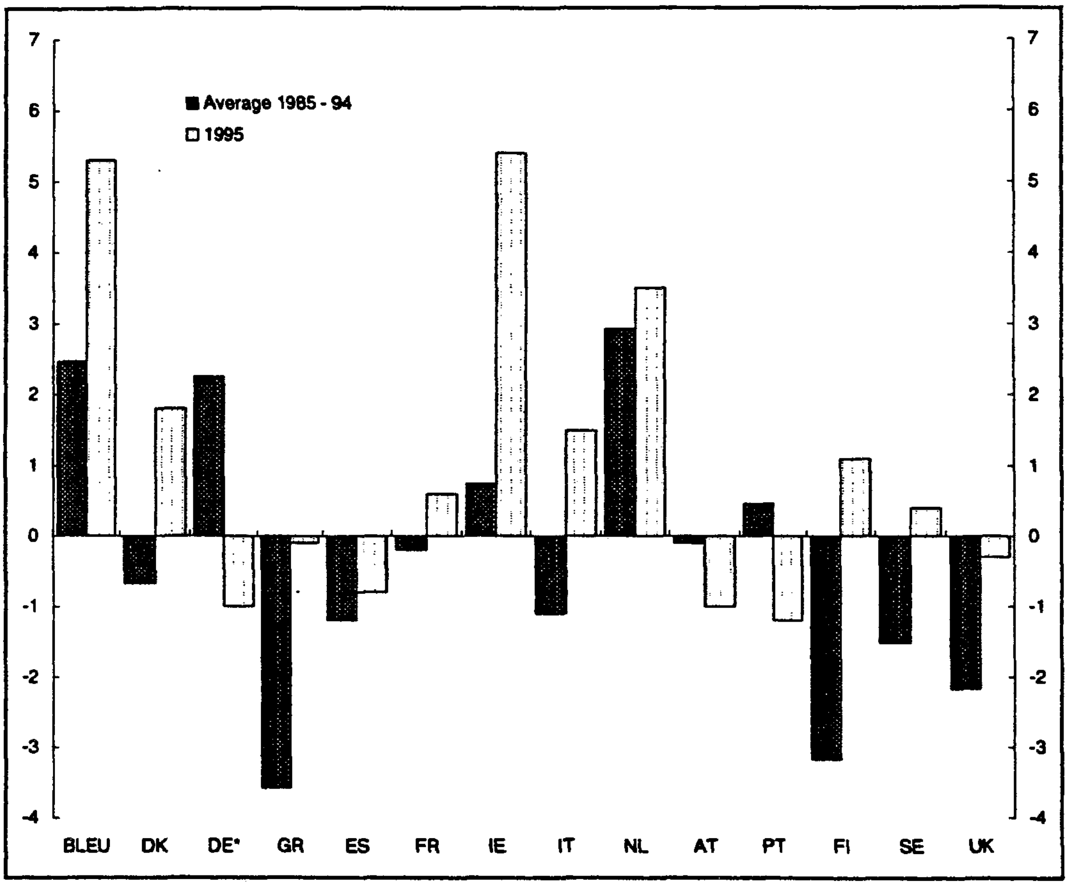
6.3 The situation and development of the balance of payments on current account

Current account balances may be seen as related to the criterion on the government budgetary position, to exchange rate stability and inflationary pressures. As regards the link to fiscal policy, such an approach seeks to evaluate the fiscal positions within an overall assessment of sectoral balances. Concerning exchange rates, persistent, or increasing (trended) current account imbalances may be seen as an indicator of real exchange rate disequilibria. This would suggest, for example, that a country with an external deficit has an 'overvalued' real exchange rate. But a point that has often been made in this context is that the current account deficit or surplus is the obverse of capital flows. Clearly, the existence and scale of investment opportunities at home and abroad could play an important part in determining the current account balance. In this sense, a deficit, especially if it is the counterpart of direct investment inflows, may have some favourable aspects - highlighting the presence of relatively favourable rates of return on capital. For example, in the case of countries such as Spain, it is necessary in assessing longer-term trends in the balance of payments to bear in mind the very high growth rates of investment that have been observed.

Current account balances, as a percentage of GDP, are shown in Chart 6.2 both for projections for 1995 and for the average over the period 1985-94. From a longer-term perspective, only two countries (Greece and Finland) had deficits over the period on average in excess of 3% of GDP. Comparing the projections for 1995 with the longer-term figures, in Greece, Spain and the United Kingdom current account balances have improved relative to the average, but remain in deficit. Only in unified Germany, Austria and Portugal were current account balances expected to be worse in 1995 than the average over 1985-94. Although some of these countries experienced exchange rate instability in 1995, there is evidently no one-to-one correlation. The relationship between the real exchange rate of a country and its current account is a complex one. As already mentioned, a current account deficit may be the consequence of various factors (some temporary, others of a more structural nature) and, in addition, current accounts are only one factor in the determination of the level of the real exchange rate.

Chart 6.2 **Current account balances**

(as a percentage of GDP)



Source: National data. Data for 1995 are projections.

* Western Germany up to 1991, unified Germany thereafter.

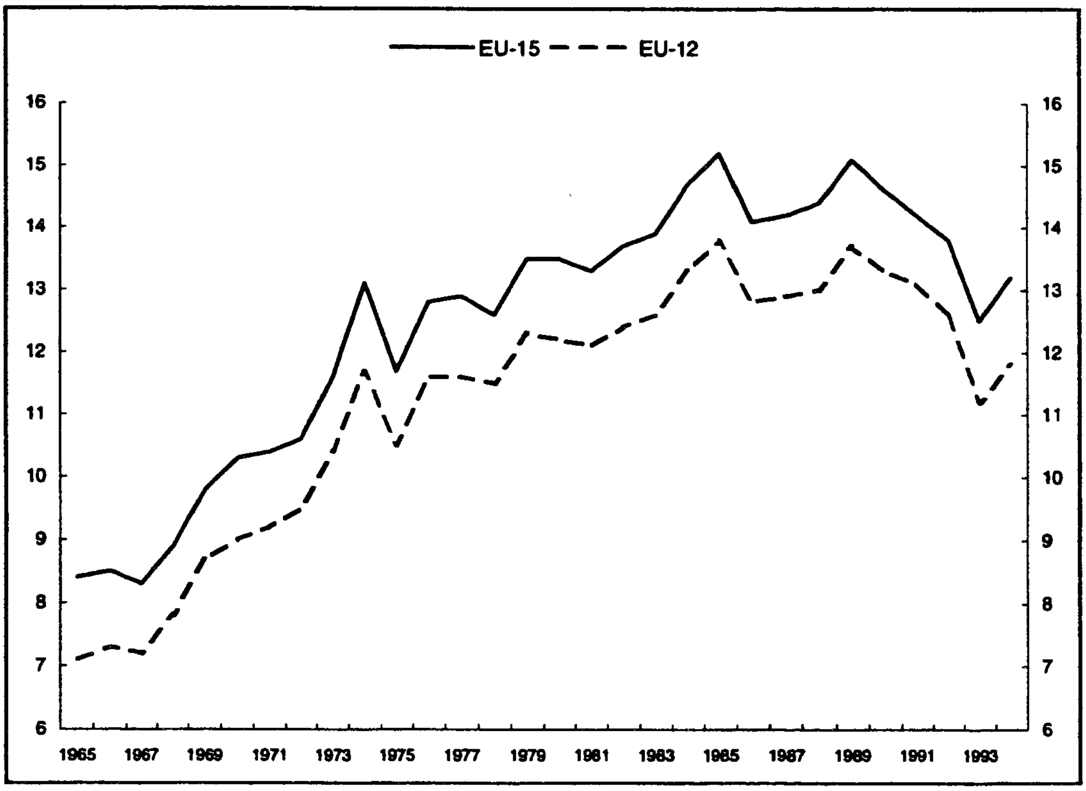
Current account balances, as noted above, may also be brought into the process of assessing convergence by examining their relationship with fiscal positions. A priori, a "twin deficit" indicates a reliance on foreign savings to fund the fiscal imbalance. When a fiscal deficit is accompanied by a current account surplus as in, for example, Belgium and the Netherlands and more recently in Italy, this indicates that deficits are financed by national private saving.

The current account position may also shed some light on inflationary pressures. For example, strong domestic demand pressures may be reflected in a growing external deficit. There is no strong signal from this indicator at present.

6.4 The results of the integration of markets

Progress with respect to the integration of markets may be evaluated from several angles. Considering first the legal dimension, implementation of Single Market legislation provides one measure of the degree to which legal obstacles remain. According to the figures from the European Commission, the average transposition rate stood at 92.6% as of 1st June 1995. All countries had transposition rates of over 90%, with the exceptions of Greece and Finland, although in Finland the transposition rate has increased significantly since then. While there has been significant progress in implementing the measures listed in the 1985 Single Market White Paper, a number of problem areas remain, notably: public procurement, the insurance industry, free movement of people (especially mutual recognition of professional training and education), intellectual and industrial property. It is important that these problems are resolved, and the Single Market completed. Greater competition should ensue, which over time will help to improve the structural performance of goods and labour markets. In turn, this will increase the likelihood that convergence will be sustainable.

Chart 6.3 **Intra-EU trade***
(as a percentage of GDP)



Source: IMF (Direction of Trade Statistics).
* Defined as the sum of exports from EU countries (EU-15 or EU-12) to other EU countries, divided by total EU GDP.

Aside from these remaining legal barriers to the functioning of the Single Market, some information on the progress achieved with regard to the integration of markets can be derived from examining growth in intra-EU trade and changes in foreign direct investment between EU countries. Chart 6.3 shows the growth of intra-EU trade (as a proportion of

Union GDP) for both the EU-12 and the EU-15, using data provided by the IMF, over the period since 1965. The same group of countries is considered, even though membership of the EU has grown over this period. As can be seen, intra-EU trade between the EU-12 and EU-15 has tended to increase - in the case of the EU-15 from around 8.5% of EU GDP to just over 13% in 1994 (and for the twelve Member States before the accession of Austria, Finland and Sweden, from 7% to just below 12%). However, the rate of growth appears to have slowed from the early 1980s onwards, and is lower for both groups of countries in 1994 than in 1979, due to a sharp decline from 1990 onwards. The gap between the two groups has remained roughly constant over the whole sample period - at around 1.3%. A more comprehensive breakdown of patterns of trade (as a proportion of total trade) among Member States, including the new entrant countries, is shown in Table 6.3. The table shows intra-EU trade at four different periods in time. These figures provide stronger evidence of the increased integration of markets - for the EU-12 and EU-15. However, intra-EU trade among the original six countries and for the EU-9 (i.e. including Denmark, Ireland and the United Kingdom) shows little change over the period since 1980. This may be because the growth in trade occurred earlier among these countries, or because increased trade has focused on Europe more generally.

Table 6.3 **Intra-EU trade**

(as a percentage of total trade)

	1980	1985	1990	1994[a]
EU-6	27.5	26.1	28.8	26.6
EU-9	33.2	33.5	39.4	34.4
EU-12	34.0	36.1	44.7	40.4
EU-15	38.5	40.8	47.4	46.0

Source: IMF (Direction of Trade Statistics).
(a) Data for 1994 are for the fourth quarter only.

Direct investment is a straightforward alternative to the export of goods and services across national frontiers, and thus provides a further source of useful information. The data attempt to estimate investments made with the intention of obtaining ownership and control over companies in other countries. Thus, from the perspective of European integration they indicate the increasing inter-relatedness of corporate enterprises in Member States. Figures for foreign direct investment between Member States are only available up to 1993, and focus on the EU-12. For a number of countries, at least in nominal terms, the scale of investment flows to or from other Member States has increased considerably. As the figures may vary greatly from year to year, it may be better to focus on the average over several years. Taking the period since 1990, and considering first the figures for outward investment, France, Germany and the Netherlands provide much of the foreign direct investment in other EU countries, followed by Belgium-Luxembourg, the United Kingdom, Italy, Spain and Denmark. In terms of intra-EU inward direct investment, the principal recipients are France, Spain and Belgium-

Luxembourg, followed by the United Kingdom, the Netherlands, Ireland, Germany and Italy.

Summarising the indicators of integration at the macroeconomic level, the most positive aspect is provided by foreign direct investment, as well as the implementation of Directives. Aggregate patterns of trade per se provide a somewhat more equivocal picture of the progress of integration.

6.5 The development of the ECU

The overall private ECU market (see Table 6.4) is estimated to have contracted by 7.5% in 1994, and to have been stable in the first quarter of 1995, to stand at ECU 171.2 billion at the end of March 1995. The largest decline has been in estimated bank lending (final bank lending and lending to banks outside the BIS reporting area), which contracted from ECU 64.4 billion at the end of 1993 to ECU 57.3 billion at the end of March 1995. The share of the ECU in the total for all currencies fell from 3.1 to 2.4%. The period since the

Table 6.4 **Indicators of the development of the ECU**

(end-period; in billions of ECU)

	Dec 93	Dec 94	Mar 95	Jun 95	Sep 95
Bonds	125.0	123.3	122.0	117.4	-
of which:					
international[a]	77.9	69.3	69.3	65.9	-
domestic[a]	47.1	54.0	52.7	51.5	-
Euro notes	6.8	6.7	8.4	8.2	-
Treasury bills	7.4	3.5	3.6	3.5	-
Estimated bank lending[b]	64.4	56.3	57.3	-	-
Estimated market size[c]	183.6	169.8	171.2	-	-
Total ECU lending[d]	191.2	167.9	184.9	-	-
Total ECU deposits[e]	188.8	166.5	181.4	-	-
Exchange rate spread[f]	-0.1	-0.4	-0.7	-1.0	-0.8
Short-term interest rate spread[f]	0.0	0.1	0.1	0.0	0.0
Long-term interest rate spread[f]	-0.3	0.0	0.0	-0.1	0.0

Source: National data and BIS Quarterly Statistics on International Banking and Financial Market developments.
(a) The distinction between domestic and international issues is made in the BIS Quarterly Statistics.
(b) Final bank lending and lending to banks outside the reporting area.
(c) ECU 20 billion is deducted for estimated double counting; there is an overlap between the securities and banking markets owing to the role of banks as issuers and holders of ECU securities. In the absence of comprehensive data, this overlap may only be estimated.
(d) Including interbank lending.
(e) Including interbank deposits.
(f) Quarterly averages, percentage points.

beginning of 1994 has also seen a contraction of total ECU bonds outstanding, from ECU 125 billion to ECU 117.4 billion at the end of June 1995. Repayments of maturing bonds were high in both 1994 and 1995, while issuance, notably at long maturities, slumped in 1995 reportedly as a consequence of uncertainty over aspects of EMU. Although overall international bond issuance was weak in 1994-95, the decline in ECU issues went further, as the share of international ECU bonds in the total outstanding fell from 4.9 to 3.9% between the beginning of 1994 and mid-1995. For short-term instruments there was again a slight fall in 1994, but this was partly compensated by growth in the first half of 1995; medium-term notes were the main source of growth.

