EUROPEAN ECONOMY

EUROPEAN COMMISSION
DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

Supplement A
Economic trends
No 1 – January 1996

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REPORT ON CONVERGENCE IN THE EUROPEAN UNION IN 1995

Summary

Further progress towards meeting the convergence criteria was achieved in 1995. Inflation declined further this year, and price convergence has strengthened, with eleven Member States (including the three new Members) having inflation at or below the reference value. The budgetary position of the Member States has in general improved, but not at a sufficient pace. In the large majority of Member States government deficits were reduced in 1995; contrary to past years, in only a few Member States did the government debt ratio increase markedly this year. Convergence of long–term interest rates remained by and large unchanged although the average level of interest rates increased somewhat in comparison with 1994. Although less calm than in 1994, developments in the exchange rate mechanism (ERM) were sometimes turbulent, and there was a realignment of central parities in March at the request of Spain and also involving Portugal.

As an interim, informal, assessment of convergence achievements up to the end of 1995 in the terms of the Treaty criteria, the situation is largely satisfactory as far as inflation and interest rates are concerned but much less so regarding budgetary performance, with only Germany, Ireland and Luxembourg not having an excessive deficit. A first formal examination of the fulfilment of the convergence criteria will be made in the reports to be prepared by the Commission and the EMI before the end of 1996.

The same group of Member States which had inflation at or below the reference value in 1994 (B, DK, D, F, IRL, L, NL, UK) continued to do so in 1995; in addition, this group was enlarged by the three new Member States (A, FIN, S), which also respected the criterion. Inflation convergence has been notable among the Member States which have long participated in the ERM and were in the narrow band prior to the August 1993 widening of the bands (B, DK, D, F, IRL, NL). Four Member States (GR, E, I, P) still have inflation rates above the reference value, but in recent years they have narrowed the gap between their inflation performance and that of the other Member States. In 1995 the inflation rate came down substantially in Greece (but it still remains very high) and Portugal, and more gradually in Spain, but in Italy this year there was an increase in the inflation rate. In these countries (and several others) exchange rate depreciation added to cost pressures, but the effects on domestic prices were more moderate than in the experience of earlier decades. Other indicators of inflation reviewed (developments in unit labour costs and in import prices) do not signal that the good inflation performance will be undermined. Nevertheless, as economic recovery proceeds and spare capacity is reduced, progress in reducing inflation may become more difficult.

Less progress has been made in budgetary convergence. Only three Member States (D, IRL, and L) do not currently have an excessive deficit in the terms of the Treaty (art. 104c). The recovery in economic activity and discretionary budgetary adjustment measures made roughly equal contributions to the reduction in the deficit in the EU as a whole in 1995, but the pace of adjustment has not been fast enough and most Member States in excessive deficit are faced with the need to implement significant additional adjustment measures in order to satisfy the budgetary convergence criteria. While deficits have generally been reduced, only four Member States (DK, D, IRL, and L) are estimated to have deficits below 3 percent of GDP in 1995.

Trends in government debt ratios continue to be unsatisfactory in most Member States, but the sharp deterioration recorded in the early 1990s has eased, several Member States have already stabilised their gross debt ratios and others are close to doing so. Indeed, of the eleven Member States with gross debt ratios higher than the 60% of GDP reference value, four are likely to achieve a reduction in the ratio this year. Between 1993 and 1995 the debt ratio will have declined by 11½ percentage points of GDP in Ireland (following substantial reductions in earlier years), by almost 6 ½ percentage points in Denmark and by 3 percentage points in Belgium and the Netherlands. The sharp increase in the debt ratio in Germany this year (to just below 60% of GDP) results from exceptional one–off debt takeovers related to unification.

All Member States, except Luxembourg, have prepared convergence programmes in which budgetary consolidation is a principal objective. Budgetary developments in 1995 provide a mixed picture, with most Member States likely to achieve deficits consistent with their programmes (B, D, GR, E, IRL, NL, P, FIN), two others (DK and S) achieving much lower deficits than in their convergence programmes, and four (F, I, A, UK) showing slippages compared to the deficits indicated in their convergence programmes .

Convergence in long–term interest rates remained largely unchanged in 1995. Interest rates rose at the beginning of the year, reflecting turbulence in foreign exchange markets and tensions in the ERM. Reductions have taken place since, which have been particularly pronounced in those Member States already with low interest rates. Long–term interest rates in the Community have generally remained higher than the average levels reached in 1994 when eight of the twelve Member States respected the criterion. Nevertheless, in 1995, ten of the fifteen Member States had long–term interest rates below the reference value for this criterion. The larger group this year includes two of the new Member States (A and FIN). Improving long–term interest rate convergence will require further progress in resolving budgetary uncertainties and in securing price stability in a durable manner.

In the ERM, tensions emerged in the first months of the year, leading to the devaluation of the Spanish peseta and the Portuguese escudo in March. Exchange rate movements have tended to show greater dispersion in 1995 compared to the previous year, and greater volatility has generally characterised the currencies not participating in the ERM. The Austrian schilling joined the ERM when Austria entered the Union at the beginning of this year.

In addition to the formal convergence criteria other indicators of convergence and integration have been reviewed. Developments in current account positions appear to be generally satisfactory, with external deficits declining and surpluses increasing relative to GDP this year. In the light of the integration of financial markets in the Union, in no Member State are developments in the external accounts hindering progress towards convergence. A continuing strong current account position in several Member States is additional evidence of successful policies aimed at convergence.

Progress in widening the use of the ECU has slowed, reflecting principally the impact of exchange rate instability in the EMS and the uncertainty about EMU prospects. The ECU market relies heavily on re–investment of funds and this has diminished, while the primary and secondary ECU bond market contracted this year. On the other hand, commercial and financial activity denominated in ECU has performed well.

Notable progress in financial integration has been achieved by the Member States and, since June 1994, a regime of free movement of capital prevails in the Union. This has contributed substantially to easing the financing of external deficits and to easing the external constraint. Capital flows within the Union and with the rest of the world have risen markedly in recent years, and the capital and financial markets of the Member States are increasingly reflecting portfolio diversification related to competition and innovation. A rising proportion of government borrowing is now financed through international capital flows, and non–residents have become important holders of paper issued by governments other than their own.

The evidence on the impact of the Internal Market programme on economic integration is currently being assembled and the results will become available next year. A set of indicators will then be reviewed with the objective of making possible an evaluation of progress in economic integration in the Union.

PERFORMANCE OF THE MEMBER STATES IN RELATION TO CONVERGENCE IN 1995

	Inflation(1)		**General government budgetary position**					**Long–term interest rates**	**Exchange rates**
	Private consumption deflator(2)	Consumer price index(3)	Existence of an excessive deficit	Deficit/ GDP(2)	Debt/GDP(2)				ERM participation
	1995	Oct 1994 – Sept 1995	Council decisions, 26.9.94 & 10.7.95	1995	1995	Change 95/94	Change 95/93	Oct 1994 – Sept 1995	Nov 1995
Reference value :	2.9(4)	3.0(4)		3.0	60			10.4 (4)	
B	1.5	1.6	yes	4.5	134.4	–0.6	–3.1	7.9	yes
DK	2.0	2.2	yes	2.0	73.6	–2.0	–6.7	8.6	yes
D	1.8	2.2	no	2.9	58.8	8.6	10.6	7.1	yes
GR	9.2	9.9	yes	9.3	114.4	1.4	–0.1	18.4	no
E	4.9	4.7	yes	5.9	64.8	1.8	4.4	11.5	yes
F	1.9	1.7	yes	5.0	51.5	3.1	6.2	7.8	yes
IRL	2.5	2.6(5)	no	2.7	85.9	–5.2	–11.5	8.5	yes
I	5.6	4.7	yes	7.4	124.9	–0.5	5.5	12.3	no
L	1.9	2.1	no	–0.4	6.4	0.5	0.1	6.2	yes
NL	1.6	2.2	yes	3.1	78.4	0.4	–2.9	7.2	yes
A	2.4	2.5	yes	5.5	68.0	2.8	5.0	7.3	yes
P	4.2	4.2	yes	5.4	70.5	1.1	3.3	11.7	yes
FIN	1.2	1.3	yes	5.4	63.2	3.4	5.9	9.4	no
S	2.8	2.6	yes	7.0	81.4	1.7	5.2	10.7	no
UK	2.9	3.3	yes	5.1	52.5	2.4	3.9	8.4	no
EUR	3.1	3.0		4.7	71.0	2.9	4.8	8.1	

(1) Data on consumer price index are not yet harmonised.
(2) Estimates from Commission services' Autumn 1995 Economic Forecasts.
(3) Percentage change in average level of index in latest 12 months over average in previous 12 month period.
(4) Average of three best performers in terms of price stability plus 1.5 (inflation) or 2.0 (interest rates) percentage points.
(5) Measured on the basis of quarterly data.

REPORT ON CONVERGENCE IN THE EUROPEAN UNION IN 1995*

I. Introduction

Purpose of the report

The present report on progress in nominal convergence in the Union, which reviews recent developments with particular reference to 1995, is prepared in order to provide continuity with the two previous convergence reports[1]. While there exists no Treaty obligation for the preparation of a convergence report for the present year (as there was no formal Treaty obligation for the preparation of the 1994 convergence report either), it is nevertheless essential that progress in convergence is continuously assessed. A convergence report will also be prepared in 1996, in order to comply with article 109j of the Treaty.

The Treaty on European Union sets out four explicit criteria according to which nominal convergence can be measured (Article 109j(1) and the associated protocol). At the same time, however, the Treaty requires that the assessment of convergence take into account evidence from other pertinent indicators, which would permit the emergence of a broader picture of the progress towards stability and integration between the Member States. Of these indices, a set refers to what may be regarded as indicators of the sustainability of nominal convergence. In this regard, the present report also reviews developments in unit labour costs and in import prices, as well as developments in the current account.

The report also discusses developments in the ECU, and it briefly reviews some "results of the integration of markets", principally as concerns the integration of financial markets. A full evaluation the internal market programme is currently under way, and the results will become available in time for next year's report.