According to a survey undertaken on behalf of the European Commission, the value of ECU payments for commercial operations in 1994 was in the range of ECU 50-75 billion, amounting to the equivalent of 6-11% of intra-EU trade. This is well in excess of previous estimates of the use of the private ECU. According to the survey, the principal locations of the paying banks were Belgium and the United Kingdom, while France, the Netherlands, Spain, Belgium and the United Kingdom were the destinations for over 90% of the payments.

The spread between the ECU market and theoretical or "basket" exchange rates has traditionally remained in a range of ±20 basis points (except during periods of currency crisis), as banks would take positions in the private ECU against a basket of component currencies so as to profit from the elimination of larger differences. But the spread widened markedly and durably from April 1994 onwards, and broadened further in the first quarter of 1995 to reach the widest margin since the exchange rate crises of 1992-93. In the second and third quarters of 1995 it remained wide. At the same time, the short and long-term interest rate spread remained close to par throughout 1994-95. The persistent and large exchange rate spread in 1994 and the second quarter of 1995, when exchange rate tensions were not marked, is thought to reflect a deterioration of liquidity conditions in the private ECU market. Banks seem less willing to maintain open positions, although a profit may be realised from such positions at the beginning of Stage Three. Awareness of the lack of an institutionalised link of market to basket as well as the practice of marking-to-market, are thought to have increased perceptions of risk in position-taking in private ECUs against a basket, of component currencies. Uncertainty regarding which countries will participate in the European currency area may also play a role. Last, the market exchange rate has also been weakened by the sale of proceeds of maturing bonds into other currencies. The maintenance of par values for interest rates may offer a partial counterbalance to the concerns the exchange rate spread may evoke.

These developments have occurred despite favourable structural developments during the past year, which include a Council Regulation, and the European Commission's Recommendation and Explanatory Note, all of which aimed at assuaging uncertainties about the definition of the private ECU in financial and other contracts and its legal status more generally at the national level. Steps have also been taken to improve the working of the private ECU markets, notably in Greece, France and Italy.

Nevertheless, the overall assessment of the "development of the ECU" over 1994-95 has to be an unfavourable one. The key underlying adverse factors are deemed to be exchange rate volatility per se; uncertainty about aspects of EMU; and the long-term weakness that the ECU is used mainly for financial purposes and lacks a strong wholesale and retail customer base in the non-financial sectors. Persistent spreads between the market and theoretical ECU exchange rate are a symptom of this impaired development, although the maintenance of par values for short and long-term interest rates offers a more positive perspective.

7. ASSESSMENT OF THE PERFORMANCE OF INDIVIDUAL COUNTRIES

This section seeks to summarise the various assessments made in Sections 2-6 to form an overall view of the performance of individual countries. (For summary data, excluding exchange rate developments, see Table 7.1.) In the assessment of the degree of

Table 7.1 Economic indicators and the Maastricht Treaty convergence criteria
(excluding the exchange rate criterion)

		Inflation [a]	Long-term interest rate [b]	General government lending (+) or borrowing (-) [c]	General government gross debt [c]
Belgium	1994	2.4	7.8	-5.3	135.0
	1995[d]	** 1.6	** 7.9	-4.5	134.4
Denmark[e]	1994	*** 2.0	*** 7.8	-3.8	75.6
	1995[d]	2.1	8.6	# -2.0	73.6
Germany	1994	2.7	6.9	# -2.6	# 50.2
	1995[d]	2.1	7.1	# -2.9	# 58.8
Greece	1994	10.9	20.8	-11.4	113.0
	1995[d]	9.9	18.8	-9.3	114.4
Spain	1994	4.7	10.0	-6.6	63.0
	1995[d]	4.7	11.5	-5.9	64.8
France	1994	** 1.7	** 7.2	-6.0	# 48.4
	1995[d]	*** 1.7	*** 7.8	-5.0	# 51.5
Ireland	1994	2.4	7.9	# -2.1	91.1 [f]
	1995[d]	2.5	8.5	# -2.7	85.9 [f]
Italy	1994	3.9	10.6	-9.0	125.4
	1995[d]	4.9	12.3	-7.4	124.9
Luxembourg	1994	2.2	6.4	# 2.2	# 5.9
	1995[d]	2.1	6.2	# 0.4	# 6.3
Netherlands	1994	2.8	6.9	-3.2	78.0
	1995[d]	2.2	7.2	-3.1	78.4
Austria	1994	3.0	7.0	-4.4	65.2
	1995[d]	2.5	7.4	-5.5	68.0
Portugal	1994	5.2	10.4	-5.8	69.4
	1995[d]	4.2	11.7	-5.4	70.5
Finland	1994	* 1.1	* 9.1	-5.8	# 59.8
	1995[d]	* 1.3	* 9.4	-5.4	63.2
Sweden	1994	2.3	9.7	-10.4	79.7
	1995[d]	2.8	10.8	-7.0	81.4
United Kingdom	1994	2.4	8.0	-6.8	# 50.1
	1995[d]	2.7	8.4	-5.1	# 52.5

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

convergence achieved, reference is made only to data up to 1995. Consequently, no reference is made to measures which have already been adopted or are envisaged for 1996, and forecasts and expectations for 1996 are not taken into account.

Data used for fiscal positions (as a percentage of GDP) are the autumn 1995 Commission projections of deficits and debts for 1995. Exchange rates are evaluated over the two-year period October 1993-September 1995. Comments on inflation and long-term interest rates relate to the most recent data available for a twelve-month period, that is, the average from October 1994 to September 1995. It should be noted that these are national, non or not fully harmonised figures.

Issues relating to the choice of the reference value for the inflation criterion are discussed in Section 2.1. There it was concluded that price stability may in principle be best reflected by the country with the lowest inflation rate. However, the average of the best three performers in terms of price stability may provide a good starting-point if there are no outliers. As the latter consideration applies for the period under review, the following assessment of individual countries is based on the average of the best three inflation performers, without prejudice to any future judgement. Regarding the criterion on long-term interest rates, issues relating to the choice of the reference value are discussed in Section 5.1. The role of outliers was also addressed in this context. Following the procedure applied for the price criterion, the assessments in this section are based on the average of the long-term interest rates of those three countries with the lowest inflation rates.

It should be noted that in June 1995 all EU countries other than Germany, Luxembourg and Ireland were considered by the EU Council to have excessive deficits in 1995.

Inflation in the *Belgian* economy, standing well below the reference value, is underpinned by ongoing wage moderation and recent trends in the effective exchange rate. In contrast, despite the recent structural improvements in the Belgian budget, the fiscal deficit ratio, projected to be 4.5% in 1995, remains too high. Further progress in consolidation is therefore necessary in order to reduce the deficit ratio to well below 3%. This is all the more necessary in order to reduce sufficiently the very high debt ratio of 134.4% and to bring it towards 60% at a satisfactory pace. Successful pursuit of exchange rate stability vis-à-vis the strongest currencies within the ERM has been a constant feature of Belgian economic policy for some time; reflecting the long-term credibility of the peg, nascent pressures in early 1995 were quickly dampened by appropriate policy action. In line with inflation, long-term interest rates stand below the reference value. These patterns partly reflect the strong price and current account performance of the Belgian economy.

The *Danish* inflation rate remains below the reference value, although a narrowing of the output gap requires close attention. Effective exchange rate developments are exerting downward pressure on inflation. Although the deficit ratio in 1995 is expected to be well below 3%, a further decline will be preferable under present cyclical conditions, also to bring down the debt ratio. The exchange rate has been subject to some instability in 1995, but in the course of 1995 has returned steadily to its central ERM parity vis-à-vis the strongest currencies. The long-term interest rate stands below the reference value.

German inflation has returned to a level more consistent with price stability after the unsatisfactory performance seen in the early 1990s, aided by the appreciation of the effective exchange rate. It stands below the reference value; however, the development of wages, growth of which increased in 1995, will need to be monitored closely. On the fiscal side, progress has been made in reducing structural imbalances - although a lower structural deficit would be desirable - and the deficit ratio in 1995 is expected to rise to 2.9%, somewhat in excess of the Government's gross fixed capital formation. Such an increase in the deficit to a level close to the 3% reference value of the Treaty offers a warning signal. The inclusion of several off-budget items in the official figures has boosted the debt ratio, which has risen by 20 percentage points in five years and now stands just below the 60% reference value of the Treaty. The Deutsche Mark has been consistently one of the strongest currencies within the ERM. The long-term interest rate in Germany is continuously among the lowest in the EU and well below the reference value.

The *Greek* inflation rate, albeit declining rapidly, remains the highest in the EU and well above the reference value. Considerable effort is evidently needed to meet the price criterion. Inflation for non-traded goods is much higher than for traded goods; structural rigidities have underpinned the former, while competition from abroad reflected in lower import price inflation has put the latter under downward pressure. The fiscal deficit-to-GDP ratio of 9.3% and debt-to-GDP ratio of 114.4% continue to be among the highest in the Union, thus making the implementation of strict policies aiming at fiscal consolidation clearly necessary in order to reduce the deficit ratio to well below 3%. This is all the more necessary in order to reduce sufficiently the very high debt ratio and to bring it towards 60% at a satisfactory pace. In this respect, it will be crucial that further increases in primary balances are achieved and sustained. The drachma does not participate in the ERM, and has tended to depreciate in nominal terms against the strongest currencies in the ERM, in line with the exchange rate target vis-à-vis the ECU. The long-term interest rate in Greece (which is indexed to the twelve-month Treasury bill rate) remains well in excess of the reference value, but the differential has narrowed noticeably recently, reflecting inflation trends and fiscal performance.

Inflation in *Spain*, having declined in recent years, stands above the reference value of the Treaty. The increase in the inflation rate in spring 1995 was strongly influenced by increases in indirect taxes and was largely reversed during the summer, following a tightening of monetary policy. However, the risk of wage growth arising from partial indexation clauses in collective bargaining agreements will require close attention. The deficit-to-GDP ratio is expected to stand at 5.9% this year, while the debt ratio exceeded the reference value for the first time in 1993 and has risen further to an expected 64.8% in 1995. Further progress towards fiscal consolidation is therefore needed in order to bring the deficit ratio down to below 3% and also to ensure that the debt ratio will comply with the requirements of the Treaty. The exchange rate of the peseta, which participates in the ERM, has been subject to considerable instability and underwent a realignment in March 1995; thereafter it steadily recovered to stand close to its new ERM central parity vis-à-vis the strongest currencies. Although yields have fallen since the end of 1994, long-term interest rates stand well above those in countries with the lowest inflation, and yields stand above the reference value.

In *France*, inflation is well below the reference value. Recently, indirect tax increases have raised CPI inflation, and risks may stem from future wage growth even if current wage growth is moderate. The projected 1995 deficit-to-GDP ratio of 5% is not close to the reference value and is too high for the current stage of the cycle. Thus, further progress towards fiscal consolidation is needed to bring the actual deficit ratio down to below 3%. The debt ratio continues to rise, albeit remaining well below 60%. The exchange rate underwent fluctuations in early 1995 but returned close to the ERM central parity vis-à-vis the strongest currencies. Bond yields are below the reference value.

The *Irish* price performance is currently one of low inflation, and CPI inflation rates are below the reference value. However, as GDP continues to grow rapidly, capacity constraints could emerge and pose risks. In 1995 the Irish deficit ratio is expected to stand below the reference value of 3%, while the debt ratio is estimated at 85.9%, well above 60% of GDP. However, the debt ratio has declined from 96.5% in 1990. Against the background of the progress made in the reduction of the debt ratio Ireland was not the subject of an EU Council decision on excessive deficits under Article 104c (6) of the Treaty. The recent deterioration in structural budget balances, with little prospect of this being reversed in 1995, is a matter of concern. The exchange rate vis-à-vis the strongest currencies underwent large fluctuations in 1995 and remains below the ERM central parity against the strongest currencies. Levels of bond yields are below the reference value.

Inflation in *Italy* has risen well above that of most other EU countries and stands above the reference value. Indirect tax increases have raised consumer prices directly, but there have also been further upward pressures coming from higher input prices and strong demand. Monetary policy has been tightened in response to inflationary pressures. To prevent new inflationary impulses, wage increases will have to continue to be contained in the coming renewal of labour contracts. Outcomes in Italian public finances are not satisfactory. In 1995, the Italian general government deficit is expected to stand at 7.4% of GDP. It remains well above the reference value and, therefore, much progress is clearly necessary in order to reduce the deficit ratio to well below 3%. This is all the more necessary in order to ensure that lasting progress towards a sustainable fiscal position can be achieved and the very high debt ratio can be reduced sufficiently and brought down towards 60% at a satisfactory pace. The debt ratio, among the highest in the Union, is expected to be 124.9% of GDP in 1995, almost 24 percentage points above its level of four years earlier, albeit remaining approximately stable for the first time in fifteen years. While reforms such as that of the pension system move in the right direction, there is an urgent need to tackle general structural issues in the public budget. The lira is not in the ERM and has depreciated considerably vis-à-vis other Member States' currencies in 1995. The bond yield, despite having declined, stands well above that in countries with the lowest inflation and is in excess of the reference value.

Luxembourg maintains a low inflation rate below the reference value. It is the only Member State to record a budgetary surplus. Furthermore, the stock of debt is small, amounting to below 10% of GDP. The country thus clearly meets the requirements for sound public finances as specified in the Treaty. The currency is in a monetary association with the Belgian franc and exhibits stability within the ERM vis-à-vis the strongest currencies. Bond yields are well below the reference value.

In *the Netherlands*, the inflation rate is below the reference value, and performance is likely to be further underpinned by the firm exchange rate. The only limited improvement in fiscal balances during the cyclical upturn - with a deficit of still slightly above 3% of GDP - is a ground for disappointment and further progress is needed to bring the deficit ratio to well below 3%. Such fiscal consolidation is needed in order to reduce the debt-to-GDP ratio sufficiently and to bring it down from 78.4% in 1995 towards 60% at a satisfactory pace. Exchange rate stability within the ERM has been firmly maintained, as the guilder remains within a very narrow fluctuation band vis-à-vis the Deutsche Mark. Long-term interest rates remain well below the reference value, reflecting price and exchange rate stability as well as a strong current account position.

Austria has returned closer to price stability in 1995, aided by a firm exchange rate, rapid productivity growth and increased competition following accession to the EU. Its inflation rate is below the reference value. However, the development in wages, growth of which increased in 1995, will need to be monitored closely. The fiscal deficit ratio rose to 5.5% in 1995 after the accession of the country to the EU, and is not close to the reference value. The debt ratio, expected to be 68% in 1995, continues to rise. Fiscal consolidation is therefore needed in order to bring down the deficit ratio to below 3% and also to ensure that the debt ratio will comply with the requirements of the Treaty. As has been the case for over a decade before EU entry, exchange rate stability vis-à-vis the Deutsche Mark has been firmly maintained; the schilling joined the ERM in January 1995. The long-term interest rate is well below the reference value.

Inflation in *Portugal* was brought down from 13% in 1990 to 5% in 1994 and currently stands above the reference value, at around 4%. While this is a creditable performance, especially given the impact of indirect tax increases on the index, more disinflation is needed to reach levels consistent with price stability. The deficit ratio at 5.4% is not close to the reference value and the debt ratio of 70.5% remains high. Further progress towards fiscal consolidation is therefore needed in order to bring down the deficit ratio to below 3% and also to ensure that the debt ratio will comply with the requirements of the Treaty. The exchange rate of the escudo experienced instability in 1995, but remained in a median position within the ERM; following a request by the Spanish authorities the peseta underwent a realignment, and following the decision to change the central rate of the peseta, the Ministers and central bank Governors agreed on a downward adjustment of the Portuguese escudo. The long-term interest rate stands well above that in countries with the lowest inflation and is above the reference value, partly as a consequence of the past inflation performance of the economy.

Inflation in *Finland* remains the lowest in the EU and, thus, stands well below the reference value. The development of a "dual economy", with a booming traded goods sector and sluggish non-traded sector has given grounds for caution. However, given the conclusion of a two-year centralised wage agreement, the risk of wage pressures has diminished. The Finnish fiscal position, with a deficit of 5.4% of GDP, is not close to the reference value. It continues to reflect the deep recession of the early 1990s and resulting high unemployment. The consequent sharp increase in public debt, which is expected to reach 63.2% in 1995, calls for continuing efforts to reduce the deficit and also to ensure that the debt ratio complies with the requirements of the Treaty. The Finnish markka does not participate in the ERM. It has appreciated vis-à-vis the currencies of ERM-participating countries which have maintained price stability in the past two years. Long-term interest rates, which are below the reference value, have come down sharply in 1995 both in absolute terms and relative to other countries.

In *Sweden*, inflation rose during the spring of 1995 to around 3% but fell during the summer, following a tightening of monetary policy. Inflation stands below the reference value. Dual economy features and high wage settlements are, however, a cause for concern for price stability. The current Swedish public finance situation is adverse and a projected deficit of 7% of GDP in 1995 and a rising debt ratio of 81.4% are both well outside the reference values. Despite the sizable moves that have already been made there is a clear need for further consolidation in order to reduce the deficit to well below 3%. Such progress towards fiscal consolidation is also needed in order to sufficiently reduce the debt ratio and to bring it towards 60% at a satisfactory pace. Exchange rate volatility for the krona, which remains outside the ERM, was marked in 1995. It underwent a sizable depreciation during the first half of the year, followed by a corresponding appreciation. The long-term bond rate stands somewhat above the reference value for the twelve-month period since October 1994, although a reversal of the earlier widening of differentials has been observed more recently.

In the *United Kingdom*, inflation has increased in 1995 but remains below the reference value in the twelve-month period under consideration. Input cost pressures have been strong, although they have eased somewhat in recent months. Monetary policy has been tightened to address inflation risks. The deficit ratio for 1995 is expected to be 5.1% of GDP, which is not close to the reference value and is too high given the current state of the cycle. Further progress in fiscal consolidation is needed in order to reduce the deficit ratio to below 3%. The debt ratio, while rising, remains well below 60%. Sterling, which remains outside the ERM, has depreciated in 1995. Long-term bond yields are below the reference value.

CHAPTER II

MONETARY POLICY INSTRUMENTS AND THE PREPARATION OF THE PROCEDURES NECESSARY FOR CARRYING OUT A SINGLE MONETARY POLICY IN THE THIRD STAGE

Under Article 109f of the Treaty, the EMI is required to "prepare the instruments and procedures necessary for carrying out a single monetary policy in the third stage" and is required to "specify the regulatory, organisational and logistical framework necessary for the ESCB to perform its tasks in the third stage. This framework shall be submitted for decision to the ECB at the date of its establishment." The ECB will then make the final decision. As implied in Article 2 of the Statute of the ESCB and of the ECB, the legally stated primary objective of the ESCB to maintain price stability has to be the focus of the preparation of Stage Three while the corresponding instruments and procedures should be consistent with the principle of an open market economy with free competition, favouring an efficient allocation of resources. Furthermore, the operational framework should be consistent with the principle of decentralisation, i.e. that the national central banks are to be involved in the operations of the ESCB to the extent deemed possible and appropriate. The following describes successively the strategy of preparation adopted, the general issues regarding monetary policy strategy, and the progress made on the preparation of the monetary and foreign exchange policy operational frameworks and in the area of payment systems arrangements and of statistics.

The current report does not cover all the aspects of preparatory work in which the EMI is engaged. Details of the state of progress at that time, such as the preparation of the European banknote, may be found in the EMI's Annual Report, which was published in April 1995.

1. STRATEGY OF PREPARATION

The issue as to how the ESCB should operate so as to achieve the objective of price stability is to be tackled at two levels: in terms of the instruments and operational procedures to be employed, on the one hand, and in terms of the overall monetary policy strategy, on the other hand. As regards possible links between the choice of the monetary policy strategy and the design of monetary policy instruments and operating procedures, it is broadly accepted that such links are relatively loose. In the case of an intermediate monetary target or a final target, the link is even less direct than in the case of an exchange rate target. Thus, in general, a decision on the monetary policy strategy of the ESCB is not a prerequisite for the definition of its operational framework. It should only be ensured that the operational framework made available to the ESCB will be flexible enough to adjust to various situations, but those adjustments are not likely to be major even for quite different strategies. This gives the EMI the option to concentrate its work first on issues which may require a somewhat longer lead time for implementation, i.e. particularly specific features of monetary policy instruments and operational procedures.

The approach taken by the EMI in the preparations involves a number of steps. Firstly, monetary policy instruments, the evolution of which is monitored by the EMI, were compared across member countries and examined individually to assess whether they should be employed and, if so, what precise features they should have if they are to contribute to fulfilling certain functions. Most of this detailed examination of instruments has already been completed for the main generic types of instruments. The next step, to which much effort is currently being devoted, is to examine how the instruments can be optimally combined to form an operational framework for the conduct of monetary policy in Stage Three. Apart from the choice and the specification of the instruments' features, this includes issues of general relevance for the operational framework, such as the specification of the operational target, the degree of decentralisation of the execution of the ESCB monetary policy, and the possibility of remote access across the EU. Furthermore, other factors such as, for example, the structural liquidity position of the interbank market and its volatility, the structure of the financial markets, the integration of money markets or the legal environment, are also under consideration.

In addition, examination of various 'technical aspects' of instruments - such as a study of the lead time required for implementation of the operational framework, and a review of the assets which may be employed as collateral against the provision of central bank credit and of the supporting payments and securities settlement systems - is also under way.

Finally, work has recently been intensified on the issue of the monetary policy strategy in Stage Three. This work, which will deal with the general issues described below, currently involves the assessment of patterns of EU-wide money demand and the identification of the transmission mechanism of monetary policy in the EU.

2. GENERAL ISSUES REGARDING MONETARY POLICY STRATEGY

The key problem facing central banks in general is that the response of inflation to actions taken by the central bank occurs indirectly and with a significant lag. This means that actual inflation cannot be the guide for assessing the appropriate stance of monetary policy. Instead, the central bank must focus on additional information available to forecast future inflation and set its stance accordingly. This forward-looking approach enables central banks to take pre-emptive action against inflation, preventing it from emerging and becoming ingrained in people's expectations which, if it were to happen, would make it costly to eradicate. A monetary policy strategy has to meet two principal requirements. First and foremost, it should be effective in the sense that its pursuit leads to the desired outcome in terms of price stability. Secondly, it should be credible in the sense that market participants and other agents are confident of both the central bank's commitment to the final objective and its ability to achieve that objective.

In the discussions so far, three candidate strategies for Stage Three have been identified. These are exchange rate targeting, monetary targeting and inflation targeting. Exchange rate targeting is a strategy currently followed by many EU countries as a means of obtaining and maintaining price stability. This approach finds particular favour in smaller open economies where external influences on inflation are an important factor. For the single currency area as a whole, however, such an approach would not be appropriate. Monetary targeting and inflation targeting strategies - in contrast - seem more relevant candidates for Stage Three. The fundamental idea underlying the monetary targeting approach is that the principal source of inflation is excessive monetary growth and that, by controlling the growth of the money supply, price stability can be achieved. Therefore, for the adoption of such a strategy, it is necessary to have a stable, or at least predictable, relationship between the growth of the money supply and inflation. An inflation targeting strategy has been adopted by a number of EU and non-EU countries in recent years. In this case, the approach is to focus directly on expected future inflation. This involves the use of a wide range of available indicators to arrive at a projection of inflation in the future. Monetary policy is then set so as to be consistent with the achievement of price stability as defined by the target. In order to implement such an inflation target strategy, it is necessary that a predictable relationship exists between the set of indicators used and future inflation and that this relationship can be clearly explained.

The switch to Stage Three will represent a major regime shift which could result in significant changes in the behaviour of economic agents. Both approaches require further study of the transmission mechanism and the information content of various variables. The EMI will focus on the necessary background for both strategies in 1996.

3. MONETARY POLICY INSTRUMENTS AND PROCEDURES

3.1 Trends and recent evolutions in EU countries

Recent developments of monetary policy instruments and procedures in EU countries, in general, underline the progress towards convergence across EU countries. This progress was already evidenced by the increasing weight of open market transactions in central bank operations and the widening use of repurchase agreements across the EU. It was confirmed by the introduction of a regular gilt repo facility by the Bank of England. Similarly, the Bank of Greece extended the range of its monetary policy instruments by employing regular repurchase agreements based on a tender procedure. The Austrian central bank also introduced a regular open market facility based on repos. In addition, credit lines of standing facilities have been revised.

The Banque de France intends to adopt some changes in the framework of its interventions in the money market. As part of these reforms, the central bank will be allowed to withdraw liquidity by issuing its own debt paper, in line with the practice in several other countries.

Convergence can also be seen in the field of reserve requirements. The Bank of Finland, for example, introduced averaging provisions into its system of required reserves. The lowering of minimum reserve requirements in Portugal, Germany and Austria continued the trend towards reduced spreads between reserve ratios across EU countries. An exception, however, was Greece, where the reserve requirement ratio was increased (and the basis for the calculation of reserve requirements was broadened) in order to control liquidity and restrain credit expansion.

3.2 Guiding principles for the selection of monetary policy instruments

On the basis of national experience and following the provisions of the Treaty as well as the Statute of the ESCB and of the ECB, central banks have approved a number of general principles which may guide, in support of the overriding objective of price stability, the selection of monetary policy instruments:

- the principle of *operational efficiency* implies that the chosen instruments and procedures must enable the ESCB to control its targets efficiently. An important component of this efficiency criterion is that it ensures that the monetary policy signals of the ESCB will be uniform and consistent across the single currency area. Another component is that the operational framework will have to perform satisfactorily a set of operational functions which are themselves important for the achievement of the ultimate objective of monetary policy. Thus, the operational framework should enable the ESCB to steer money market rates and to ensure that their volatility is contained within the desired range. In addition, the monetary policy instruments should allow the ESCB to give signals of monetary policy intentions with an adequate degree of precision and differentiation. The operational framework should also be capable of providing basic refinancing, absorbing liquidity and influencing the structural position of the banking system vis-à-vis the central bank. Furthermore, the framework should be such as to enhance the extraction of information from market developments, facilitate monetary control, without at the same time distorting the relationship between monetary aggregates and the price level, and allow for the smooth functioning of payment systems. The relative importance of these functions, however, will depend on the final decisions on the framework and strategy;
- the chosen instrument set should *conform to the market principles* contained in the Treaty; that is, monetary policy implementation should be "in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources" (Article 105);
- the principle of *equal treatment* should apply so that the ESCB will treat all groups of financial institutions that have access to its facilities equally and regardless of their country of origin;
- the monetary policy instruments and procedures should, as far as possible, be *simple and transparent*;
- *decentralisation* should be a feature, with the ESCB having recourse to the national central banks to carry out operations "to the extent deemed possible and appropriate" (Article 12 of the ESCB Statute). Such involvement would enable the use of extensive operational experience of central banks, reducing adjustment costs and transitional problems at the start of Stage Three. In view of the desirability of *continuity,* the new operational framework should rely as much as possible on the existing infrastructure and on central bank experience, provided that the application of this principle does not conflict with the other guiding principles. A single monetary policy stance requires that a single interbank interest rate prevails throughout the single currency area. This implies that decisions on the

use and key terms of all monetary policy instruments - in particular the interest rates on open market operations and standing facilities - are taken at the centre. Therefore, the involvement of the national central banks in the operation of the single monetary policy "to the extent deemed possible and appropriate" refers to the execution of operations decided by the ECB. Also, while decentralisation is a desirable principle, it is important to ensure that it is subordinated to the principle of operational efficiency;

- the instruments to be employed should be *harmonised to the extent necessary* across countries to ensure a single monetary policy stance across the single currency area, equal treatment and avoid regulatory arbitrage. This harmonisation is also a necessary counterpart of decentralisation;
- furthermore, the general principles for the selection of monetary policy instruments also include *conformity with the decision-making framework* of the ESCB and *cost efficiency.*

3.3 Financial market structure and implications for monetary policy instruments

Apart from these principles, other factors will eventually have an impact on the shape of the operational framework of monetary policy. For example, account must be taken of the existence of differences in financial market structure across EU countries. These differences relate, inter alia, to the degree of development of financial markets, the use of certain forms of debt instruments, and the structure of the banking and financial system. At the same time, the full integration of money markets in Stage Three is necessary in order to ensure the emergence of a single monetary policy stance.