Macroeconomic developments since the recession

TABLE 1 : **Economic growth (GDP)(1) and unemployment (UNR)(2)**

	1993		1994		1995	
	GDP	UNR	GDP	UNR	GDP	UNR
B	–1.6	8.9	2.2	10.0	2.3	10.0
DK	1.5	10.1	4.4	8.2	3.4	6.4
D	–1.1	7.9	2.9	8.4	2.1	8.1
GR	–0.5	8.6	1.5	8.9	1.7	8.9
E	–1.1	22.8	2.0	24.1	3.0	22.9
F	–1.5	11.7	2.7	12.3	2.8	11.6
IRL	3.1	15.7	6.7	15.1	6.7	13.5
I	–1.2	10.3	2.2	11.4	3.2	11.6
L	0.3	2.7	4.4	3.5	3.1	3.6
NL	0.2	6.6	2.7	7.0	3.0	6.6
A	–0.1	4.2	2.7	4.4	2.4	4.5
P	–1.2	5.7	1.1	7.0	2.7	7.2
FIN	–1.2	17.9	4.0	18.4	4.8	17.1
S	–2.6	9.5	2.3	9.8	3.7	9.4
UK	2.0	10.4	3.8	9.6	2.6	8.6
EUR 15	–0.6	10.9	2.8	11.3	2.7	10.7

(1) real annual percentage change;
(2) percentage of the civilian labour force.
Source: Commission services Autumn 1995 economic forecasts

Despite a slowdown during the course this year, 1995 was the second year when economic growth, following the trough of the recession in mid–1993, advanced at a solid pace. This has created conditions conducive to strengthening the convergence process. In several Member States actual economic growth exceeded potential, and the negative output gap narrowed, but it is estimated that a margin of excess capacity continued to characterise virtually all Member States' economies. Growth in the Union in 1995 was somewhat lower than expected at the beginning of the year, reflecting principally the spring currency turmoil but also the lagged effects of the sharp rise in long–term interest rates in 1994. These may have, inter alia, adversely affected confidence and contributed to restraining private spending in several Member States this year. However, the outlook for economic growth remains generally favourable, supported by healthy fundamentals and a further rebalancing of the policy mix.

The growth slowdown during 1995 followed a strong recovery from the 1992–93 recession. On an annual average basis, GDP is estimated to have grown at 2¾ percent in 1995, at virtually the same pace as in the previous year. Economic activity in the Community has been soundly based, bolstered by sustained extra–EC export market growth, and by strong performance of investment, particularly investment in equipment. On the other hand, private consumption has been subdued with households keeping their saving rate roughly unchanged. Latest estimates show that Ireland had the highest growth rate among the Member States in 1995, averaging 6.7 percent, while Greece had the lowest, averaging 1.7 percent. Economic growth in Denmark, Spain, Italy, Luxembourg, the Netherlands, Finland, and Sweden ranged between 3.0 percent (Spain) and 4.8 percent (Finland); in the remaining Member States, economic growth clustered in a narrow range of 2 to 3 percent.

Following its marked decline by almost 4 percent over the period 1992–94, employment improved modestly in 1995, growing by an estimated ¾ of one percent. As a result, the rate of unemployment has also declined gradually, from 11.3 percent of the civilian labour force in 1994 to 10.7 percent in 1995; this represents the first fall in the unemployment rate since the beginning of the decade.

II. Progress in nominal convergence

A. Inflation convergence

A.1 Recent inflation developments

Inflation developments in the Member States

The area where the greatest progress in convergence has taken place is that of achieving price stability. According to all principal measures, inflation declined significantly in virtually all Member States[2] in 1994 and convergence has strengthened further this year. Average inflation in the Union in 1995 declined marginally relative to the previous year, reflecting the progress in reducing inflation in those Member States where inflation was

* Based on data up to **end–November 1995.**

[1] In November 1993, and in accordance with Article 109e(2)b of the Treaty, the Commission adopted the "Report on progress with regard to economic and monetary convergence and with the implementation of Community law concerning the internal market", *European Economy* no. 55, 1993. In 1994 the review of convergence was presented in Convergence Report 1994: "Achieving better convergence during a period of economic recovery", *European Economy* no. 59, 1995.

[2] The three new Member States (Austria, Finland, and Sweden) are included fully in the analysis for the first time in this year's report, but in the discussion they are not treated as part of the European Union prior to 1995.

already low. At the same time, however, inflation performance in those Member States which had experienced currency depreciations (principally Italy but also Spain) was less encouraging. Table 2 reports developments in inflation measured by the private consumption deflator, and by the consumer price index. In both 1994 and 1995 according to the former index, inflation in nine Member States (B, DK, D, F, IRL, L, NL, FIN, UK) was at or below the upper limit of the 2–3 percent range proposed by the Broad Economic Policy Guidelines as a step towards price stability; also in Austria and Sweden inflation was below 3 percent this year. Inflation measured by the consumer price index over the period October 1994–September 1995 also confirms this (except for the UK[3]).

TABLE 2 : **Inflation** (percentage change)

	Private consumption deflator			Consumer price index(1)
	1993	1994	1995	Oct 94 –Sep 95
B	3.1	3.0	1.5	1.6
DK	1.0	1.0	2.0	2.2
D	3.9	2.7	1.8	2.2
GR	13.6	10.8	9.2	9.9
E	5.6	5.1	4.9	4.7
F	2.2	1.8	1.9	1.7
IRL	1.7	2.7	2.5	2.6
I	5.1	4.8	5.6	4.7
L	4.4	2.6	1.9	2.1
NL	2.3	2.4	1.6	2.2
A	3.5	3.0	2.4	2.5
P	7.1	5.5	4.2	4.2
FIN	4.2	1.3	1.2	1.3
S	5.8	3.6	2.8	2.6
UK	3.4	2.4	2.9	3.3
EUR 15	4.0	3.2	3.1	3.0
CV	0.76	0.70	0.69	0.67
CV– ERM	0.57	0.49	0.47	0.40
CV–NERM	0.74	0.72	0.72	0.76

(1) change in average level of index in latest twelve months over the average in previous twelve months. CV = coefficient of variation (ratio of the standard deviation to the mean of the data); CV–ERM (NERM) is the coefficient of variation for the ERM (non–ERM) currencies; ERM membership is defined in the text.
Source: Commission services Autumn 1995 economic forecasts, and Eurostat.

Not only has the level of inflation declined but also the differences in inflation between the Member States have narrowed. One indication of how inflation in the Member States has tended to move closer together is provided by a statistical measure of dispersion, the coefficient of variation[4], also reported in Table 2. The variability of inflation, measured by the private consumption deflator, in the Member States (excluding Austria, Finland, and Sweden for the years prior to joining the Union in 1995) declined from 0.76 in 1993 to 0.70 in 1994 and to 0.69 in 1995. This reduction in variability has taken place at the same time as the average inflation has also declined. The Member States which have participated the longest in the ERM have continued to display the lowest inflation and have secured convergence over a considerable period of time. The coefficient of variation for the ERM group (B, DK, D, E, F, IRL, L, NL, P) which was 0.57 in 1993, has eased to 0.49 in 1994 and, with the ERM group enlarged with the participation of Austria, to 0.47 in 1995. On the other hand, substantially greater variability continues to characterise inflation in the non–ERM Member States, (GR, I, and UK in 1993 and 1994; in 1995, the same group but enlarged to include FIN and S) with the coefficient of variation remaining persistently above 0.70 during these years. The dispersion of inflation rates measured by the consumer price index also confirms that in the ERM group inflation has tended to move closer together than in the non–ERM group.

Factors influencing inflation trends

Several factors have contributed to the decline in inflation and the consequent strengthening of price convergence in 1994 and 1995. A principal factor is that, although recovery from recession has been under way, output has continued to be below potential; this has restrained upward price pressures. Furthermore, the growth slowdown this year may also have prevented inflation from accelerating.

A second factor, the contribution of which is difficult to properly evaluate, is the possible change in private agents' behaviour as inflation expectations become more stable. Moderation in wage trends could reflect an enhanced credibility of monetary policy. Moreover, the granting of independence to central banks, as required by the Treaty by the end of the second stage of EMU, may also have played some part. An innovation in monetary strategy has been the adoption of visible, easily comprehensible, and explicit inflation targets, defined predominantly in terms of the consumer price index, by several Member States (E, F, I, FIN, S, and UK, although the weight of this target in policy decisions differs from country to country); this may also have strengthened the credibility of monetary policy, especially in those Member States which do not benefit from membership in the ERM. However, it is also possible that this moderation in wage trends is a transitory phenomenon and that, as the recovery matures, the risk of a deterioration in wage demands may re–emerge.

TABLE 3 : **Nominal effective exchange rate changes** (relative to 20 industrial partners)

	Annual percentage changes			
	1992	1993	1994	1995(*)
B	2.3	0.8	1.6	4.5
DK	2.8	2.1	0.1	5.2
D	3.3	2.7	0.1	5.7
GR	–7.7	–9.6	–7.1	–2.7
E	–1.8	–13.1	–6.7	–0.3
F	3.6	1.9	0.6	3.5
IRL	2.8	–5.9	0.3	0.1
I	–2.7	–16.9	–4.6	–9.2
NL	2.4	3.0	0.4	4.4
A	2.6	2.4	0.0	4.1
P	3.6	–7.6	–4.7	2.3
FIN	–12.7	–14.8	7.5	10.9
S	1.3	–19.3	–1.2	–0.9
UK	–3.6	–9.0	0.2	–4.0
EUR 14	2.2	–13.1	–2.2	3.5

(*) on the assumption that the 4th quarter value of exchange rates is the average of October 26, 1995 value.
Source : Commission services.

A third factor behind the decline in inflation is the improved consistency between monetary and budgetary policy. Virtually all Member States have announced and are pursuing policies to reduce government deficits and reverse the rise in the public debt ratio. Despite the fact that prospects for durable consolidation of the public finances remain uncertain in some Member States, the burden imposed on monetary policy by an unbalanced policy mix has been eased. Finally, it should be mentioned that the positive developments on the inflation front occurred in spite of increases in VAT rates in a majority of Member States.

[3] The CPI in the UK is influenced by factors (e.g. mortgage interest payments) which are treated differently from most other national CPIs; the preferred measure of inflation in the UK is the retail price index excluding mortgage interest payments

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

Exchange rate developments have also played a role in inflation trends in previous years and in 1995. On the one hand, reductions in inflation in Member States which have seen currency depreciations have been more difficult to achieve. The Member States with higher inflation (GR, E, I, P) have had depreciations particularly in 1993 and 1994 and to a lesser extent this year, which have potentially sustained the inflation momentum and have slowed the reduction of inflation. Excess capacity in the domestic economy has likely offset, wholly or partially, the impact of depreciation on domestic prices. The large output gap in the case of Sweden, for example, led to rapid reductions of inflation, despite the depreciation, at a pace sufficient to meet the price stability criterion. On the other hand, the appreciation of several Union currencies in nominal effective terms (B, DK, D, F, NL, A) contributed significantly to restraining domestic price inflation in 1995.