The operational framework of the ESCB has to be prepared against the background of uncertainty about the financial market structure in Stage Three which results, for example, from the rapid evolution of EU financial markets under the influence of deregulation, innovation, globalisation and the Single Market. This general uncertainty calls for the design of an operational framework which will allow the ESCB to exercise flexibility when deciding on the use and features of instruments to be implemented.

In general, however, the structure of financial markets may not necessarily be a major constraint on the selection of the operational framework. Financial market structure may also adjust to features of the operational framework. While the operational framework can influence financial market structure, the choice of the framework should not be based on the aim of encouraging particular market structure developments. The choice of the operational framework must rather be made on the grounds of operational efficiency and adherence to the guiding principles enshrined in the Statute of the ESCB and of the ECB, most notably to those of operational efficiency and conformity with market principles.

3.4 Monetary policy instruments

Following all the above considerations, the EMI has examined, without coming to final conclusions, the usefulness and desirable properties of the three main generic types of instruments available: open market operations, standing facilities and reserve requirements.

3.4.1 Open market operations

In the overwhelming majority of EU countries, open market operations play a pivotal role in the operation of monetary policy, being the primary instrument by which money market interest rates are steered. This approach reflects the increasing flexibility and market orientation of monetary policy in EU countries and the desire to promote the development of interbank markets as an efficient means of allocating liquidity. It is widely believed that this approach should be continued in Stage Three and that open market operations should play the dominant role in the management of money market conditions.

Reversed transactions (repos) currently play a dominant role in EU countries and this is likely to continue in Stage Three. The main advantage of this instrument is the flexibility with which it can be employed, with the central bank retaining the initiative regarding the timing, frequency, amounts and maturity of the operations. Also, repos have no direct effect on the price of the underlying asset and enable a wide spectrum of paper to be employed in the operations.

Outright transactions are employed in a number of EU countries and are also likely to be available to the ESCB. If such transactions were undertaken in longer-term assets this would enable the central bank to achieve a longer-term change in its overall lending/borrowing position vis-à-vis the commercial banks. However, the instrument is in some respects less flexible than repos.

Foreign exchange swaps are also likely to be available, in principle, to the ESCB and may be particularly useful in certain circumstances, for example, when there is a shortage of domestic collateral or when stabilising the central bank's balance sheet in the face of significant changes in foreign reserves is desirable. However, potential disadvantages of this instrument, including a relatively long settlement lag and the tendency for the instrument to inhibit the development of domestic money markets, have to be considered.

As regards the withdrawal of liquidity, the issue of central bank paper or the collection of fixed-term deposits should be available, with the former being particularly useful for absorbing more structural surpluses in the money market while the latter may be more suited to dealing with temporary surpluses.

In addition to regular open market operations, which should be based on a predetermined timetable in order to facilitate banks' liquidity planning and to enhance the ability to convey signals, a need may arise from time to time to engage in additional open market operations to offset large unexpected liquidity shocks and, if circumstances require, to actively guide the short-term money market rates on a day-to-day basis. The option of conducting such fine-tuning operations should be available to the ESCB. A range of instruments and techniques could be employed in order to maximise the flexibility of the central bank in this regard.

3.4.2 Standing facilities

In line with the increasing market orientation of monetary policy, and in order to ensure maximum flexibility for the ESCB, open market operations are seen as being the pivotal instrument in the conduct of monetary policy, providing the main means of supplying/withdrawing liquidity and steering interest rates. As a result, standing facilities, i.e. facilities which may be used at the discretion of individual central bank counterparties, could include a marginal lending facility and a deposit facility.

Two other facilities, both of which involve the provision of liquidity by the central bank at rates normally below market rates are also being studied: a discount facility - involving the outright purchase of private bills of exchange - and a collateralised lending facility. Experience with these facilities is limited to only a few central banks.

3.4.3 Reserve requirements

The preliminary analysis started from an assessment of the advantages and disadvantages of reserve requirements, based primarily on the experience of national central banks. Two important functions of a compulsory reserve system pertain to money market management. The first is the creation and maintenance of a structural shortage in the money market when this is deemed necessary (enlarging function). The second is the stabilisation of money market interest rates if reserve requirements are combined with averaging provisions (stabilising function). Furthermore, compulsory reserves, if not fully remunerated, may increase the central bank's leverage over money demand by driving a wedge between the interest rates on monetary and non-monetary assets or by enlarging an existing wedge. On the other hand, less-than-fully remunerated reserves may diminish the information content of monetary aggregates and the potential relationship with final variables.

A full assessment of the relative merits of required reserves will only be possible with reference to the main features of the operational framework to be adopted. However, some basic principles which could govern decisions in the area of compulsory reserves for Stage Three have been discussed. Reserve requirements should figure among the set of monetary policy instruments potentially available to the ESCB, even though the decision on the actual use of this instrument, and on some of its features, will have to be taken in view of the operational framework of the ESCB, as well as the economic and financial conditions prevailing in Stage Three. Should a system of compulsory reserves be used, it should be fully harmonised across all Member States participating in the single currency area, so as to allow for its decentralised operation. In order to facilitate harmonisation, the system should be relatively simple. Furthermore, a decision on the possible use of reserve requirements should be based on an assessment of all the potential functions of such a system and of the extent to which these can be performed by alternative instruments. A system of reserve requirements should also be designed in such a way that it does not induce undesired delocation or disintermediation. Therefore, both the selection of the liabilities which may be subject to reserve requirements and the combination of reserve coefficients and rates of remuneration which may be specified will need to be studied carefully. Such a study is under way. Finally, while the system of compulsory reserves should be designed so as to perform potentially both money market management and monetary control functions, in cases of conflict between the two functions the technical features should be chosen so as to give priority to money market considerations.

3.5 Assessment

It should be reiterated that further preparatory work on the various types of instruments and their specific features must await the finalisation of the discussion on the operational framework.

Nonetheless, considerable progress has been made in the preparation of monetary policy instruments and procedures. This refers, in particular, to the examination of the main generic types of monetary policy instruments and to the issue of how the individual instruments will be combined to form an operational framework for monetary policy, as well as to the selection of eligible assets for mobilisation and pledging in monetary policy operations of the ESCB. Detailed blueprints for the use of the various types of monetary policy instruments will be drafted in 1996.

4. FOREIGN EXCHANGE POLICY OPERATIONAL FRAMEWORK FOR STAGE THREE OF EMU

4.1 Introduction

From the beginning of Stage Three of EMU the European System of Central Banks (ESCB) will have to conduct foreign exchange operations as well as hold and manage the official foreign reserves of participating Member States. The operational framework for the performance of these basic tasks has therefore to be prepared ahead of time. Several areas are of particular relevance in devising such a framework. These include: the organisation of foreign exchange intervention, the management of the ECB's and NCBs' foreign reserves, the transfer of foreign reserve assets from the NCBs to the ECB and exchange rate relationships with the currencies of Member States not participating initially in the single currency area.

In accordance with its programme of preparatory work, the EMI has made progress in designing an organisational framework for conducting foreign exchange intervention and guidelines for monitoring the NCBs' and Member States' operations in foreign assets which will not be transferred to the ECB in Stage Three of EMU.

4.2 Organisation of foreign exchange intervention

Whatever the exchange rate regimes which will prevail between the European currency, on the one hand, and currencies of non-participating EU Member States or those of non-

EU countries, on the other hand, foreign exchange intervention should be an instrument at the disposal of the ESCB from the start of Stage Three.

Given that the degree of centralisation is the main factor for differentiating alternative organisational frameworks, two basic options are being considered in greater detail: a centralised set-up, in which intervention operations would be carried out exclusively by the ECB; a decentralised set-up, implying that all NCBs would be given instructions by the ECB to execute intervention. These approaches would share two common features: first, the ECB would be ultimately responsible for any decision regarding intervention operations, in line with the principle of singleness of foreign exchange policy; second, market counterparties would be located in all member countries participating in the single currency area but also possibly in non-participating EU Member States or in third countries.

It was decided to make these options available to the ESCB. Indeed, it seems advisable to retain some room for manoeuvre in the future organisational framework in view of possible adjustments to be made in the light of experience and prevailing conditions. Furthermore, the two basic options are deemed to be mutually compatible in a technical sense since, inter alia, their information requirements would be largely similar and part of their common infrastructure is already in place at the level of national central banks.

On the basis of this decision to enable the ESCB to resort, over time, to either of the options, it has been agreed to carry out follow-up work in several areas:

- in the operational area: first, the criteria for the selection of market counterparties will be defined on the basis of NCBs' current practices and in line with market principles and equal treatment; second, the methods to be used for monitoring counterparties' risks as well as settlement procedures, including possible collateralisation, will be established after reviewing existing rules at EU central banks; third, the need for some harmonisation of back-office procedures will also be examined;

- in the telecommunications area, the telephone network used by NCBs to exchange, on an ongoing basis, information and data on market developments will be upgraded. A feasibility study has been completed and a new telecommunications system, which will improve both the capacity and the functions offered by the present network, is being developed. This will allow all national central banks in the ESCB to take part in the monitoring of market conditions and reporting of market feedback in the context of foreign exchange intervention;

- in the field of information technology, another feasibility study has been initiated in order to specify the technical requirements of an information and communications system interlinking the NCBs' existing market dealing infrastructure and similar facilities set up at the ECB.

4.3 Guidelines for monitoring the NCBs' and Member States' operations in foreign reserve assets

In Stage Three of EMU, following the transfer of part of their foreign reserve assets to the ECB, the NCBs will retain part of their external reserves. Likewise, Member States will be allowed to hold and use foreign exchange working balances. However, since foreign exchange operations by the NCBs and Member States should not interfere with the exchange rate and monetary policies of the single currency area, Article 31 of the Statute provides that "the [ECB] Governing Council shall issue guidelines with a view to facilitating such operations". Therefore, guidelines will be devised.

The design of these guidelines needs to take into account the potential effects of the NCBs' and Member States' foreign exchange operations on the ECB's policies. Transactions against the European currency effected by the NCBs as fiscal agents for their respective governments (i.e. external debt servicing, IMF-related operations) or on behalf of other customers (i.e. foreign exchange sales or purchases against the European currency to cover flows arising from current account transactions) are likely to affect, in most instances, both monetary conditions and exchange rate developments in the single currency area. Other transactions, which would not be conducted against the European currency (i.e. cross-currency transactions related to reserve assets management or interest income accruing on the NCBs' reserve holdings), would have fewer policy implications. However, although these operations would not directly affect the ECB's exchange rate and monetary policies through changes in the single currency area's monetary base or monetary aggregates, they may have a bearing on exchange rate developments. Member States' foreign exchange operations (i.e. foreign exchange borrowing or conversion of external assets into the single currency) may, under certain circumstances, also have a bearing on monetary aggregates or on the single currency area's exchange rate policy.

On the basis of this assessment a number of principles for designing the guidelines were agreed upon.

First, all operations that the NCBs and Member States may perform with or without approval should be included in a comprehensive list established and updated, as need be, by the ECB. Second, the ECB should monitor these operations through reporting and prior approval procedures to safeguard the singleness of the European currency area's exchange rate and monetary policies (while allowing some flexibility in the conduct of these operations by the NCBs and Member States). In view of these two distinct requirements, the prior approval procedure would apply only to operations deemed to be most sensitive and above thresholds which should be decided once the formal guidelines are adopted, at a time when the relevant monetary variables within the single currency area can be determined more accurately. Third, as a rule, reporting and prior approval requirements would be more stringent - in terms of frequency or thresholds - for operations against the European currency than for reserve management transactions, given the greater policy implications of the former. Fourth, a distinct set of guidelines, following broadly similar principles, would be applicable to Member States' operations with their foreign exchange working balances. In this framework, NCBs may be used as channels between the ECB and their respective Member States.

The above-mentioned criteria have been taken note of by the EMI Council and follow-up work upon its request is proceeding in two areas. First, the formal guidelines will be drawn up in collaboration with legal experts before their submission to the EMI Council and their final approval by the ECB Governing Council. Second, appropriate technical facilities would be needed to support the reporting and prior approval procedures, which would allow the ECB to monitor the NCBs' and Member States' operations. In this respect, as well as for organising foreign exchange intervention, a new upgraded teleconference network (see above) should prove useful in meeting some of these requirements. In addition, a feasibility study is being prepared to design an information and telecommunications infrastructure to enable exchange of the required operational data.

5. PAYMENT SYSTEM ARRANGEMENTS FOR STAGE THREE OF EMU

5.1 Introduction

The implementation of the single monetary policy implies specific requirements for payment systems, in particular with respect to interbank funds transfer systems (IFTS).

In all EU countries, the impact of monetary policy operations is currently transmitted to money markets through large-value interbank funds transfer systems which settle in the books of the central bank. Once the single currency area is established, there will be a need, as in any country, for a payment arrangement by which the operations between the central bank and the banking system can be effected quickly and safely. Moreover, as in any monetary area, an integrated money market, in which the single monetary stance applies in identical terms throughout the single currency area, requires payment arrangements that are technically efficient, would minimise systemic risks and would be cost-effective.

An area-wide IFTS will be established in order to meet these objectives. This system will aim at improving the soundness of EU large-value payment systems in Stage Three. In November 1993, EU central banks agreed that in order to reduce systemic risks associated with domestic payment systems, each Member State should have a real-time gross settlement (RTGS) system into which as many large-value payments as possible should be channelled; this would provide a sound basis for the creation of an EU-wide large-value interbank funds transfer system in Stage Three of EMU.

In November 1994, the EMI Council adopted a note on "The EMI's intentions with regard to cross-border payments in Stage Three" which was communicated to the national banking communities. It explained that the EU central banks intended to link the domestic RTGS facilities which they already offered, or intended to offer soon. In May 1995, the EMI Council released a report on the TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) system, a payment mechanism for Stage Three of EMU which would include the national RTGS systems and their linkages. The aim of that report is: 1) to provide further information to interested parties on how this new payment arrangement is intended to work; and 2) to further the process of consultation with banking communities.

5.2 The TARGET system

The development of the TARGET system will follow in particular the guiding principles of market-orientation and decentralisation which stem from the Treaty on European Union.

The *market principle* is drawn from Article 2 of the ESCB Statute, according to which "the ESCB shall act in accordance with the principle of an open market economy with free competition ...". In accordance with this principle, use of the TARGET system will not be compulsory for credit institutions, even for large-value payments (except where they are directly related to the implementation of monetary policy) in which the ESCB is involved either on the recipient or the sender side.

The *decentralisation principle* is established by Article 12.1 of the Statute: "To the extent deemed possible and appropriate ... the European Central Bank (ECB) shall have recourse to the national central banks to carry out operations which form part of the tasks of the ESCB". Following this principle, the future system will be organised around infrastructures and settlement accounts to be maintained at the level of the national central banks (NCBs).

In developing the TARGET system EU central banks and the EMI have adopted a strategy based on a minimum approach: aiming to minimise the time and costs required to establish a fully operational system while meeting the objectives assigned to the ESCB by the Treaty. The TARGET system is designed in such a way that it will be able to process cross-border payments as if they were domestic payments. The System will also facilitate the settlement of cross-border EU net settlement systems. In the beginning, it is expected to process almost exclusively large-value payments. These payments will be processed through the national domestic RTGS systems which will be linked by an Interlinking system (see 5.3 below). However, EU central banks and the EMI do not intend to prescribe the use of the new system for any specific categories of payments, except those stemming from the implementation of monetary policy, or prevent its use for some other categories. Other systems will remain for retail payments and may also remain for large-value ones provided that they meet safety standards which are not significantly weaker than those of the TARGET system.

The detailed operational features of the system will be defined during the first half of 1996 by the EMI and EU central banks. During the process there will be close contact with other parties (such as credit institutions) which have an interest in these issues.

5.3 The components of the TARGET system

The TARGET system will be composed of: one RTGS system in each of the countries which participate in the single currency area, the ECB payment mechanism and the linkages between these systems, called the Interlinking System, which will be set up according to common procedures to allow payment orders to move from one system to another. From the beginning of Stage Three the Interlinking System will operate in the European currency and national RTGS systems will be capable of operating in that monetary unit. RTGS systems of non-participating EU countries may also be connected to TARGET, provided that they are able to process the European currency alongside their national currency.

5.3.1 The RTGS systems

Only national RTGS systems will be connected to the Interlinking System and will be a part of the TARGET system. Since domestic RTGS systems represent a basic infrastructure of the payment arrangements for Stage Three of EMU, they are expected to be in operation in all the EU countries before the end of 1997 (see Table 1). More precisely, the situation is the following:

- in Denmark, Germany, Sweden and Finland, RTGS systems are already in operation;
- in Italy and the Netherlands, the existing RTGS systems are being completely redesigned;
- in Austria, the intraday gross settlement system (EBK) is being transformed into an RTGS system;
- in the United Kingdom, the existing net settlement system, CHAPS, is being transformed into an RTGS system;
- in Belgium and Greece, the large-value net settlement systems are being replaced by RTGS systems;
- in Spain and Ireland, the end-of-day gross settlement systems will be converted into RTGS systems;
- in France, Luxembourg and Portugal, completely new RTGS systems are being or will be implemented.

Some harmonisation of domestic RTGS systems is intended to avoid impediments to the efficient conduct of the single monetary policy and distortions in competition between credit institutions. In this framework, a certain level of harmonisation of the features of RTGS systems may be necessary in the following three areas: i) the provision of intraday liquidity; ii) operating hours; iii) pricing policies. Other relevant features, such as access criteria to TARGET or the conditions under which queuing facilities are managed may not require harmonisation.

Table 5.3

IMPLEMENTATION OF RTGS SYSTEMS IN EUROPEAN UNION COUNTRIES

COUNTRY	B	DK	D	SP	GR	F	IE	I	NL	P	UK	O	S	FIN
Name of the system	ELLIPS	DNF	EIL-ZV/ AZV	SLBE	Hermes	TBF	IRIS	BIREL	TOP	SPGT	CHAP S	EBK	RIX	BOF
System already in operation[1]	No	Yes	Yes	No	No	No	No	No	No	No	No	No	Yes	Yes
Date of starting		1981	1988										1990	1991
Start of work	Mar 1992	1980	1985	Dec 1992	Sep 1993	Dec 1990	Dec 1993	Dec 1992	1991	Mar 1993	1989	Dec 1993	1988	1989
General specifications	Jun 1993	1981	1986	Jun 1993	Dec 1993	Dec 1994	Jan 1995	Sep 1994	1992	Jun 1993	1992	Dec 1993	1989	1989
Detailed specifications	Sep 1994	1981	1986	Sep 1994	Apr 1995	Sep 1995	Sep 1995	Mar 1995	1993	Dec 1993	1993	Jun 1995	1990	1989
Implementation of project	Jan 1995	1981	1987	Jan 1995	1996	1996	1996	Sep 1995	1994	Jun 1994	1994	1996	1990	1990
System fully in operation	Jun 1996	1981	1988	Jun 1997	Dec 1996	Dec 1996	Dec 1996	June 1997	June 1996	Dec 1995	Jun 1996	Dec 1997	1990	Mar 1991

1 Real-time book entries on a gross basis are already possible in Austria (via the EBK system which has been available since 1989), Italy (via the BISS, which has been available since 1989) and the Netherlands. However, these systems will be transformed or completely redesigned.

5.3.2 The Interlinking System and the ECB mechanism

The term Interlinking designates the infrastructures and the procedures (within each RTGS system or in addition to the RTGS systems) which are used to process cross-border payments from one country to another within TARGET. Only the ECB and the NCBs, as settlement agents of the national RTGS systems, will be allowed to make use of the Interlinking procedures, for their own purposes and on behalf of the RTGS systems' users.

In Stage Three of EMU, the ECB may handle banking operations and carry out its own payment transactions. Therefore, a payment mechanism will be necessary to enable the ECB to process its own payments through the TARGET system.

The participation of the ECB in the Interlinking System will also have the advantage of allowing the System to facilitate settlement between NCBs within TARGET, and the settlement of cross-border EU net settlement systems.

The ECB payment mechanism is currently being designed.

6. STATISTICS

As mentioned earlier, the Treaty requires the EMI to prepare the regulatory, organisational and logistical framework to enable the ESCB to assume its duties at the start of Stage Three, and to "promote the harmonisation, where necessary, of the rules and practices governing the collection, compilation and distribution of statistics in the areas within its field of competence". This involves ensuring the availability of properly articulated single currency area statistics in Stage Three.

The early stages - of establishing prospective needs, compiling an inventory of available statistics, and assessing the gaps to be filled - were described in the EMI's Annual Report for 1994. In the course of 1995, further work has been carried out on a "Monetary Financial Institution" sector (a definition having been agreed by the EMI Council in late 1994). Conceptual work has been done, all in the context of statistical needs for Monetary Union, on interest rates, capital issues, commercial bank and central bank balance sheets, and collective credit institutions. In the area of balance-of-payments statistics, work has been done on direct, portfolio and "other" investment, and on other balance-of-payments matters. More remains to be done in some of these areas. Since statistical changes often take a long time, however, implementation lags are already under consideration for a report to the EMI Council in early 1996.

In order to assess the progress towards convergence in the Community, the EMI must take a close interest in the relevant areas of statistics. The EMI has accordingly collaborated with the Commission in developing a harmonised index of consumer prices, and in preparing statistics of government deficits and debt. Furthermore, the EMI has devoted considerable efforts to developing statistics on long-term government bond yields for the purpose of assessing convergence.

The Treaty gives the Commission responsibility for statistics relating to convergence. In July the EMI Council endorsed a report which, following consideration of the ECB's prospective functions and the location of statistical expertise in most Member States, recommended that the ECB should be primarily responsible at European level for monetary and banking statistics, and should share responsibility with the Commission (EUROSTAT) for balance-of-payments statistics and financial accounts. A second report considered how the necessary co-operation at European level, in the first instance between the EMI's Statistics Division and EUROSTAT, could be achieved. The Commission (EUROSTAT) was consulted in the preparation of these reports. As a further contribution to the planning for Stage Three, a third report considered the organisation of statistical work in the ESCB, in particular the functions of the ECB and the national central banks respectively.

CHAPTER III

STATUTORY REQUIREMENTS TO BE FULFILLED BY NATIONAL CENTRAL BANKS TO BECOME AN INTEGRAL PART OF THE ESCB

1. GENERAL OBSERVATIONS

1.1 Introduction

Article 7 of the EMI's Statute requires that the reports to the Council on the state of preparations for the third stage shall include an assessment of "the statutory requirements to be fulfilled for national central banks to become an integral part of the ESCB". Article 109j (1) of the Treaty requires the EMI (as well as the Commission) to report, by the end of 1996 at the latest, inter alia on "the compatibility between each Member State's national legislation, including the statutes of its national central bank, and Articles 107 and 108 of this Treaty and the Statute of the ESCB". Article 108 of the Treaty, as reproduced in Article 14.1 of the Statute, states in this connection that Member States shall ensure, at the latest at the date of the establishment of the ESCB, that their national legislation, including the statutes of their national central banks (NCBs), are compatible with the Treaty and the Statute.

The EMI has started examining the legislative measures which need to be taken by the Member States with a view to complying with the Treaty. The results of this first examination are presented below. Work in this area will continue with a view to reaching definitive conclusions for the report to be submitted in accordance with Article 109j of the Treaty.

1.2 Scope of adaptation

1.2.1 Areas of adaptation

For the purpose of identifying those areas where adaptation of statutes may be necessary, a distinction may be drawn between:

- independence of NCBs (see in particular Articles 107 of the Treaty and Articles 7 and 14.2 of the Statute); and
- integration of NCBs in the ESCB (see in particular Articles 12.1 and 14.3 of the Statute), independence, incidentally, being a particular feature of integration.

The Statute contemplates an important role for the Governors of the NCBs in the formulation of monetary policy (via their membership in the Governing Council of the ECB) and for the NCBs in the execution of the operations of the ESCB (see Article 12.1 of the Statute, last paragraph). With regard to ESCB-related tasks, NCBs' independence is, therefore, a prerequisite for ESCB independence and, thus, it will be essential that the NCBs enjoy the same level of independence in the performance of these tasks vis-à-vis external bodies as will the ECB. Article 109e (5) of the Treaty clearly illustrates the link between Article 108 and central bank independence when it states that, during Stage Two, each Member State shall, as appropriate, start the process leading to the independence of its central bank, in accordance with Article 108.

Article 14.3 of the Statute states that NCBs shall be an integral part of the ESCB, shall act in accordance with guidelines and instructions of the ECB and that the Governing Council shall take the necessary steps to ensure compliance with such guidelines and instructions. Non-compliance could, ultimately, lead to a procedure before the European Court of Justice under Article 35.6 of the Statute. Article 14.3 reflects the basic principle that the ESCB is an autonomous, self-regulatory system in which its components need to be in a position to comply with decisions taken by the highest decision-making body of the system, the Governing Council. Any provisions in national legislation (particularly in NCB statutes) which would prevent compliance with decisions from the centre would be incompatible with the effective operation of such a system. Therefore, to enable the creation of such a system, adaptations to national legislation and NCB Statutes may be necessary to ensure compatibility with the Treaty and the Statute. In addition, the adoption of 'enabling provisions' in the statutes of NCBs ensuring that NCBs can indeed operate as an integral part of the ESCB may, depending on the content of a particular NCB's statutes and its domestic legal environment, also be appropriate. Details of changes which may be required to enable integration are likely to emerge as preparations for Stage Three proceed and, in some cases, will vary from NCB to NCB.

1.2.2 'Compatibility' versus 'harmonisation'

Article 108 of the Treaty stipulates that national legislation shall be 'compatible' with the Treaty and the Statute. The term "compatible" indicates that the Treaty does not require the "harmonisation" of NCBs' statutes, either inter se or with that of the ECB. National particularities may continue to exist. Indeed, Article 14.4 of the ESCB Statute permits NCBs to perform functions other than those specified in the ESCB Statute, to the extent that these do not interfere with the objectives and tasks of the ESCB. Provisions enabling such additional functions would be a clear example of circumstances where differences in NCB statutes may continue. Rather, the term "compatible" implies that national legislation and statutes of the NCBs need to be adjusted in order to eliminate inconsistencies with the Treaty. In particular, while national traditions may continue to exist, all provisions which infringe on an NCB's independence as defined in the Treaty and its role as an integral part of the ESCB have to be adjusted. Also, the above does not preclude that statutes of NCBs for reasons of transparency and legal security, where appropriate, would nevertheless follow the wording of the relevant provisions of the Treaty and the Statute as closely as possible in order to avoid any confusion.

1.2.3 Timetable for adaptation

Article 108 of the Treaty requires national legislation to be compatible "at the latest, at the date of establishment of the ESCB" (which, under Article 109l (1) of the Treaty, will be earlier than the starting date of Stage Three). Timely adaptation during Stage Two will not only ensure that time-consuming legislative processes are accommodated, but will also allow relevant authorities, such as the EMI, the time to review proposed adaptations of national legislation and, specifically, of NCB statutes in the framework of reports under Article 7.1 of the EMI's Statute and 109j of the Treaty.

Article 109e (3) of the Treaty stipulates that the provisions of Article 107 shall apply "from the beginning of Stage Three". Despite this apparent inconsistency with Article 108 of the Treaty, it is submitted that NCBs should become effectively independent by the date of the establishment of the ESCB. Clear support for this view can be found in Article 109e (5), which expressly states that the process leading to NCB independence should be commenced during the second stage. Indeed, unless this provision is interpreted to indicate advance adaptation, it would lack any meaning.

Also, from a practical perspective, it is obvious that adaptation needs to be fully effective by the date of the establishment of the ESCB at the latest. Before the start of Stage Three, the ECB's Governing Council will have to decide upon the policy framework of the ESCB. At this crucial stage, it is important that the Governors, who will sit on the Governing Council, come from fully independent NCBs. Therefore, weighing up the text and rationale of Articles 108 and 109e (5) against Article 109e (3) of the Treaty warrants the opinion that the statutes of NCBs should be consistent with Article 107 of the Treaty no later than the date of establishment of the ESCB in order to ensure that NCBs enjoy full independence with respect to ESCB-related tasks.

Other statutory requirements must, by nature, only enter into force at the moment that the integration of an NCB into the ESCB becomes effective, i.e. the starting date of Stage Three, or in the case of a Member State with a derogation, the date at which it joins Monetary Union.