A.2 Inflation convergence measured by the Treaty definition

The Treaty requires that inflation convergence should be assessed by means of the consumer price index on a comparable basis. Such data are not yet available (see Box 1). However, trends in national consumer price indices and in private consumption deflators, have been largely similar. As seen in Table 2, both indicators show that inflation in most Member States has eased further in 1995 compared to last year. As an illustration of the measurement of price convergence, as required by the Treaty, data both on the private consumption deflator (as used in previous Convergence Reports) and on the consumer price index are presented in Table 4.

The Treaty lays down that those Member States will be considered as converging in price stability which have an average rate of

TABLE 4 : **Inflation convergence**
(inflation measured by the percentage change in the respective price indices)

		Private consumption deflator[1]			Consumer price index[2]
		1993	1994	1995	1995
	B	–	–	1.5	1.6
	DK	1.0	1.0	–	–
Three	**IRL**	1.7	–	–	–
best	**F**	2.2	1.8	–	1.7
performers:	**NL**	–	2.4	1.6	–
	FIN	–	–	1.2	1.3
	UK	–	2.4	–	–
Reference value(*)		3.1	3.2	2.9	3.0
		Convergent Member States			
Number:		5	8	11	10
out of:		12	12	15	15
	B	3.1	3.0	1.5	1.6
	DK	1.0	1.0	2.0	2.2
	D	–	2.7	1.8	2.2
	F	2.2	1.8	1.9	1.7
	IRL	1.7	2.7	2.5	2.6
	L	–	2.6	1.9	2.1
	NL	2.3	2.4	1.6	2.2
	A	–	–	2.4	2.5
	FIN	–	–	1.2	1.3
	S	–	–	2.8	2.6
	UK	–	2.4	2.9	–

(1)Annual average;
(2) change in average level of index in the period October 1994 – September 1995 over average in previous twelve months;
(*) arithmetic average of the three best performers in terms of inflation plus 1.5 percentage points.
Source: Commission services Autumn 1995 economic forecasts and Eurostat.

Box 1: Inflation convergence according to the Treaty

Inflation convergence is defined by art. 1 of the Protocol on the convergence criteria. According to this, a Member State meets the criterion if its price performance is sustainable and its inflation rate 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 is to be measured by the consumer price index on a comparable basis, taking into account differences in national definitions.

An operational definition of price convergence encompasses three elements: first, the definition of what constitutes a sustainable price performance; secondly, the establishment of the consumer price index on a comparable basis according to which convergence will be measured; and, thirdly, the exact aggregation of the inflation index of the three best performers. Progress has been made in the latter areas but harmonised indices are not yet available.

Work is currently under way to develop consumer price indices for each of the Member States which are comparable with each other. The Commission, in co–operation with the national statistical services, proposed a framework Council regulation (adopted in October 1995) containing provisions for a stepwise harmonisation of consumer price indices. According to the regulation, a preliminary ad–hoc harmonisation of national CPIs will be made available, at the latest, by March 1996.

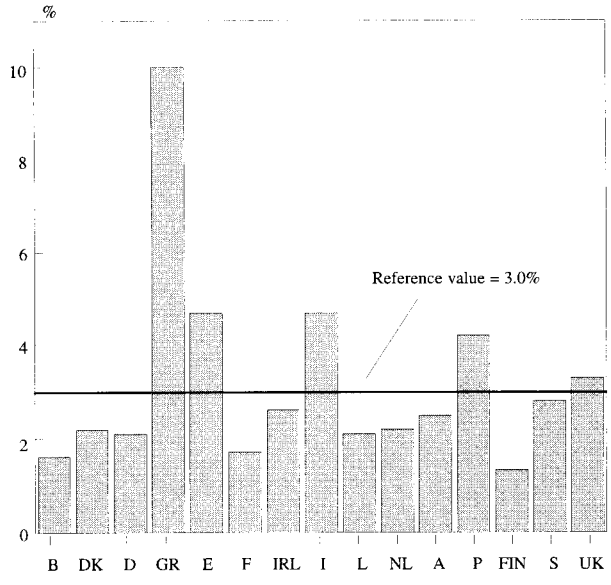
The first step in the harmonisation project will consist of excluding areas where differences in the price indices of the Member States are most marked: first, the treatment of owner–occupied housing; secondly, the treatment of health and education costs; and, thirdly, the differential treatment of various other items such as financial services, insurance costs, local authority services, package holidays etc.

It is envisaged that, in the second stage, the harmonised index will begin in January 1997 and estimates of price changes relative to a common index reference period will be made available. Additional work on harmonisation will also be undertaken, and it is possible that some items excluded in the first stage from the index will be reintroduced if an appropriate common method of treating them has been established.

The harmonised CPI will be collected and reported with monthly frequency, and the weights of the index will be updated in a manner that ensures that comparability requirements are met. As yet no official data on the harmonised indices have become available.

A final issue concerns the operational definition of the inflation rate of, at most, the three best performers in terms of price stability. The Treaty's wording provides for the possibility to consider the inflation rate of two Member States (or even one) to serve as a reference for the measure of convergence. One approach is to consider the average inflation rate in the three best performing Member States, with inflation measured by the arithmetic average of twelve monthly indices relative to the arithmetic average of the twelve monthly indices of the previous period.

GRAPH 1 : **Consumer price inflation**
(change in average level of index in the period October 1994 to September 1995 over the average in previous twelve months)



Source: Commission services.

inflation observed over a period of one year prior to the examination not exceeding by more than 1½ percentage points the rate of inflation of at most the three best performing Member States in terms of price stability. On the basis of this criterion and using an arithmetic average to establish the reference value, the results reported in Table 4 can be obtained (the data in this table consider the new Member States, Austria, Finland and Sweden, as part of the convergence assessment only from this year onwards). The reference value declines between 1994 and 1995, reflecting the good inflation performance in the reference group, i.e. the group formed by the three best performers. With the exception of Finland in 1995, the reference group is composed of Member States which have long belonged to the narrow band of the ERM. No Member State has belonged unfailingly throughout this period to the reference group of the three best performers; Denmark, France, and the Netherlands have twice been part of the group. On the other hand, and on the basis of these data, Germany has not been among the three best performers as regards inflation in the years under review. Finally, all the three new Member States have an inflation rate in 1995 below the reference value; moreover, Finland is the best performing Member State this year.

Convergence in price inflation has strengthened substantially in the period since 1993. In 1993, five Member States respected the price stability criterion; in 1994, eight of the twelve Member States met the criterion, while in 1995 eleven of the fifteen Member States met the criterion and so were convergent in terms of inflation. If the consumer price index for the period October 1994–September 1995 is used to measure inflation, the same Member States, apart from the UK, have inflation lower than the reference value.

Four Member States (GR, E, I, and P), despite their considerable progress, have not yet recorded an inflation rate equal to the reference value. In this group, while Greece has made marked progress in reducing inflation, it nevertheless remains considerably above the reference value; in Spain the pace of disinflation has remained slow and in Italy, on the other hand, inflation worsened in 1995; in Portugal, currently the Member State within this group with the lowest inflation rate, the distance from the reference value narrowed further this year.

A.3 Other indicators of inflation and of the sustainability of price convergence

While price convergence has strengthened in 1994 and 1995, and prospects for additional progress remain good, the sustainability of this progress will in part depend on satisfactory behaviour of input costs and other factors influencing consumer prices. The Treaty requires that developments in "unit labour costs and other price indices" (art. 109j) should also be considered in the assessment of convergence.

Cost and, more specifically, wage developments are important indicators of inflation pressures. Developments in nominal wages may be consistent with price stability or they may be evolving in a manner eroding competitiveness, with potential exchange rate implications and, most importantly, they could signal the emergence of cost–push factors threatening to price stability. Moreover, trends in nominal wages, to the extent that they are forward–looking indicators for expected price changes, either reflect stable inflation expectations or signal incomplete credibility of the inflation objectives; this evidence is important for assessing whether price developments risk being destabilized by adverse wage inflation trends. Finally, supplementary information on inflation trends from other price indices (underlying inflation, producer prices, import prices) is also relevant for the assessment of the sustainability of inflation.

Developments in unit labour costs

Further moderation in the growth of nominal unit labour costs (compensation of employees per unit of output) was marked in 1994 and 1995, thus reversing the adverse trends of the early part of the decade (Table 5). For the Union as a whole growth in unit labour costs virtually stagnated in 1994 but recovered in 1995. This moderation reflects both the slowdown in nominal wage growth and the recovery in productivity growth after the recession. Key factors influencing the former are the substantial unemployment which continues to prevail in virtually all the Member States, and the apparent decline in inflation expectations. Wage settlements appear to incorporate inflation expectations consistent with the price objectives of the authorities, and in this regard economic policies seem to have renewed, and built upon, their credibility. Nevertheless, it is too early to judge whether these developments signal a structural break in wage determination .

Labour productivity growth decelerated in the beginning of the decade as economic growth began slowing in virtually all the Member States (Table 5). Productivity growth accelerated markedly in 1994, to 3.1 percent, as the recovery gained strength; during 1994 growth in unit labour costs remained virtually stagnant. As the cyclical rebound of productivity growth comes to an end, unit labour costs are estimated to have grown by 1.8 percent in 1995.

In 1994 unit labour costs declined in absolute terms in Denmark, Germany, France, Ireland, Italy, the Netherlands, Finland and the UK as a result of wage restraint but principally reflecting the cyclical rebound of productivity growth; in the rest of the Community unit labour costs generally showed positive growth despite the equally pronounced acceleration of productivity growth. Wage trends moderated substantially also in two of the Member States which were still divergent in terms of price stability in 1994 (E and P), but in Greece growth in unit labour costs accelerated relative to 1993. This was accounted for by primarily a deterioration in nominal wage settlements, while also growth in productivity was negative for a third consecutive year. In general, these developments eased the task of monetary policy in most Member States and contributed favourably to the conditions which made possible the declines in short–term interest rates.

TABLE 5 : **Nominal unit labour costs (I) and productivity growth (II)** (percentage change, total economy)

	1991		1992		1993		1994		1995	
	(I)	(II)	(I)	(II)	(I)	(II)	(I)	(II)	(I)	(II)
B	5.7	2.1	3.7	2.3	3.4	–0.2	1.8	3.0	0.5	2.1
DK	1.4	2.9	2.6	1.2	–0.3	2.2	–1.4	4.7	2.0	1.3
D	–	–	6.1	4.1	3.6	0.6	–0.4	3.6	1.8	2.1
GR	7.7	5.6	11.0	–0.6	11.1	–1.5	12.7	–0.4	9.1	0.7
E	6.5	1.6	7.3	1.9	3.7	3.0	1.6	2.9	3.4	0.5
F	3.6	0.7	2.3	2.1	2.6	–0.4	–0.5	2.6	1.3	1.7
IRL	1.5	2.2	3.4	3.5	2.4	2.5	–0.8	4.0	–0.4	3.1
I	8.1	0.4	3.9	1.8	2.1	1.5	–0.3	3.8	1.6	3.1
L	5.8	–1.0	6.9	–0.6	6.8	–1.4	1.5	3.0	3.0	0.6
NL	3.5	0.9	3.7	1.0	2.7	0.4	–0.2	2.6	1.4	1.8
A	5.1	1.2	4.5	1.3	4.2	0.4	0.2	2.8	1.7	2.3
P	15.4	–0.6	6.3	2.9	8.3	0.7	3.5	1.3	2.6	3.3
FIN	7.8	–2.0	–1.8	3.7	–4.4	5.7	–1.8	5.4	3.7	1.7
S	6.4	0.4	0.8	3.2	0.4	3.2	2.4	3.3	1.3	1.9
UK	7.4	1.1	3.8	1.6	1.2	3.7	–0.3	3.2	1.3	1.9
EUR 15	5.5	1.4	4.3	2.4	2.7	1.3	0.2	3.1	1.8	2.0

Source: Commission services Autumn 1995 economic forecasts.

The acceleration in unit labour costs in 1995, which is a reflection of renewed nominal wage growth and of the end of the cyclical rebound in productivity growth, will likely continue to be consistent with favourable inflation trends. However, in certain Member States (GR and E in particular) the pace of growth of unit labour costs, especially in light of the modest productivity growth, could signal potential increases in prices on the part of firms and an ultimate threat to the reduction in inflation achieved so far. Furthermore, these trends are diverging from the moderation prevailing in other Member States, in which developments in unit labour costs do not appear to signal a deterioration in the underlying cost environment or a deterioration in competitiveness.

As can be seen in Table 6, the Member States which saw depreciations of their currencies in the period 1992–94 (cf. Table 3) have had, correspondingly, the largest increases in import prices. Also, the Member States which experienced the largest appreciations relative to the US dollar this year (B, DK, D, F, NL, and FIN) have also had low or negative import price inflation. This has provided support to the favourable inflation trends registered in 1995. On the other hand, large increases in import prices this year, ranging from 5 percent to 10 percent continued to characterise Italy, the UK, Sweden, Greece, and Spain, although in the last two countries import prices have decelerated this year. To sterilise the domestic inflation impact of these developments it is essential that policies on inflation remain cautious.

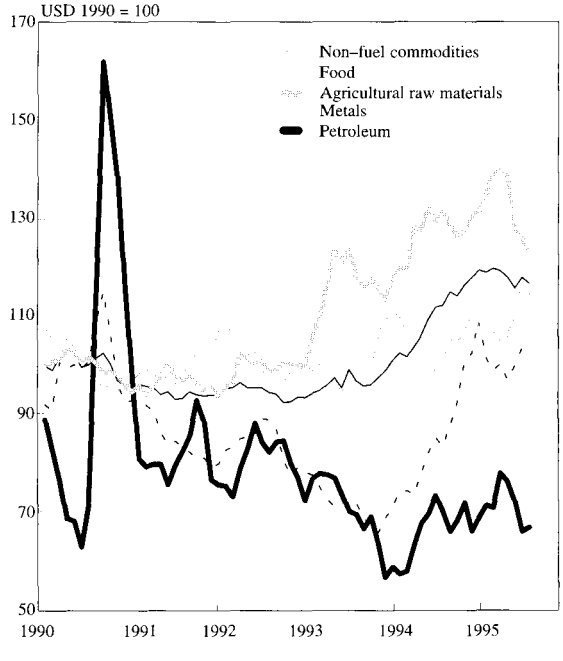
Developments in import prices

Trends in import price inflation in domestic currency reflect trends in international prices, the value of the exchange rate, and the price–setting behaviour of foreign suppliers.

Following the sharp increase in international commodity prices in 1994, most primary commodity prices have been stable this year, at a higher level than in 1994. However, there have been increases in some agricultural products (wheat and maize, in particular) which are imported into the Community, as well as a transitory increase in the price of oil in the beginning of the year, which was subsequently reversed. In general, trends in international primary commodity prices have behaved favourably from the perspective of contributing to domestic inflation in 1995, and are likely to continue so next year as well.

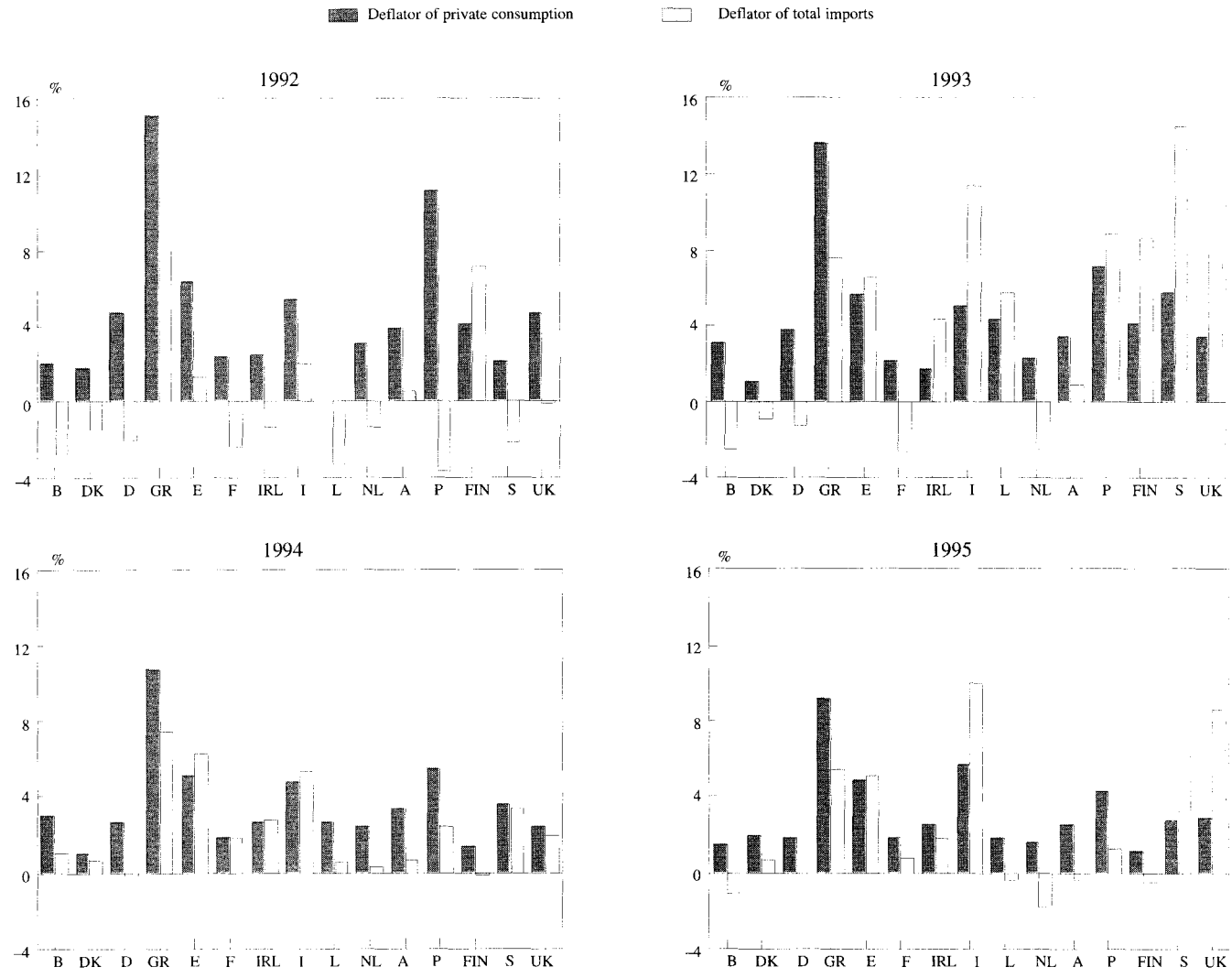
Import price inflation can be highly correlated with domestic price measures of inflation (cf. Graph 3). The exchange depreciation of several Community currencies in 1992 and in 1993, coinciding with unstable international commodity prices, contributed to an acceleration in import price inflation, in these Member States during these years; this reversed the decline in import prices seen in 1992 when Community currencies registered appreciations. The marked appreciation against the US dollar, on the other hand, has had a beneficial effect on import prices and on domestic prices in several Member States in 1995.

GRAPH 2 : **International commodity prices**



Source : Commission services, IMF.

GRAPH 3 : **Domestic and import price inflation** (annual percentage change)



Source: Commission services.

TABLE 6 : **Import price inflation**
(percentage change in the deflator of imports of goods and services, in national currency)

	1991	1992	1993	1994	1995
B	–0.4	–2.7	–2.5	1.0	–1.1
DK	2.1	–1.5	–0.9	0.7	1.3
D	–	–1.5	–1.5	–0.5	0.0
GR	8.8	8.4	7.6	7.5	5.6
E	–0.3	1.3	6.6	6.3	5.1
F	0.0	–2.4	–2.7	1.8	0.8
IRL	2.4	–1.3	4.4	2.8	1.9
I	–0.1	2.0	11.4	5.3	9.9
NL	0.4	–1.4	–2.5	0.3	–1.8
A	0.9	0.5	0.9	0.7	–0.4
P	1.4	–3.7	8.9	2.4	1.3
FIN	0.6	7.2	8.7	–0.2	0.5
S	0.1	–2.2	14.5	3.4	6.2
UK	0.3	–0.1	8.1	1.9	8.6
EUR 15	0.8	–0.6	2.9	2.2	3.3

There are no separate data for Luxembourg: EUR 15 weighted in common currency.
Source: Commission services Autumn 1995 economic forecasts.