1.3 Member States with a derogation, Denmark and the United Kingdom

1.3.1 Member States with a derogation

In relation to the application of Article 108, the Treaty and the Statute do not make a distinction between Member States with and Member States without a derogation. Also, Article 109k of the Treaty and Article 43 of the Statute do not provide for an exemption to the obligation to ensure central bank independence for Member States with a derogation. A derogation only implies, in accordance with these Articles, that the respective NCB retains its powers in the field of monetary policy and participates in the ESCB on a restricted basis until the date on which the Member State joins Monetary Union.

1.3.2 Denmark

Protocol No. 12 of the Treaty on certain provisions relating to Denmark states that the Danish Government shall notify the Council of its position concerning participation in Stage Three before the Council makes its assessment under Article 109j (2) of the Treaty. Denmark has already given notification that it will not participate in Stage Three. In accordance with Article 2 of Protocol No. 12, this means that Denmark will be treated as a country with a derogation. The implications thereof for Denmark have been elaborated in a Decision taken by the Heads of State or Government at their Edinburgh Summit meeting on 11th and 12th December 1992. This Decision states that Denmark will retain its existing powers in the field of monetary policy according to its national laws and regulations, including the powers of Danmarks Nationalbank in the field of monetary policy.

1.3.3 United Kingdom

According to Protocol No. 11 of the Treaty on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland, the United Kingdom shall be under no obligation to move to Stage Three unless it notifies the Council that it intends to do so. The same Article requires that the United Kingdom shall notify the Council whether it intends to move to Stage Three before the Council makes its assessment under Article 109j (2) of the Treaty. If no date for the beginning of Stage Three is set under the procedure outlined in Article 109j (3) of the Treaty, the United Kingdom may notify its intention to move to Stage Three before 1st January 1998. In the event that the United Kingdom notifies the Council that it will not move to Stage Three, Article 2 of Protocol No. 11 will exempt the United Kingdom from the impact of, inter alia, Articles 107 and 108 of the Treaty. Therefore, modifications will be required by the United Kingdom to comply with these provisions if it gives notice to the Council that it does intend to move to Stage Three.

2. STATUTORY REQUIREMENTS RELATING TO THE INDEPENDENCE OF NCBs

2.1 General remarks

The ESCB will have the exclusive right and duty to define and implement monetary policy. Independence from political authorities will allow the system to define a monetary policy aimed towards the statutory objective of price stability. Independence also requires the system to possess the powers necessary to implement monetary policy decisions.

Central bank independence is also a prerequisite for Monetary Union. The institutional aspect of Monetary Union requires monetary powers, currently held by Member States, to be pooled in a new system, the ESCB. Such pooling would not be acceptable if Member States could influence the decisions taken by the governing bodies of the ESCB.

Finally, central bank independence is instrumental in the credibility of the move to Monetary Union. The favourable experience of a number of countries which have formed independent monetary authorities is particularly relevant for a plural community of nation states. In such a community, competing interests are likely to lead to greater pressures arising for monetary policy to be influenced by short-term considerations. Unless a sufficient level of independence exists to allow such pressures to be resisted, a monetary policy stance might develop which is incompatible with price stability in the longer term.

Central bank independence finds its limits in statutes defining the objective of a central bank and the scope of its powers, as well as in the review by the judiciary of specific administrative acts addressed to one or more parties. Central bank independence merely aims at attributing (not delegating) the responsibility for monetary policy to an independent institution.

2.2 Provisions in the Treaty on independence of NCBs

The principle of central bank independence has been elaborated in different articles of the Treaty and the Statute, from which various features of central bank independence may be deduced.

2.2.1 Institutional independence

Article 107 of the Treaty, as reproduced in Article 7 of the Statute, prohibits the ECB, the NCBs and members of their decision-making bodies from seeking or taking instructions from Community institutions or bodies, from any government of a Member State or from any other body. It prohibits Community institutions and bodies and the governments of the Member States from seeking to influence the members of the decision-making bodies of the ECB or of the NCBs.

According to Article 107 of the Treaty, the prohibition on instructions and attempts to influence applies to the exercise of the powers and the performance of the tasks and duties conferred by the Treaty upon the ESCB and its components. The main tasks of the ESCB are defined in Article 3 of the ESCB Statute:

- to define and implement the monetary policy of the Community;
- to conduct foreign exchange operations consistent with the provisions of Article 109 of this Treaty;
- to hold and manage the official foreign reserves of the Member States;
- to promote the smooth operation of payment systems.

The reference in Article 107 to the tasks and duties of the ESCB implies that the independence requirement is restricted to all ESCB-related tasks. In other fields of activity, instructions are not forbidden. This applies, for example, to NCBs in fulfilling the function of fiscal agent (Article 21.2 of the Statute) or other tasks permitted within the limitations of Article 14.4 of the Statute, which states that NCBs may perform functions other than those in the ESCB Statute, unless the Governing Council finds, by an appropriate majority, that these interfere with the objectives and tasks of the ESCB.

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

Article 107 refers to any effort to influence. However, this should not be interpreted in such an extensive way that it would preclude a dialogue between NCBs on the one hand and government and other state bodies (parliament, etc.) on the other. The crucial issue is whether a national institution has any mechanism at its disposal to ensure that its views influence decisions taken by the Governing bodies of the ESCB in the performance of their tasks, either through the right to interfere with any decision reached or the right to vote on decisions. Also, in Stage Three, the primary responsibility for the fulfilment of the ESCB's tasks is vested in the Governing Council of the ECB. Dialogue with political authorities then takes place mainly at a Community level.

2.2.2 Personal independence

Central bank independence is further substantiated by the provision of the Statute which provides for security of tenure for members of the ESCB's decision-making bodies. Article 14.2 of the Statute states that the statutes of NCBs shall, in particular, provide for a minimum term of office of a Governor of five years. It also gives protection against the arbitrary dismissal of Governors, by stating that a Governor may be relieved from office only if he/she no longer fulfils the conditions required for the performance of his/her duties or if he/she has been guilty of serious misconduct, with the possibility of appeal to the European Court of Justice. Statutes of NCBs will need to conform to this.

Such independence would be further enhanced if the same rules were also applied to other members of decision-making bodies of NCBs dealing with ESCB-related tasks. Article 107 of the Treaty and Article 7 of the Statute explicitly refer, inter alia, to "members of the decision-making bodies of the national central banks". Another ground for the extension of the security of tenure to other members of NCB decision-making bodies is the fact that they may have to deputise for the Governor in the Governing Council of the ESCB (see Article 10.3 of the Statute).

Article 107 of the Treaty and Article 14.2 of the Statute specify examples of features of central bank independence. However, as external influence on decision-making bodies of NCBs may take many different forms, their independence needs to be assessed on a case-by-case basis in the context of the legal framework in which an NCB operates.

2.2.3 Functional independence

NCBs in Stage Three operate in a framework of which the objectives are determined by Article 2 of the Statute. The core element of this Article is "maintaining price stability". This requires appropriate adaptation of those statutes of NCBs which do not unambiguously reflect such objectives. This objective was enshrined in the new central bank statutes of the Banque de France and the Banco de España (see Section 4.2 below). Under Article 14.4 of the ESCB Statute, an NCB may continue to perform tasks and functions other than those related to the ESCB unless these are deemed to interfere with the objectives and tasks of the ESCB.

3. OTHER STATUTORY REQUIREMENTS FOR NCBs TO BECOME AN INTEGRAL PART OF THE ESCB

As stated above, NCBs of Member States without a derogation will become an integral part of the ESCB. Integration of the NCBs within the ESCB, in accordance with Article 14.3 of the Statute, may necessitate measures to be taken in addition to those designed to assure a sufficient level of independence, as required by Articles 107 and 109e (5) of the Treaty and Article 7 of the Statute. In particular, such measures may be necessary to enable NCBs to execute tasks as members of the ESCB and in accordance with decisions by the ECB, and to fulfil their financial obligations towards the ECB. The nature and content of such adaptations will need to be elaborated further and will, in many cases, become clearer as the preparatory work for Stage Three advances.

4. ADAPTATION OF STATUTES OF NCBs AFTER THE SIGNING OF THE TREATY[1]

4.1 Institutional features of NCBs of the Member States of the European Union

A description of the current institutional features of the NCBs of Member States of the European Union, together with an indication of prospective changes, if any, to their statutes is attached as Annex 1 to this report. By way of a supplement, a table on institutional features of NCBs is attached as Annex 2. In a number of cases, these institutional features are the result of recent adjustments with regard to, inter alia, the requirements of the Treaty.

To varying degrees, current institutional features do not preclude the necessity of further adaptations with a view to Stage Three of EMU.

4.2 Adaptation of statutes prior to November 1995

Since the signing of the Treaty, statutes of various NCBs have been changed in order to ensure compliance with the requirements of the Treaty. Some of these adaptations were designed to make national legislation consistent with Article 104 of the Treaty, which prohibits the provision of central bank credit to the public sector, as well as with Article 104a, which prohibits the granting of privileged access by governmental or public bodies to financial institutions. To this effect, legislative action was taken in Belgium, Germany, Greece, Spain, France, Italy, the Netherlands and Portugal. In Luxembourg, implementation of the prohibition of monetary financing was originally envisaged in a draft law which also aimed at implementing other provisions of the Treaty. As the adoption of this law is taking more time than originally envisaged, the Luxembourg legislative

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[1] (Draft) legislation mentioned in this chapter only takes into account laws which are designed to adapt statutes of NCBs to requirements of the Treaty. Other legislation amending such statutes is not dealt with.

authorities have now decided to implement the prohibition of monetary financing separately, in order to comply with Article 104 of the Treaty. The draft of the law to that effect was submitted to the EMI for consultation[2] on 6th September 1995 and the EMI delivered its opinion (CON/95/14) on 5th October 1995. Among the three countries which joined the Community in 1995, legislative action in this field was completed in Austria and Sweden, whilst a bill was being prepared in Finland. As well as statutory amendments, operational practices were changed in a number of countries to ensure compliance with Articles 104 and 104a of the Treaty.

Further adaptations of central bank legislation have been made with a view to Stage Three of EMU. The three most important examples are the Banque de France, the Banco de España and the Banco de Portugal. In the first two cases the reform has been substantial. Legislation regarding the National Bank of Belgium and the Banca d'Italia was also amended.

The legal regime of the *Banque de France* was amended by Acts 93-980 of 4th August 1993 and 93-1444 of 31st December 1993, which came into effect on 1st January 1994. These new laws set price stability as the primary objective of monetary policy; they have vested responsibility for the formulation and implementation of monetary policy in the Monetary Policy Council (the "Conseil de la politique monétaire"), which must not seek or receive instructions from the Government or any other person. Members of the Council are subject to exclusivity and secrecy rules and the terms of their appointment and substitution are precisely defined. The Prime Minister and the Minister for Economy and Finance (or a representative) may attend meetings of the Council, but without voting or veto rights. The Council deals purely with monetary policy decisions, whilst a General Council (the "Conseil Général") exercises all other management responsibilities at the Banque de France. The General Council comprises the members of the Monetary Policy Council plus one representative of the staff. A Government representative attends meetings of the General Council.

The status of the *Banco de España* was amended by Act 13/1994 of 1st June 1994 on the Autonomy of the Banco de España. The law sets price stability as the primary objective of monetary policy and gives the Bank full capacity and independence to define and implement monetary policy. In particular, the law explicitly prohibits the Government or any other public authority from giving instructions to the Bank regarding either the objectives or the implementation of monetary policy. Other provisions referring to the appointment, term of office and termination of the appointment of the Governor and Council members also reflect generally accepted requirements for the independence of decision-making bodies of central banks.

In Portugal, amendments of the Organic Law of the *Banco de Portugal* were adopted in September 1995. The new law redefined the primary objective of the Banco de Portugal as being to maintain price stability, taking into account the general economic policy of the Government. It also enhanced the independence of the Banco de Portugal with respect to the Government in the conduct of monetary policy. Furthermore, the new law

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[2] Under Article 109f (6) of the Treaty and Article 5.3 of the EMI's Statute.

elaborated the statistical functions of the Bank relating to the collection and compilation of monetary, financial and exchange and balance-of-payments statistics. Finally, the new law amended the definition of the payment systems function of the Bank. The new law was submitted to the EMI for consultation[3] and the EMI delivered its opinion (CON/95/11) on 27th July 1995.

In Belgium, a law of 22nd March 1993 introduced provisions adjusting the competence of the Government in controlling the decisions and operations of the *National Bank of Belgium*. Prior to this law, while there was no right of instruction from political authorities, the Government Commissioner and the Minister of Finance had the right to oppose, and the right to suspend the implementation of, any decision of the Bank which was contrary to the interests of the State, the law or the statutes of the Bank. The new law restricted these opposition and suspension rights 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. Such rights can now only be exercised when the Bank's decisions on these matters are not in conformity with the law and the statutes of the Bank.

In Italy, Law 82 of 7th February 1992 vested the authority to determine discount rates in the Governor of the *Banca d'Italia* (prior to this law, discount rates were fixed by the Minister of the Treasury). Furthermore, Law 483 of 26th November 1993 gave to the Banca d'Italia the responsibility for setting bank reserve requirements within given limits. In addition, Article 146 of Legislative Decree 385 of 1st September 1993 attributed oversight of payment systems to the Banca d'Italia.

4.3 Prospective adaptations of statutes of NCBs

During 1995 draft legislative provisions containing amendments to the statutes of the NCBs of Luxembourg and Belgium were submitted to the EMI for official consultation.

In Luxembourg, a draft Law on the *Institut Monétaire Luxembourgeois* and the Monetary Status of the Grand Duchy of Luxembourg was submitted to Parliament in December 1993, the enactment of which is still pending. The draft states, in its "Exposé des Motifs", that its purpose is to implement all Treaty provisions concerning Stage Two, and also to introduce some central banking features which are to be put in place before Stage Three. In accordance with the draft law, the principal objective of the Institut Monétaire Luxembourgeois will be to ensure price stability, while supporting the economic policy of the Luxembourg Government. A clear definition of the basic tasks of the Institut Monétaire Luxembourgeois is also given. These include the definition and implementation of monetary policy. The Institut Monétaire Luxembourgeois is to conduct its affairs in accordance with the principle of a market economy. However, the monetary association between Belgium and Luxembourg will remain unchanged during Stage Two. The draft declares that additional legislation will be required prior to Stage Three. The draft law was submitted to the EMI for consultation[3] on 18th February 1994 and the EMI delivered its opinion on 12th March 1994.

In Belgium, a further amendment to the Organic Law of the *National Bank of Belgium* is being prepared. This will provide the Bank with a lien on all securities booked in its accounts in the name of the participants in the real-time gross settlement payment system called ELLIPS, which is in the process of being established. The purpose of the amendment is to ensure the repayment of intraday or overnight credits granted by the National Bank of Belgium to participants, thus fostering the efficient management and smooth functioning of the system. The above amendment is designed to comply with Article 18.1 of the Statute, which states that the ECB and the NCBs may conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral. A draft law was submitted to the EMI for consultation[3] on 10th July 1995 and the EMI delivered its opinion (CON/95/12) on 30th August 1995.

The EMI has been informed of preliminary or preparatory work on amendments to national legislation concerning central banking in Ireland, the Netherlands, Belgium, Finland and Sweden.

4.4 Concluding remarks

The above paragraphs show that the adaptation of statutes of NCBs is a matter of continuing concern in the Member States of the European Union. In many cases, the adaptation process is of a gradual nature, anticipating further changes to make statutes of NCBs compatible with the Treaty in accordance with Article 108. The EMI will monitor this process. It will deliver opinions to the national authorities when consulted on draft legislative provisions under Article 109f (6) of the Treaty and Article 5.3 of the Statute of the EMI. It will also assess progress made in the context of its reports under Article 7 of the Statute of the EMI and Article 109j of the Treaty.

ANNEX 1

INSTITUTIONAL FEATURES OF THE NATIONAL CENTRAL BANKS OF THE MEMBER STATES OF THE EUROPEAN UNION

NATIONAL BANK OF BELGIUM

1. Legal basis

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

2. Organisational structure

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

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

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

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

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

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

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

While there is no right of instruction from political authorities, there is a government commissioner in the Bank who is entitled to participate without voting rights in every meeting of the decision-making bodies of the Bank. A power of suspension and a right to oppose decisions can in general terms be exercised by the government commissioner and the Minister of Finance respectively against any decision of the Bank contrary to the law, to the statutes of the Bank or to the interests of the State. However, by virtue of the Law of 22nd March 1993, this power no longer exists with regard to the basic tasks of the Bank - namely the definition and implementation of monetary policy, the conduct of foreign exchange operations consistent with the exchange arrangements applicable to the franc, the holding and management of the official foreign reserves and the promotion of the smooth operation of payment systems - insofar as the decisions are in conformity with the law and the statutes of the Bank. In these areas, the autonomy of the Bank has thus been established.

3. Objectives and tasks

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

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

4. Relations with political bodies

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

5. Prospective institutional changes

The Bank is in the process of reviewing, in consultation with the Belgian Ministry of Finance, where further adaptations of its statutes would be appropriate with a view to Stage Three of EMU. A draft law aiming at facilitating the establishment and realisation of collateral provided to the Bank in the framework of credit operations is in the process of being adopted in order to comply with Article 18.1 of the Statute, which states that the ECB and the NCBs may conduct credit operations with credit institutions and other market participants with lending being based on adequate collateral. The draft was submitted for consultation to the EMI under Article 109f (6) of the Treaty and Article 5.3 of the Statute and the EMI delivered its opinion (CON/95/12) on 30th August 1995.

DANMARKS NATIONALBANK

1. Legal basis

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

2. Organisational structure

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

The Board of Governors consists of three members. The Chairman is appointed by the Crown. The other Governors are appointed by the Board of Directors. There is no fixed term of office. In practice, appointments are for life, with a retirement age of seventy. The Board of Governors has full and sole responsibility for monetary policy. Governors are prevented from active involvement in the management of trading organisations and companies and may not carry on or take part in private trading activities.

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

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

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

The Chairman of the Board of Governors may be dismissed by the Crown, the two other members by the Board of Directors. In the latter case, a majority of two-thirds of the members of the Board of Directors is required. For the members of the Board of Directors and the Committee of Directors there are no rules relating to dismissal.

3. Objectives and tasks

The National Bank of Denmark Act states that the Bank shall have the objective of maintaining a safe and secure currency system and to facilitate and regulate payment flows and the extension of credit.

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

The Bank also manages official reserves and serves as fiscal agent for the central government.

4. Relations with political bodies

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

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

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

5. Prospective institutional changes

No changes have been made to date and no prospective legislative changes have been notified to the EMI.

DEUTSCHE BUNDESBANK

1. Legal basis

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

2. Organisational structure

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

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

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

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

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

3. Objectives and tasks

The Bundesbank Act defines the main function of the Bank as the safeguarding of the currency and providing for the execution of domestic and external payments. Without prejudice to the performance of its functions, the Bank is required to support the general economic policy of the Federal Cabinet.

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

4. Relations with political bodies

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

Regarding relations with the Government, 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 the request of a member of the Federal Cabinet, a decision of the Central Bank Council can be deferred for up to two weeks. This right has not been used to date. In addition, the Government is involved in the appointment procedure as described above.

Finally, the Bank publishes Monthly and Annual Reports. Its annual accounts are verified by auditors and by the Federal Audit Office.

5. Prospective institutional changes

No changes have been made to date and no prospective legislative changes have been notified to the EMI.

BANK OF GREECE

1. Legal basis

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

2. Organisational structure

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

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

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

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

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

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

3. Objectives and tasks

The statutory objective of the Bank is to control the currency in circulation and credit. This is considered to imply that monetary stability is the ultimate objective of the Bank.

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

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

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

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

4. Relations with political bodies

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

5. Prospective institutional changes

The Bank has proposed to the Government various further legislative changes concerning its objectives, independence, organisational structure, and monetary functions and operations. The proposed legislation aims at increasing the degree of independence of the Bank and to make it compatible with the Treaty.

BANCO DE ESPAÑA

1. Legal basis

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

2. Organisational structure

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

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

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

The Governing Council is composed of the Governor, the Deputy Governor, six elected Council members, the Director-General of the Treasury and Financial Policy and the Vice-President of the National Securities and Exchange Commission. The six elected Council members are appointed by the Government following a proposal by the Economy and Finance Minister, after consultation with the Governor. Elected Council members serve a four-year term and may be reappointed once. The main functions of the Governing Council are to approve general guidelines for action by the Bank to fulfil its assigned functions and to supervise the implementation of monetary policy by the Executive Commission. Two members of the Governing Council, the Director-General of the Treasury and the Vice-President of the Exchange Commission, have no voting rights when monetary policy matters are under discussion.

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

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

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

3. Objectives and tasks

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

The Bank's main tasks are to define and implement monetary policy; hold and manage reserves; implement exchange rate policy; promote the smooth operation and the stability of the financial system and, in particular, of the payment system; issue banknotes and bring coins into circulation; act as fiscal agent for the Government and supervise credit institutions. The Bank may require credit institutions to immobilise funds by setting a reserve requirement. However, the use of monetary policy instruments imposing obligations on entities other than credit institutions requires clearance by the Government.

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

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

4. Relations with political bodies

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

The Governor may be required to attend the meetings of the Fiscal and Financial Council, an economic policy co-ordination body where all regional autonomous governments and the State are represented, and report on monetary policy, financial markets and the banking system.

The budget of the Bank is submitted to Parliament for approval. It is not consolidated with the General State Budget nor it is subject to Government approval. The yearly balance sheet and profit and loss accounts are submitted to Government for approval, and are subject to audit by the Court of Auditors.

5. Prospective institutional changes.

No further institutional changes are planned. The Bank is preparing its new internal Rules of Procedure.

BANQUE DE FRANCE

1. Legal basis

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

2. Organisational structure

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

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

The Monetary Policy Council includes the Governor, two Vice-Governors and six other members appointed by Government. The six other members have a non-renewable term of nine years. Members of the Monetary Policy Council cannot be dismissed before the expiry of their term except for reasons of incapacity or serious misconduct and they are subject to a strict regime of professional exclusivity. The Monetary Policy Council is responsible for formulating and implementing monetary policy.

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

3. Objectives and tasks

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

The Bank conducts monetary policy in the context of the exchange rate regime which is determined by the Government. It shall carry out these duties within the framework of the Government's overall economic policy. In formulating and implementing monetary policy the Monetary Policy Council of the Bank can neither seek nor accept instructions from the Government or any other person in the performance of its duties.

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

4. Relations with political bodies

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

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

5. Prospective institutional changes.

No further institutional changes are currently foreseen.

CENTRAL BANK OF IRELAND

1. Legal basis

The formation, powers and functions of the Central Bank of Ireland are set out in the Central Bank Acts, 1942-89. The Bank is an institution established by statute whose capital is wholly owned by the State.

2. Organisational structure

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

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

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

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

3. Objectives and tasks

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

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

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

4. Relations with political bodies

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

5. Prospective institutional changes

The Central Bank and the Department of Finance are giving consideration to which Treaty provisions may require amendments to national legislation.

BANCA D'ITALIA

1. Legal basis

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

2. Organisational structure

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

The Governor is appointed by the Board of Directors acting by a qualified majority for an unlimited period of time; the appointment must then be approved by decree of the President of the Republic on a proposal of the President of the Council of Ministers in agreement with the Minister of the Treasury, the Council of Ministers having been heard. The Governor can be dismissed by the Board of Directors with the same procedure and majority. The Governor presents monetary policies objectives to be included in the Government's annual policy planning. The Governor is in charge of the conduct of monetary policy.

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

The Board of Directors is composed of the Governor and thirteen independent members elected one for each of the main branches of the Bank; they cannot be members of the Chambers, hold a political office, or be administrators, agents, auditors, managers or employees of credit institutions. The members of the Board are elected for a renewable term of three years. No specific provision regarding their dismissal from office is included in the Bank's statute. The task of the Board is to administer the Bank; the Board has no powers with respect to monetary policy measures. The General Manager and the two Deputy General Managers also attend the meetings of the Board of Directors.

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

The Board of Auditors includes five auditors and two substitutes, nominated by the General Assembly for a renewable term of three years. Besides controlling the administration of the Bank as to the compatibility with laws, regulations and the Statute, it votes on the budget as proposed by the Board of Directors and expresses its opinion on the distribution of the annual dividend.

3. Objectives and tasks

The Italian Constitution states that the Republic has a duty to protect savings, which implies that the Bank should pursue the goal of monetary stability. In the light of this, no explicit reference to the objective of price stability has been made in the statutory provisions concerning the Banca d'Italia.

The main tasks are the issue of banknotes (in agreement with the Government, as far as their production is concerned); conduct of monetary policy; fixing of discount rates and of obligatory reserves; supervision of banks and other financial institutions; fiscal agent for the Government; and management of official reserves jointly with the Italian foreign exchange office.

4. Relations with political bodies

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

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

An annual report and other documents are published on a regular basis.

5. Prospective institutional changes

No prospective legislative changes have been notified to the EMI.

INSTITUT MONÉTAIRE LUXEMBOURGEOIS

1. Legal basis

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

2. Organisational structure

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

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

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

3. Objectives and tasks

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

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

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

4. Relations with political bodies

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

5. Prospective institutional changes

The passage to the final stage of EMU will entail the dissolution of the monetary association with Belgium, with the Institut Monétaire Luxembourgeois taking over the full functions of the central bank of Luxembourg. A draft Law on the Institut Monétaire Luxembourgeois and the Monetary Status of the Grand Duchy of Luxembourg was submitted to Parliament in December 1993, the enactment of which is still pending. The draft states in its "Exposé des Motifs" its purpose of implementing all Treaty provisions concerning Stage Two and also of introducing some features of NCBs which are to be put in place before Stage Three. In accordance with the draft law, the principal objective of the Institut Monétaire Luxembourgeois will be to ensure price stability, while supporting the economic policy of the Luxembourg Govemment. A clear definition of the basic tasks of the Institut Monétaire Luxembourgeois is also given. These include the definition and implementation of monetary policy. The Institut Monétaire Luxembourgeois is to conduct its affairs in accordance with the principle of a market economy. However, the monetary association between Belgium and Luxembourg will remain unchanged during Stage Two. The draft declares that additional legislation will be required in due time for Stage Three. The draft law was submitted to the EMI for consultation on 18th February 1994 and the EMI delivered its opinion on 12th March 1994. As the adoption of the draft is taking more time than originally envisaged, the Luxembourg legislative authorities have now decided to implement the prohibition of public financing separately in the Budget Law for 1996 in order to comply with Article 104 of the Treaty rather than wait for the adoption of the above law which includes this prohibition as well. A draft of a law to that effect was submitted to the EMI for consultation under Article 109f (6) and Article 5.3 of its Statute on 6th September 1995 and the EMI delivered its opinion (CON/95/14) on 5th October 1995.

NEDERLANDSCHE BANK

1. Legal basis

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

2. Organisational structure

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

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

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

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

3. Objectives and tasks

The statutory objective of the Bank is to safeguard the value of the currency. Price stability is thus clearly a policy objective.

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

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

In the event of major conflict, the Minister of Finance has the authority to give such directions to the Governing Board as he deems necessary for the Bank's policy to be properly co-ordinated with the Government's monetary and financial policies. The Governing Board, however, can state its objections to these directions and appeal to the Crown. The Crown's decision can only be taken by the Council of Ministers meeting in plenary session. If it is decided that the Governing Board has to comply with the directions, the reasoned decision of the Crown, as well as the Bank's objections, are published in the official gazette. However, until now the Minister of Finance has never exercised his statutory right to give directions; this was intended by the legislator, and has continued to be considered by policy-makers, as an ultimate remedy only. In practice, therefore, the Bank has a high degree of independence and has complete freedom to enact measures of monetary control such as cash reserves, provided that the banking system has been consulted.

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

4. Relations with political bodies

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

5. Prospective institutional changes

In order to comply with the requirements of Article 108 of the Treaty establishing the European Community, the Bank has commenced preparatory discussions with the Netherlands Ministry of Finance with the aim of modernising the Bank Act 1948 and bringing it into line with the requirements for Stage Three of EMU, at the latest before the establishment of the ESCB.

OESTERREICHISCHE NATIONALBANK

1. Legal basis

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

2. Organisational structure

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

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

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

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

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

3. Objectives and tasks

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

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

4. Relations with political bodies

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

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

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

5. Prospective institutional changes

No prospective legislative changes have been notified to the EMI.

BANCO DE PORTUGAL

1. Legal basis

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

2. Organisational structure

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

The Governor is appointed for a renewable term of five years by the Government on a proposal by the Ministry of Finance. The Governor may be dismissed at any time by the Government (also on the grounds of "service convenience").