B. Budgetary convergence

B.1 Budgetary Developments in 1995

Government deficits

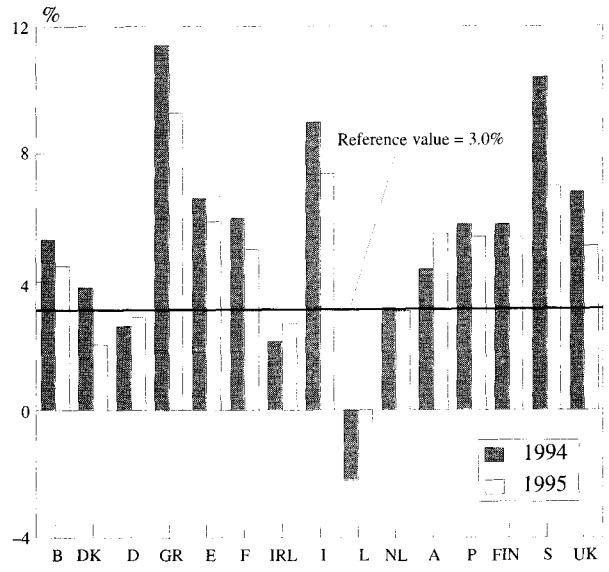
The recession of 1992–1993 led to a significant deterioration in budgetary positions and to an increase in deficit and debt ratios in all the Member States. This set back in budgetary convergence led Member States to step up their fiscal adjustment efforts and accelerate the process of budgetary consolidation especially taking advantage of the recovery of economic growth. Member States have already acknowledged the need for budgetary consolidation and debt reduction and have incorporated their policy intentions in convergence programmes in which targets for deficit and debt reduction are key features. After the presentation of a convergence programme by each of the new Member States in 1995, all except Luxembourg have now presented such programmes. During 1994 and 1995 budgetary positions have improved and progress in convergence took place at a renewed momentum. However, for the majority of the Member States respect of the budgetary convergence criteria has yet to be achieved.

TABLE 7 : **General government deficit**
(percent of GDP)

	1993	1994	1995
B	6.7	5.3	4.5
DK	4.5	3.8	2.0
D	3.5	2.6	2.9
GR	12.1	11.4	9.3
E	7.5	6.6	5.9
F	6.1	6.0	5.0
IRL	2.4	2.1	2.7
I	9.6	9.0	7.4
L	–1.8(*)	–2.2(*)	–0.4(*)
NL	3.2	3.2	3.1
A	4.1	4.4	5.5
P	7.1	5.8	5.4
FIN	8.0	5.8	5.4
S	13.4	10.4	7.0
UK	7.8	6.8	5.1
EUR 15	6.3	5.5	4.7

(*) indicates a surplus.
Source: Commission services Autumn 1995 economic forecasts.

GRAPH 4 : **General government net borrowing**
(percent of GDP)



Source: Commission services.

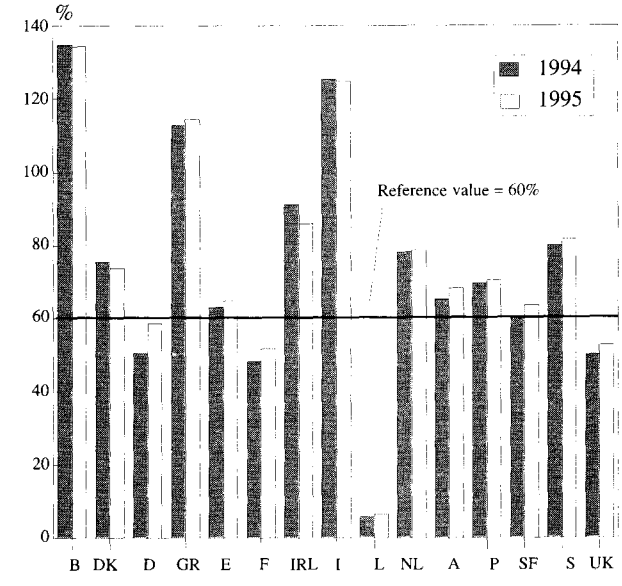
According to the Commission's Autumn 1995 economic forecasts, eleven Member States (B, DK, GR, E, F, I, NL, P, FIN, S, and UK) have improved their government deficit as a percentage of GDP in 1995 (Table 7 and Graph 4). The largest deficit reductions – albeit from a relatively high level – between 1993 and 1995 are estimated to take place in Sweden (6.4 percentage points in terms of GDP), Greece and the UK (2.8 and 2.7 points, respectively). With the exception of Austria, the increases in 1995 in the government deficits were confined to Member States with the lowest deficits in the previous year; while Luxembourg markedly reduced its surplus, in Germany and Ireland[5] the rise in the deficit did not breach the 3 percent of GDP reference value.

Despite the deficit reductions which have taken place this year, only one additional Member State, Denmark, has reduced its deficit below the 3 percent of GDP reference value. In the remaining Member States, the Netherlands had a deficit only marginally higher than the reference value (3.1 percent of GDP), while the rest had deficits above 4 percent of GDP. Government deficits continued to be particularly large this year in Greece (9.3 percent of GDP), Italy (7.4 percent) and Sweden (7.0 percent).

General government debt ratios continued to deteriorate, but at a slowing pace

Between 1993 and 1994 the ratio of government debt to GDP in the Union rose by 1.9 percentage points, a less rapid increase than that which took place between 1992 and 1993 (5.9 percentage points) and reflected the impact of the recession. Latest estimates show a further rise in EU debt ratio of just over 3 percentage points in 1995, taking it to a record higher level of 71 percent. The faster rise this year than in 1994 is to a large extent due to the exceptional increase in Germany (see below). The current level of the debt ratio, and its trend rise since the beginning of the decade, suggest that the need for fiscal retrenchment continues to be urgent. In contrast to government deficits, which, following a marked widening during the recession, have subsequently declined, debt ratios have continued to increase further during the recovery (see Graph 5 and Table 8). It is clear that the reduction of

GRAPH 5 : **General government gross debt**
(percent of GDP)



Source: Commission services.

the deficit has not been sufficiently large, together with nominal GDP growth, to halt the rise in debt ratios; the latter increased further in ten Member States in 1994, and in eleven this year.

The public debt circumstances of each Member State differ, however. Despite the increase in 1994 and 1995, the debt ratio in four Member States (D, F, L, UK) continued to be below 60 percent of GDP. The increase in Germany's debt ratio in 1995 is of an exceptional nature and is due to a unification related debt take–over; this brought it to just under 60 percent of GDP, up from 48.2 percent in 1993.

Three Member States (B, GR, and I) have debt ratios exceeding 100 percent of GDP and, as shown in Table 8, progress in reducing their ratios since 1993 has been unequal within this group. Belgium has reduced its debt ratio by a cumulative 3 percentage

[5] Part of the increase in the deficit in Ireland in 1995 reflects the treatment on a cash basis of arrears of social welfare benefits due under the Equal Treatment Directive.

Box 2 : Budgetary convergence criteria

According to Article 109j, a Member State meets the budgetary convergence criterion if, at the time of examination, it is not experiencing an excessive deficit as determined in accordance with Article 104c(6) and the respective protocols. The existence of an excessive deficit is assessed on the basis of the following two criteria:

(1) whether the ratio of the planned or actual government deficit to gross domestic product does not exceed 3 %, unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

(2) whether the ratio of gross government debt to gross domestic product exceeds 60 percent, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The wording used in the Treaty reflects various concerns. In the case of the deficit, the Treaty allows for exceptional and temporary circumstances and takes into account a positive trend, but within the very narrow limits determined by the phrase "close to the reference value". In the case of the debt/GDP ratio, the Treaty after first setting a reference value for the level of the ratio recognises the inertia of this aggregate: even under very favourable growth and deficit conditions significant reductions in the debt/GDP ratio may take many years (see graphs in Box 3). A debt/GDP ratio "sufficiently diminishing and approaching the reference value at a satisfactory pace" may be taken as a sign of a credible consolidation process.

TABLE 8 : **General government gross debt**
(percent of GDP)

	Level			Change		
	1993	1994	1995	93/92	94/93	95/94
B	137.5	135.0	134.4	6.4	–2.5	–0.6
DK[1]	80.3	75.6	73.6	11.3	–4.7	–2.0
D[2]	48.2	50.2	58.8	4.1	2.0	8.6
GR	114.5	113.0	114.4	22.9	–1.5	1.4
E	60.4	63.0	64.8	12.0	2.6	1.8
F	45.3	48.4	51.5	5.7	3.1	3.1
IRL	97.4	91.1	85.9	3.1	–6.3	–5.2
I	119.4	125.4	124.9	11.0	6.0	–0.5
L	6.3	5.9	6.4	1.2	–0.4	0.5
NL	81.3	78.0	78.4	1.7	–3.3	0.4
A	63.0	65.2	68.0	4.7	2.2	2.8
P	67.2	69.4	70.5	4.8	2.2	1.1
FIN	57.3	59.8	63.2	15.8	2.5	3.4
S	76.2	79.7	81.4	9.1	3.5	1.7
UK	48.6	50.1	52.5	6.7	1.5	2.4
EUR 15	66.2	68.1	71.0	5.9	1.9	2.9

1) Government deposits with the central bank, government holdings of non-governmental bonds and public enterprises related debt amounted to some 20 percent of GDP in 1995.
2) The sharp increase in the German debt ratio in 1995 is mainly caused by the take-over by the government of off-budget unification-related liabilities, the most important of which is the debt of the "Treuhandanstalt".
Source: Commission services Autumn 1995 economic forecasts.

points during this period, while in Greece the debt ratio resumed its growth this year following a decline in 1994, largely associated with debt management operations. In Italy, on the other hand, the steady increase of the debt ratio seems to have come to a halt in 1995 when a small reduction is expected for the first time.

The debt ratios in Spain and Finland are around 65 percent of GDP, exhibiting, however, a rising trend, while in Austria the debt ratio has risen rapidly since 1993, to 68 percent in 1995; on theother hand, and after rising steadily since 1993, the debt ratio in Portugal has now reached just over 70 percent of GDP. Of the remaining Member States (DK, IRL, NL, and S), which have debt ratios between 70 and 90 percent of GDP, Denmark and Ireland have made clear progress in 1995; in Ireland this progress follows several years of significant reductions in the debt ratio (except for 1993, mainly as a result of the depreciation of the Irish punt); in Denmark, the debt ratio started to decline in 1994. In the Netherlands the debt ratio also fell in 1994 but rose again slightly in 1995 (mainly due to a financial operation related to housing). The upward trend in the debt ratio in Sweden has continued but at a much slower pace this year.

The state of the budgetary position of the Member States is reflected in the September 1994 and the July 1995 Council decisions concerning the existence of excessive deficits in accordance with Article 104c of the Treaty. In the 1994 decisions, all the Member states except two, Ireland and Luxembourg, were found to have an excessive deficit. In 1995 the Council decided to abrogate the decision of the previous year on Germany and decided that all the three new Member States had an excessive deficit.

Budgetary convergence in 1995

Table 9 presents a summary of budgetary performance in 1995 taking account of the Treaty criteria. Despite the reductions in government deficits over the past three years, the majority of the Member States does not respect the reference value for the deficit. Only Denmark, Germany, and Ireland have budget deficits below 3 percent of GDP this year and Luxembourg has a surplus. In the Netherlands the deficit is close to the reference value.