The Board of Directors includes the Governor, one or two Deputy Governors, and three to five members, all appointed by the Government on the proposal by the Ministry of Finance for a renewable term of five years. They may be dismissed from office by the Government. The Board manages the Bank. The Governor has a casting vote and the right to suspend Board decisions and submit them to Government. Directors are subject to a strict regime of professional exclusivity.

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

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

3. Objectives and tasks

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

To implement monetary policy the Bank has full freedom in setting policy instruments. Policy decisions that have to be published to be effective ("Avisos" of the Bank) are signed by the Minister of Finance.

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

4. Relations with public bodies

The annual budget of the Bank is forwarded to the Finance Minister. The annual accounts are submitted, together with the opinion of the auditors, to the Minister of Finance for approval. The Bank is subject to the obligation to publish its accounts periodically.

5. Prospective institutional changes.

There are no further institutional changes notified to the EMI.

SUOMEN PANKKI

1. Legal basis

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

2. Organisational structure

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

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

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

3. Objectives and tasks

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

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

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

Monetary policy is determined by the Bank independently. The Act does not impose any requirement on the Bank to negotiate monetary policy decisions beforehand with

Government. The Minister of Finance may not attend meetings of the Board nor may he veto any monetary policy decisions taken by the Bank.

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

The decision-making procedure regarding changes in the external value of the markka is defined in the Currency Act. The principle is that the Government takes decisions on changes in the exchange rate. The Bank is responsible for maintaining the exchange rate within the limits laid down by such a decision. Within that framework, the Bank has full freedom regarding its operations in the foreign exchange market.

Under the Currency Act, the Council of State (Government) confirms the limits on the fluctuation range of the markka, on a proposal from the Bank. The Parliamentary Supervisory Council decides on the making of such proposals on the basis of a proposal from the Board. The Government can then either approve the proposal as it stands or reject it.

If a serious disturbance occurs in the foreign exchange market, the Bank is entitled to temporarily disregard the limits on the fluctuation range. The Government can, at the proposal of the Bank, retain the Bank's said right in force until further notice. The markka has been floating since 1992.

4. Relations with political bodies

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

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

5. Prospective institutional changes

The legislation on the Bank is in the process of being reformed. The Suomen Pankki Committee has prepared a proposal on the reform of the Act on Suomen Pankki. The Government Bill has not yet been submitted to Parliament.

The Committee proposes that the objectives, tasks and powers of the Bank be defined in greater detail in law. According to the proposal, the primary objective of the Bank's activities is to safeguard the value of money. Without prejudice to this objective, the Bank shall also support the attainment of other economic policy objectives and promote the stability of the financial system. The tasks of the Bank shall be to determine and implement the country's monetary policy, to manage and invest the foreign currency reserves, to be responsible for its part for the reliability and efficiency of the payment and financial system and to participate in its development, and to compile the necessary statistics. Since the Bank bears only partial responsibility in certain of these tasks, the proposal includes a provision on co-operation with other authorities. However, when carrying out its statutory tasks, the Bank may neither seek nor accept instructions concerning its activities.

One aim of the proposed reform is to highlight the division of responsibilities between the Bank's different administrative bodies and ensure that their respective tasks are clearly defined. The Committee found it important to emphasise the status of the Parliamentary Supervisory Council as a supervisory and administrative body whereas the Board of Suomen Pankki is to decide on monetary tasks. This would clarify the division of responsibilities by putting the Board indisputably in charge of monetary policy.

SVERIGES RIKSBANK

1. Legal basis

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

2. Organisational structure

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

The Riksdag can give the Bank instructions through legislation, but the Government cannot in any way instruct the Bank.

3. Objectives and tasks

The Swedish Constitution makes the Riksbank responsible for all matters of exchange rate and monetary policy (see below). There is no statutory objective for monetary policy.

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

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

The Bank has full responsibility for the formulation and implementation of monetary policy. The Riksbank Act specifies the available policy instruments, but the use of these instruments is determined exclusively by the Bank. Prior to taking decisions of major importance, the Bank must consult the Minister of Finance, but the Minister has no powers to veto or delay a decision by the Bank. Consequently, the Bank has independence with regard to its goals and the instruments to achieve them.

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

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

4. Relations with political bodies

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

In addition, the Governor appears before hearings of the Riksdag's Finance Committee three or four times each year. Recently, some of these hearings have been open to the public.

5. Prospective institutional changes

Legislation in order to comply with requirements of the Treaty with a view to Stage Three of EMU will be proposed during the current legislative period.

BANK OF ENGLAND

1. Legal basis

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

2. Organisational structure

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

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

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

3. Objectives and tasks

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

The main tasks of the Bank are the formulation of advice on monetary policy, the implementation of monetary policy, the issue of the currency, the management of official reserves, the supervision of banks, and the promotion of sound and efficient payment and settlement systems.

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

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

The Bank acts as fiscal agent for the Government.

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

4. Relations with political bodies

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

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

5. Prospective institutional changes

No changes have been made to date and no prospective legislative changes have been notified to the EMI.

ANNEX 2

INSTITUTIONAL FEATURES
OF EUROPEAN UNION CENTRAL BANKS

	NATIONAL BANK OF BELGIUM	DANMARKS NATIONALBANK	DEUTSCHE BUNDESBANK	BANK OF GREECE	BANCO DE ESPAÑA
PRINCIPAL STATUTORY OBJECTIVE	None, although safeguarding the currency implicit	To maintain a safe and secure currency system	To safeguard the currency	To control currency in circulation and credit	To ensure price stability
LEGAL AUTHORITY FOR:					
1- Exchange rate regime	1 - Government	1 - Government	1 - Government	1 - Government	1 - Government after consulting the central bank
2- Setting targets for: - monetary growth	2 - Central bank [a]	2 - Central bank [a]	2 - Central bank	2 - Central bank	2 - Central bank [b]
- inflation	Central bank [a]	Central bank [a]	Central bank [a]	Government [a]	Central bank
3- Changing key interest rates	3 - Central bank	3 - Central bank	3 - Central bank	3 - Central bank	3 - Central bank
RESPONSIBILITIES:					
1- Execution of monetary and exchange rate policy	1 - Yes	1 - Yes	1 - Yes (2-week suspension of decisions possible at the request of Government but never been used)	1 - Yes	1 - Yes
2- Issue of banknotes	2 - Yes	2 - Yes	2 - Yes	2 - Yes	2 - Yes
3- Payment system services	3 - Yes	3 - Yes	3 - Yes	3 - Yes	3 - Yes
4- Bank of banks and government	4 - Yes	4 - Yes	4 - Yes	4 - No exclusive arrangement	4 - Yes
5- Supervision of financial institutions	5 - No	5 - No	5 - No	5 - Yes	5 - Yes
6- Safeguard financial stability	6 - Yes	6 - Yes	6 - Yes	6 - Yes	6 - Yes
7- Official reserve management	7 - Yes	7 - Yes	7 - Yes	7 - Yes	7 - Yes
GOVERNING BODIES	- Governor - Board of Directors - Council of Regency - Board of Censors - General Council	- Board of Governors - Board of Directors - Committee of Directors - Royal Bank Commissioner	- Central Bank Council - Directorate - Managing Boards of Land Central Banks	- General Council - Governor (- Deputy Governors)	- Governor - Deputy Governor - Governing Council - Executive Commission
APPOINTMENT OF GOV'NOR					
By:	- Crown on proposal of the Government	- Crown on proposal of the Government	- Federal President on proposal of Federal Governmentt after consultation of Central Bank Council	- President of the Republic on a proposal of the Government after being nominated by the Council	- Crown on proposal of President of Government
Term:	- 5 years (renewable)	- Life, up to the age of 70	- Normally 8 years, minimum 2 years (renewable)	- 4 years (renewable)	- 6 years (non-renewable)
RECENT AND PLANNED CHANGES	Legislation to ensure central bank independence on monetary policy decisions was adopted on 22nd March 1993.	None	None	The Bank of Greece has proposed to Government legislative changes which aim to increase its degree of independence and to make its Statute fully compatible with the Treaty on European Union.	Law 13/1994 of 1st June 1994 on the Autonomy of the Banco de España introduced the provisions of the Treaty on European Union relating to central banks.

(a) No targets set at present. (b) No targets set at present; only monitoring ranges/rates used.

	BANQUE DE FRANCE	CENTRAL BANK OF IRELAND	BANCA D'ITALIA	INSTITUT MONÉTAIRE LUXEMBOURGEOIS	NEDERLANDSCHE BANK
PRINCIPAL STATUTORY OBJECTIVE	Ensuring price stability	To safeguard the integrity of the currency	Safeguard of price stability implicit in the Constitution	Includes the promotion of the stability of the currency	To safeguard the value of the currency
LEGAL AUTHORITY FOR: 1- Exchange rate regime 2- Setting targets for: - monetary growth - inflation 3- Changing key interest rates	 1 - Government 2 - Central bank Central bank 3 - Central bank	 1 - Government 2 - Central bank Central bank [a] 3 - Central bank	 1 - Government 2 - Central Bank[c] Government 3 - Central bank	 1 - Government 2 - Central bank [a] Jointly with Government [a] 3 - Central bank [a]	 1 - Government 2 - Central bank[a] Central bank [a] 3 - Central bank
RESPONSIBILITIES: 1- Execution of monetary and exchange rate policy 2- Issue of banknotes 3- Payment system services 4- Bank of banks and government 5- Supervision of financial institutions 6- Safeguard financial stability 7- Official reserve management	 1 - Yes 2 - Yes 3 - Yes 4 - Yes 5 - Yes, through Commission Bancaire 6 - Yes 7 - Yes	 1 - Yes 2 - Yes 3 - Yes 4 - Yes 5 - Yes 6 - Yes 7 - Yes	 1 - Yes 2 - Yes (production in agreement with the Goverment) 3 - Yes 4 - Yes 5 - Yes 6 - Yes 7 - Yes (together with the Italian Exchange Office)	 1 - Yes (partly) 2 - Yes 3 - Yes 4 - No 5 - Yes 6 - Yes 7 - Yes	 1 - Yes (a right of instruction of Government still formally exists but has never been used) 2 - Yes 3 - Yes 4 - Yes 5 - Yes 6 - Yes 7 - Yes
GOVERNING BODIES	- Monetary Policy Council - General Council	- Board of Directors	- Governor, Director-General, 2 Deputy Director-Generals (Directorate) - Board of Directors	- Management - Council	- Governing Board - Supervisory Board
APPOINTMENT OF GOV'NOR By: Term:	 - Council of Ministers - 6 years (renewable)	 - President, on the advice of Government - 7 years (renewable)	 - Board of Directors with approval of Government - Unlimited	 - Grand-Duke on proposal of Council of Ministers - 6 years (renewable)	 - Nominated by joint meeting of Governing Board & Supervisory Board and appointed by Crown on proposal of Council of Ministers - 7 years (renewable)
RECENT AND PLANNED CHANGES	Laws of 4th August 1993 & 31st December 1993 on the Statute of the Banque de France introduced the provisions of the Treaty on European Union relating to centrat banks.	Consideration is being given to amendments to national legislation.	None	A bill to effect the changes in legislation required by the Treaty on European Union is pending in Parliament.	Law of 9th December 1993 introduced provisions of the Treaty on European Union relating to central banks. Final adjustments in order to comply with the Treaty are under consideration.

(a) No targets set at present. (c) Presented to the Government and incorporated in official planning documents.

	OESTERREICHISCHE NATIONALBANK	BANCO DE PORTUGAL	SUOMEN PANKKI	SVERIGES RIKSBANK	BANK OF ENGLAND
PRINCIPAL STATUTORY OBJECTIVE	To maintain the internal and external value of the Austrian currency	To maintain price stability taking into account the general economic policy of the Government	To maintain a stable and secure monetary system and to assist and facilitate the circulation of money in Finland	None, although safeguarding of the currency implicit	None, although safeguarding the currency implicit
LEGAL AUTHORITY FOR: 1- Exchange Rate Regime 2- Setting targets for: - monetary growth - inflation 3- Changing key interest rates	1 - Central bank in co-operation with Government 2 - Central bank [a] Central bank [a] 3 - Central bank	1 - Government after consulting the central bank 2 - Central bank[a] Central bank [a] 3 - Central bank	1 - Government on proposal of the central bank 2 - Central bank [b] Central bank 3 - Central bank	1 - Central bank 2 - Central bank [a] Central bank 3 - Central bank	1 - Government 2 - Government [b] Government 3 - Government
RESPONSIBILITIES: 1- Execution of monetary and exchange rate policy 2- Issue of banknotes 3- Payment system services 4- Bank of banks and government 5- Supervision of financial institutions 6- Safeguard financial stability 7- Official reserve management	1 - Yes 2 - Yes 3 - Yes 4 - Yes 5 - No 6 - Yes 7 - Yes	1 - Yes 2 - Yes 3 - Yes 4 - Yes 5 - Yes 6 - Yes 7 - Yes	1 - Yes 2 - Yes 3 - Yes 4 - Yes (bank of banks) No (bank of Government) 5 - No 6 - Yes 7 - Yes	1 - Yes 2 - Yes 3 - Yes 4 - Yes 5 - No 6 - Yes 7 - Yes	1 - Yes 2 - Yes 3 - Yes 4 - Yes 5 - Yes 6 - Yes 7 - Yes (as agent for the Government)
GOVERNING BODIES	- General Council - Board of Executive Directors	- Governor - Board of Directors - Board of Auditors - Advisory Board	- Parliamentary Supervisory Council - Board	- Governing Board - Governor	- Court of Directors
APPOINTMENT OF GOV'NOR By: Term:	- President of the Republic on nomination by the Federal Government - 5 years (renewable)	- Council of Ministers on proposal of Minister of Finance - 5 years (renewable)	- President of the Republic on a proposal of the Parliamentary Supervisory Council - Indefinite	- Governing Board - 5 years (renewable)	- Crown on proposal of Prime Minister - 5 years (renewable)
RECENT AND PLANNED CHANGES	None	Amendments to reinforce the independence of the central bank in line with Articles 109e (5) and 108 of the Treaty on European Union were adopted in September 1995.	Legislation in order to comply with the requirements of the Treaty on European Union is under consideration.	Legislation in order to comply with the requirements of the Treaty will be proposed during the current legislative period.	None. Changes will be needed if the United Kingdom participates in Stage Three.

(a) No targets set at present. (b) No targets set at present; only monitoring ranges/rates used.