Four Member States (D, F, L, UK) continue to have a debt ratio below the reference value in 1995. Within the group of Member States which still have a debt ratio above 60 percent of GDP, the

TABLE 9 : **Budgetary convergence in 1995**
(variables as percent of GDP)

	Deficit	Debt	Δ debt 1993–95
Reference value	3.0	60.0	
B	4.5	134.4	–3.1
DK	2.0	73.6	–6.7
D	2.9	58.8	10.6
GR	9.3	114.4	–0.1
E	5.9	64.8	4.4
F	5.0	51.5	6.2
IRL	2.7	85.9	–11.5
I	7.4	124.9	5.5
L	–0.4 (*)	6.4	0.1
NL	3.1	78.4	–2.9
A	5.5	68.0	5.0
P	5.4	70.5	3.3
FIN	5.4	63.2	5.9
S	7.0	81.4	5.2
UK	5.1	52.5	3.9

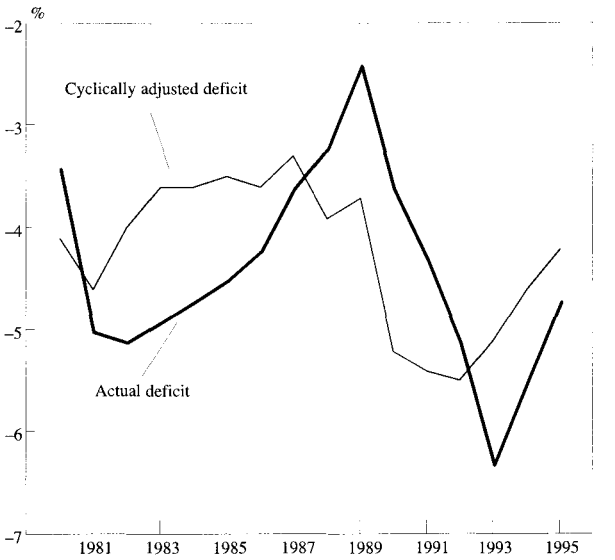
Member States not having an excessive deficit in 1995: D, IRL, L

Δ = change; (*) indicates a surplus.
Source: Commission services Autumn 1995 economic forecasts.

debt ratio has declined in four of them (B, DK, IRL, NL) in the period 1993–95. In Ireland, the debt ratio has continued to diminish significantly, and during this period it fell by 11.½ percentage points. Denmark has recorded a debt reduction of 6.½ percentage points in terms of GDP, and Belgium 3 points, over the same period. In the Netherlands the reduction also amounts to 3 percentage points, although the debt ratio has risen marginally this year. Finally, in Greece a marginal reduction has taken place although the debt ratio has risen once more in 1995.

Compared to 1994, some improvement in budgetary convergence has taken place this year. Deficits are generally lower in 1995 and the number of Member States with a government deficit below the reference value has increased by one (DK) (and the Netherlands is very close); moreover, increases in the debt ratio in 1995 have generally been smaller than in the previous year (except for Germany where the increase was due to exceptional circumstances) and much smaller than the increase of 1993. A tendency towards debt stabilisation and/or debt reduction seems apparent in the Member States.

GRAPH 6 : **Actual and cyclically adjusted deficit**
(Percent of GDP)



Source: Commission services.

B.2 Underlying trends and consolidation efforts

Budget balances supported by cyclical developments

The deterioration of budget imbalances during the course of the recession was largely the result, in most Member States, of the behaviour of the automatic stabilisers, that is, the rise in cyclical expenditure and the decline in revenues. A comparison of actual government deficits with deficits adjusted for the effect of economic cycle on the budget [6], shown in Graph 6 and Table 10, suggests that, for the Community as a whole, approximately half of the reduction in the deficit in the period 1993–95 has been the result of the cyclical upswing in economic activity and the other half due to a reduction in the structural deficits.

The timing of structural adjustment, as presented by changes in the cyclically adjusted deficit, has varied from one Member State to another. In 1994, with the recovery under way, nine of the Member States recorded reductions in the cyclically–adjusted deficit, and Luxembourg a deterioration in its cyclically–adjusted surplus; Denmark, France, Ireland, the Netherlands, and Austria continued to experience a deterioration, and in the UK there was no change in the cyclically–adjusted deficit. Several Member States realised the greatest reductions in the cyclically–adjusted deficit during the recession (B, D, IRL, I, and NL), but in the course of the recovery further reductions have taken place at a slowing pace. For the first time in 1995, on the other hand, Denmark and France saw reductions in the cyclically–adjusted deficit, while in Greece and the UK the largest reductions have been delayed until this year. Since 1993 Belgium has achieved a 4.4 percentage points of GDP adjustment in its cyclically–adjusted deficit, followed by Greece and Italy (3.1 and 2.9 points, respectively) Germany and the Netherlands (1.8 and 2.1 points, respectively), and Sweden (1.5 points). Both the delay in reducing cyclically–adjusted deficits and the size of the reductions relative to the initial fiscal imbalances suggest that the opportunity to take advantage of the recovery and promote durable consolidation of the public finances has not been fully realised.

TABLE 10 : **Changes from previous year in the actual and cyclically adjusted general government deficit**
(percent of GDP)

	Change in deficit			Change in cyclically–adjusted deficit		
	1993	1994	1995	1993	1994	1995
B	–0.4	–1.4	–0.8	–2.5	–1.3	–0.6
DK	1.6	–0.7	–1.8	1.0	0.8	–1.0
D	0.7	–0.9	0.3	–1.1	–0.8	0.1
GR	0.4	–0.7	–2.1	–0.3	–0.7	–2.1
E	3.3	–0.9	–0.7	0.9	–1.1	–0.4
F	2.1	–0.1	–1.0	0.4	0.1	–0.6
IRL	0.0	–0.3	0.6	–1.0	0.7	1.5
I	0.1	–0.6	–1.6	–1.4	–0.4	–1.1
L*	–1.0	0.4	–1.8	na	–0.3	–1.9
NL	–0.7	0.0	–0.1	–2.4	0.1	0.2
A	2.1	0.3	1.1	0.8	0.7	1.1
P	3.8	–1.3	–0.4	2.2	–1.8	–0.3
FIN	2.1	–2.2	–0.4	0.5	–0.6	1.7
S	5.6	–3.0	–3.4	2.3	–2.2	–1.6
UK	1.7	–1.0	–1.7	1.5	0.0	–1.3
EUR	1.2	–0.8	–0.8	na	–0.5	–0.4

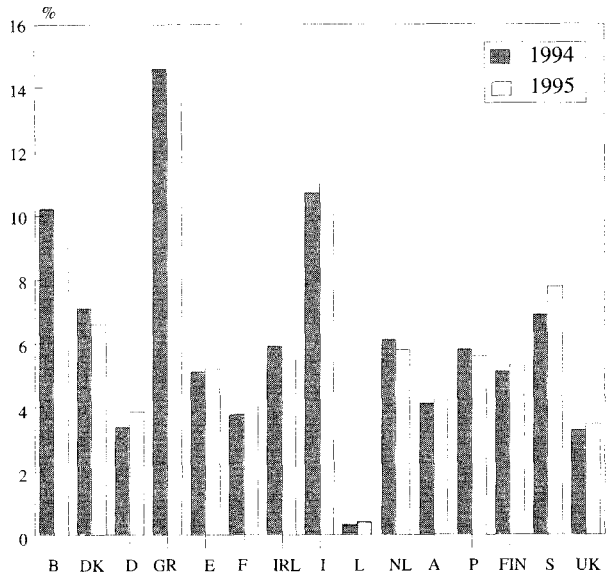
A negative (positive) sign indicates a reduction (increase) in the respective deficits; * Luxembourg has a surplus, thus a negative (positive) sign indicates a reduction (or increase) in its surplus; na= not available.
Source: Commission Autumn 1995 economic forecasts.

Interest payments

The persistent increase in general government debt and the evolution of interest rates has led to debt service payments representing an increasingly large share of total expenditure with the result that the flexibility of budgetary policy is becoming circumscribed. Absolute levels of general government debt and, therefore, interest burdens, vary considerably between Member States. Graph 7 shows the ratio of interest payments to GDP in 1994 and 1995; Greece and Italy had the largest such ratios reflecting both the size of public debt and the fact that the average interest rate at which

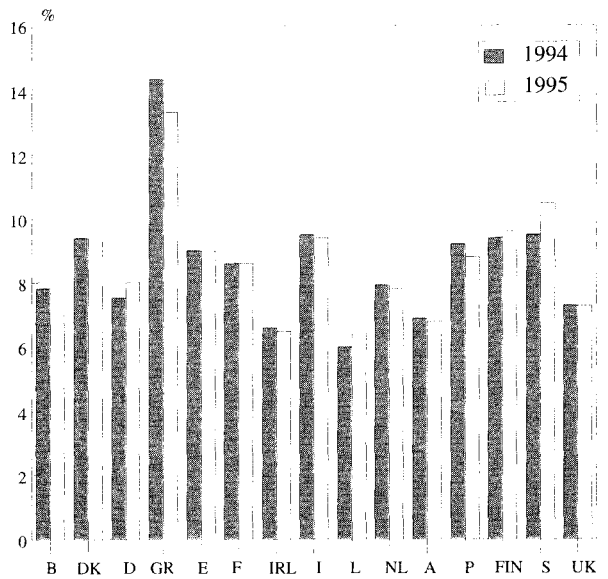
[6] The method for cyclically adjusting government deficits is described in "Technical note: the Commission services method for cyclical adjustment of government budget balances", in *European Economy* no. 60, 1995.

GRAPH 7 : **Actual interest payments**
(as % of GDP)



Source : Commission services.

GRAPH 8 : **Effective rate of interest on government debt**
(in % of gross public debt)



Source : Commission services.

the deficit is financed is comparatively high. In the case of Belgium the share of interest payments to GDP is also large, and in Sweden and Denmark it represents over 6 percent of GDP. Interest payments are equivalent to four to five times the level of government capital expenditure in the cases of Belgium, Greece, and Italy, and two to three times in Denmark and Sweden.

The increase in long–term interest rates, discussed in section C below, will have adverse implications particularly for the Member States where the debt ratio is high and increasing. The widening dispersion and the rise in the level of long–term interest rates implies that the contribution of interest payments to deficits and, ceteris paribus, to the accumulation of public debt has increased this year.

Debt stabilisation and primary gaps

Changes in the debt ratio depend on the real rate of interest on government debt, the rate of growth of the economy, the stock of debt relative to GDP and the non–interest (primary) balance of the government budget (see Box 3 for a discussion). Since neither the rate of interest on the debt nor the rate of growth of the economy can be influenced directly by government, budgetary policy contributes to stabilisation and reduction of the debt ratio mainly through primary balances. In general, a surplus in the primary balance is necessary to bring about a stabilisation and further decline in the debt ratio; the larger the stock of debt, the larger, ceteris paribus, is the primary surplus required to stabilise the debt ratio. Table 11 shows that eight Member States (B, DK, GR, IRL, I, L, NL, and A) had primary surpluses in 1993, notwithstanding the recession, and the majority of them has sustained; these surpluses into the present year. In those Member States where the debt ratio is very high (B, GR, I) primary surpluses have been sustained; Belgium has had a primary surplus for almost a decade now and in Greece and Italy the primary surpluses are larger this year than in 1994. In the Member States where the debt ratio is above the reference value of 60 percent but below 70 percent (E, P, A, FIN) and is also rising, progress was very limited, with only Portugal showing a small primary surplus this year. The remaining Member States within this group continued to have primary deficits, the largest of which was in Austria. In the group where the debt ratio is in the range of 70 to 90 percent of GDP (DK, IRL, NL, S) primary surpluses were realised, ranging from 0.8 percent of GDP in Sweden to 4.7 percent of GDP in Denmark. While continuing to have a debt ratio below the reference value, France and the UK have recorded primary deficits. Finally, Germany and Luxembourg also had primary surpluses this year.

TABLE 11 : **General government total and primary balance***
(percent of GDP)

	1993		1994		1995	
	Total	Primary	Total	Primary	Total	Primary
B	–6.7	3.8	–5.3	5.0	–4.5	4.5
DK	–4.5	3.3	–3.8	3.3	–2.0	4.7
D	–3.5	–0.2	–2.6	0.8	–2.9	0.9
GR	–12.1	1.0	–11.4	3.2	–9.3	4.2
E	–7.5	–2.2	–6.6	–1.5	–5.9	–0.6
F	–6.1	–2.5	–6.0	–2.2	–5.0	–1.1
IRL	–2.4	4.3	–2.1	3.8	–2.7	2.8
I	–9.6	2.6	–9.0	1.7	–7.4	3.6
L	1.8	2.2	2.2	2.5	0.4	0.8
NL	–3.2	3.2	–3.2	2.8	–3.1	2.7
A	–4.1	0.3	–4.4	–0.3	–5.5	–1.3
P	–7.1	–0.4	–5.8	–0.1	–5.4	0.2
FIN	–8.0	–3.4	–5.8	–0.7	–5.4	–0.1
S	–13.4	–7.0	–10.4	–3.5	–7.0	0.8
UK	–7.8	–4.9	–6.8	–3.5	–5.1	–1.6
EUR 15	–6.3	–0.8	–5.5	–0.2	–4.7	0.7

* (–) indicates net (primary) borrowing.
Source: Commission Autumn 1995 economic forecasts.

Progress towards achieving greater primary surpluses or smaller deficits became clear since the recession. Table 12 and Graphs 9a and 9b place this experience in perspective by comparing the primary surplus which would be necessary to stabilise the debt ratio in the period since 1993 with the actual primary surplus achieved in each Member State. The difference between these variables is the primary gap: when it is positive, it implies that the fiscal adjustment actually achieved fell short of that required to stabilise

Box 3: Debt Dynamics: Basic Relationships

The gross government debt ratio may be expressed as:

$$\frac{D_t}{Y_t} = \frac{(1 + i)}{(1 + n)} * \frac{D_{t-1}}{Y_{t-1}} + \frac{PD_t}{Y_t} + \frac{SF_t}{Y_t} \qquad (1)$$

where: D=government debt, Y=GDP at current market prices, PD=primary deficit, i=nominal interest rate on government debt, n=nominal GDP growth and SF=stock–flow adjustment, t=time.

The first term is the sum of the government debt of the previous year and the interest payments due as a percentage of current GDP. The second term represents the primary deficit. The third term constitutes the so–called "stock flow adjustment" which regroups the remaining factors which influence government debt. It includes the effect of the net accumulation of financial assets by the government, the consolidation for the holdings of government debt titles within the government sector, changes in the national currency value of foreign currency denominated debt as a result of exchange rate movements and minor statistical adjustments.

The change in the debt ratio, after elimination of inflation, can be expressed in terms of real interest rate and real growth:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \frac{(r_t - g_t)}{(1 + g_t)} * \frac{D_{t-1}}{Y_{t-1}} + \frac{SF_t}{Y_t} \qquad (2)$$

where: r=real interest rate on government debt, g=real GDP growth

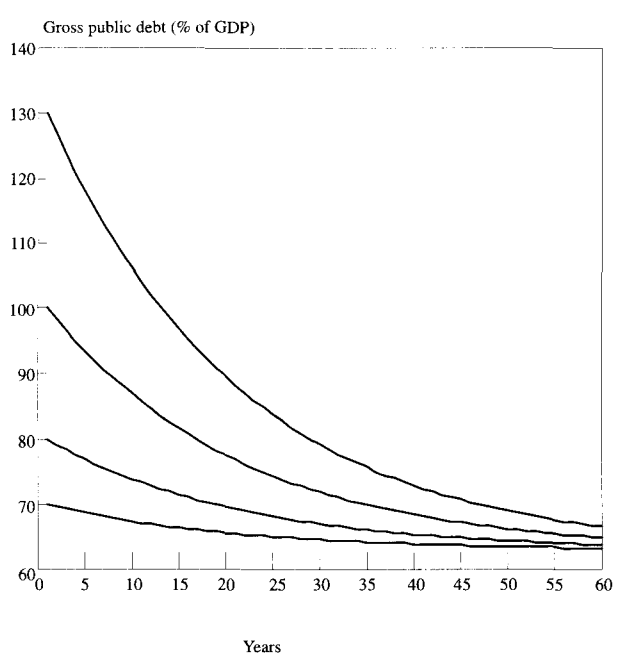
This allows to draw some interesting conclusions. The relative levels of the real interest rate and real GDP growth have a direct effect on the outstanding stock of government debt. When the real effective interest rate on government debt exceeds economic growth, the negative impact of interest payments outweighs the positive impact of real growth on the government debt ratio, and as a result an increase in the debt ratio is generated.

When the real effective interest rate exceeds real GDP growth, the government must run a sufficiently large primary surplus in order to stabilise the government debt ratio. The difference between this debt–stabilising primary balance (second term on the right hand side in equation (2)) and the actual primary balance (first term on the right hand side of equation (2)) is called the primary gap. When the primary gap is negative, i.e. when the actual primary surplus is larger than the debt–stabilising surplus, the government debt ratio will decrease, provided that the stock–flow adjustment remains sufficiently small.

The accompanying Graphs present the time path of adjustment towards the 60 percent of GDP value for the debt ratio under assumptions which are consistent with potential output growth of 3 percent and inflation of 2 percent per annum, and with a stable deficit of 3 percent of GDP (the reference value for the deficit criterion). Graph I shows that, with this deficit, reaching the the 60 percent of GDP reference value for the debt ratio is an extremely long process. Furthermore, should the favourable assumption about nominal GDP growth fail to be realised, reaching the terminal debt objective will be achieved at an even longer time horizon.

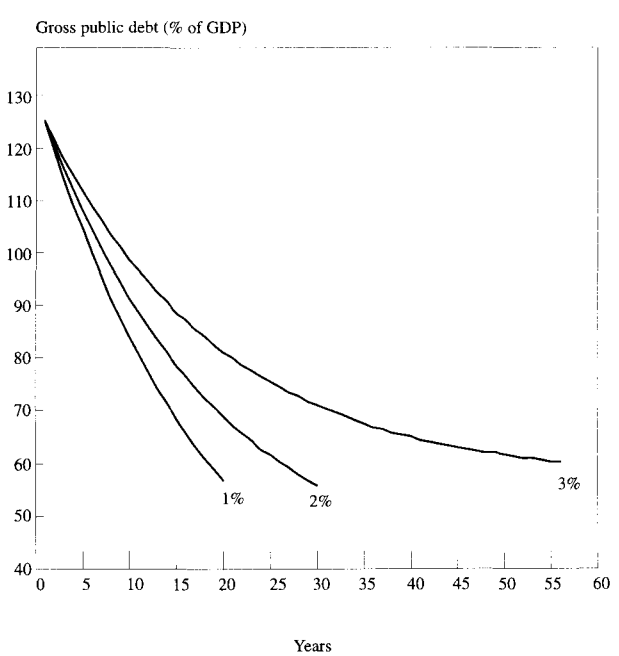
Alternatively, Graph II presents the path of adjustment under the same assumptions about nominal GDP growth but under alternative assumptions about budget deficits, and for an initial value of the debt ratio exceeding 100 percent of GDP. While with a 3 percent of GDP deficit the adjustment is extremely lengthy, a sustained deficit of 2 percent of GDP will make possible achieving the terminal value in half as much time. Moreover, with a sustained deficit of 1 percent of GDP, even highly indebted Member States would achieve a marked reduction in the debt ratio early in the next century.

GRAPH I : **The dynamics of the Public Debt/GDP ratio**
(Inflation 2 %, real GDP growth 3 %, budget deficit 3 %)



Source : Commission services.

GRAPH II : **Dynamics of the Debt/GDP ratio**
(Inflation 2 %, real GDP growth 3 %, alternative budget deficit)



Source : Commission services.

TABLE 12 : **Estimates of primary gaps**
(difference between the debt–stabilising and the actual primary balance,in percent of GDP)

	1993	1994	1995
B	3.6	–1.2	–1.4
DK	2.8	–1.4	–2.2
D	2.4	0.2	0.9
GR	1.5	–1.4	–1.9
E	6.0	3.1	1.2
F	5.7	4.2	2.8
IRL	–4.1	–5.1	–4.7
I	6.3	2.3	–1.1
L*	–2.1	–2.6	–0.8
NL	1.4	–0.7	–0.6
A	2.1	0.6	2.4
P	3.6	1.7	0.1
FIN	7.5	3.0	0.6
S	13.3	6.3	1.6
UK	5.7	4.0	2.7
EUR 15	6.1	2.4	2.0

Source: Calculations based on the Commission services Autumn 1995 economic forecasts.

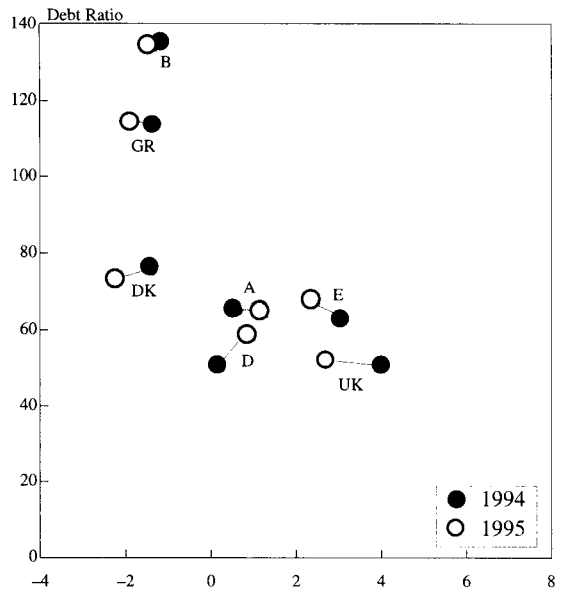
the debt ratio; a primary gap of zero indicates that the actual budget balance is sufficient to keep the debt level constant; finally, a negative primary gap implies that the debt ratio is being reduced [7].

In 1993 the primary gap for all the Member States except Ireland and Luxembourg was positive, and in some cases substantial, implying that the debt ratio would continue to grow. This unsustainable situation was reversed in 1994; half of the Member States improved their fiscal position in that year and recorded primary gaps larger than necessary to stabilise the debt ratio. Further improvements took place in 1995, with more Member States than in 1994 having positive primary gaps. However, positive primary gaps persist in some Member States where the debt ratio has been above 60 percent of GDP and increasing. In Spain and Austria greater fiscal adjustment than actually achieved was necessary to halt the rise in the debt ratio, while in Finland a modest increase in the primary gap took place. Sweden has continued to experience a sustained deterioration in its debt ratio, but the reduction in the primary gap since 1993 has been impressive.

While Member States are making progress in containing the growth of the debt ratio, at the same time in several of them (D, GR, E, F, NL, A, P, FIN, S, UK), and notwithstanding the fact that in some the debt ratio is below the 60 percent of GDP mark (D, F, UK), debt stabilisation has not been achieved, and it remains a first step in fiscal consolidation in those where the debt ratio is above 60 percent of GDP. In view of recent budgetary trends which have been inadequate in halting the rise and reversing the path of indebtedness, substantially greater than heretofore fiscal determination to reduce public debt in the Member States is necessary.

[7] This holds true only if there are no stock–flow adjustments which add to the outstanding stock of government debt.

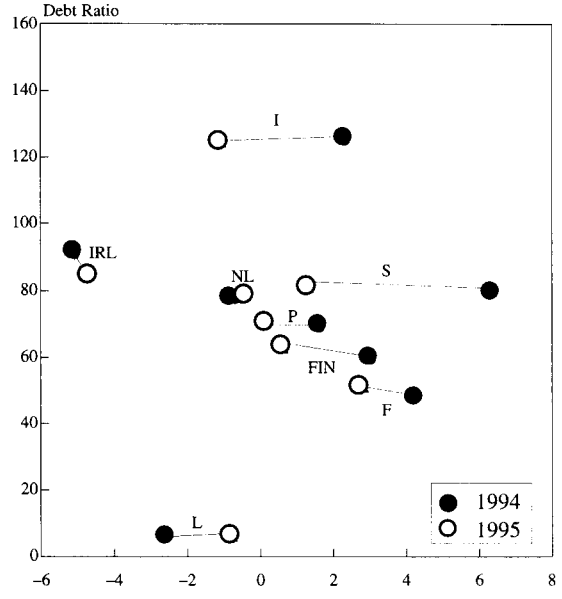
GRAPH 9a : **Primary gap and debt ratio(*)**



(*) difference between the debt–stabilising and the actual primary balance. The line indicates a movement in the two variables between 1994 and 1995.

Source : Commission services.

GRAPH 9b : **Primary gap and debt ratio**



(*) difference between the debt–stabilising and the actual primary balance. The line indicates a movement in the two variables between 1994 and 1995.

Source : Commission services.

C. Convergence in long–term interest rates[8]

C.1 Recent developments in long–term interest rates

Since 1994 the direction of nominal long rates in the European Union has been downward, except for in late 1994 and the first quarter of 1995, when turbulence in the international exchange markets and tensions in the ERM led to some upward swings in

GRAPH 10 : **Average of government bond yields in the EU**

Source : Commission services.

yields (see Graph 10). Falling long–term interest rates have widely been an international phenomenon originating from a slowing down in US growth, deflationary pressures in Japan and later also perceptions of lower inflationary pressures throughout Europe together with a more stable political situation in a number of EU countries. The average level of bond yields in the EU so far has fallen 80 basis points compared to the level at the beginning of this year, but at 8.2 % in September 1995 it remained considerably above the lowest point of 6.7 % in January 1994.

Falling long–term interest rates between January and September 1995 were most evident in the countries with already low interest rates (see Table 13). Sweden and Greece were the only high interest rate countries with a substantial reduction in interest rates. In Sweden, the firming of the commitment during the year to adjust the public finance situation and in addition its entry into the EU allowed the yield on long–term government bonds to decline by 120 basis points. In Greece interest rates declined by 275 basis points, but interest rates continue to be very high. In the other high interest rate countries the yield reductions remained between 60 (Portugal) and 110 basis points (Spain), while in the low interest rate countries reductions between 150 (Belgium) and 80 basis points (France) were observed. The strongest decrease was realised by Finland, where long–term interest rates declined by 225 basis points to 8 %.

TABLE 13 : **Recent evolution of long–term interest rate**

	monthly average of daily data		
	Jan. 1995	Sept. 1995	change
B	8.5	7.0	–1.5
DK	9.1	7.8	–1.3
D	7.6	6.6	–1.0
GR	19.0	16.3	–2.8
E	11.9	10.8	–1.1
F	8.2	7.4	–0.8
IRL	8.8	8.0	–0.8
I	12.4	11.6	–0.8
L	6.1	6.1	0.0
NL	7.7	6.6	–1.1
A	7.7	6.9	–0.8
P	11.8	11.2	–0.6
FIN	10.2	8.0	–2.2
S	10.9	9.7	–1.2
UK	8.7	7.9	–0.8

Source: Commission services.

Except for Greece, where interest rates were on a steady downward path, for the other high interest rate countries, interest rate convergence began deteriorating in the spring of 1995 under the influence of the unrest in the exchange markets which led to a realignment of the Spanish peseta and the Portuguese escudo. Also the Italian lira and Swedish krona both sustained tensions and reached all–time lows against the German mark of 1275 LIT (3 March) and 5.43 SKR (23 April). The exchange market turbulence drew attention to the underlying fundamentals which are difficult to redress in some Member States. As the credibility of the economic policies of the authorities was not firmly established, the risk premium on long–term government bonds increased in the Spring.

Spain, Italy, Portugal and Sweden were able to recuperate some of the lost ground from the second quarter onwards, but interest rate differentials against the DM in September 1995 continue to be above those observed throughout most of 1994. Long–term interest rate differentials were wider than 400 basis points for Spain, Italy and Portugal, while the differential for Sweden was 310 basis points. In Greece, the interest rate differential with Germany fell below 10 %, coming from almost 13.5 % in the beginning of 1994.

C.2 Standstill in interest rate convergence

According to Article 109j of the Treaty and the protocol related to that Article, a Member State is convergent on long–term interest rates if the average nominal long–term bond yield, over the preceding 12 months, does not exceed by more than 2 percentage points a reference rate determined by at most the three best performing Member States in terms of price stability. Measured by the average rise in consumer price indexes the best performing Member States with respect to inflation in the 12 month period up until September 1995 were Belgium, France and Finland, with long–term interest rate levels of respectively 7.7 %, 7.7 % and 9.3 %. Thereby, these three countries together determine the reference rate (see Table 14; annex A gives further details). These three countries did not have the lowest average interest rates over the preceding 12 months; Germany, the Netherlands and Austria (leaving aside Luxembourg which does not have comparable interest rates, see Table 14) were the three Member States with the lowest interest rates (see Graph 10).

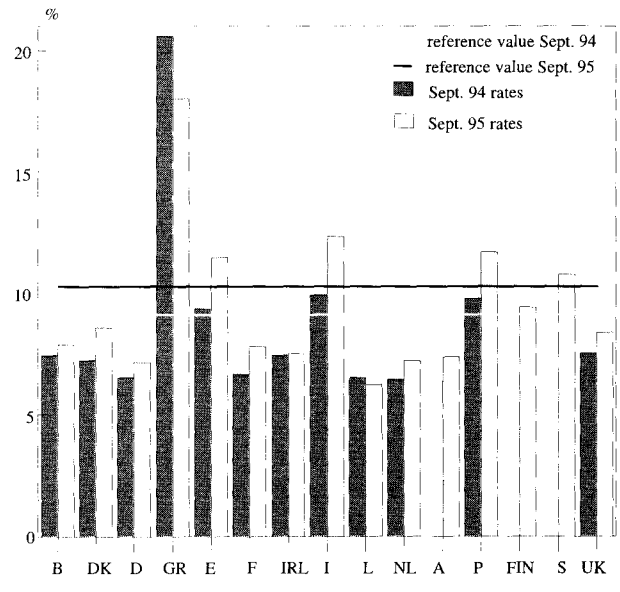
[8] Analysis based on data up to September 1995.

TABLE 14 : **Long–term interest rate convergence in the Member States**

averages of daily data	yearly average 1993	1994	1995[1]
Three best price performers, measured by the consumer price index			
B	–	–	7.9
DK	7.2	7.9	–
F	–	7.2	7.8
IRL	7.7	7.9	–
FIN	–	–	9.4
UK	7.3	–	–
reference value[2]	9.4	9.7	10.4
Convergent Member States			
Number:	8	8	10
out of:	12	12	15
	B, DK, D, F, IRL, L, NL, UK		
			A, FIN
pro memori			
average of 3 best price performers	7.4	7.7	8.4
dispersion from av. of 3 best p. p.[3]	1.7	1.5	2.0

1 Oct. 1994 to Sept. 1995.
2 the reference value is the unweighted arithmetic average of the interest rates given by the three best performing Member States in terms of price stability plus 200 basis points; in 1993 and 1994 the calculations are based on 12 Member States, while in 1995 the 3 newcomers are included.
3 measured by the standard deviation around the average of the 3 best price performers.

GRAPH 11 : **Interest rate convergence Sept. 95 vs. Sept. 94** (12 month moving average)



Source : Commission services.

The Treaty does not say exactly how the reference value for assessing interest rate convergence should be calculated. As a starting point the unweighted arithmetic average of the interest rate of the three best performers in terms of inflation could be used (see Box 4). This gives 10.4 % as a reference value (8.4 % plus 2 %). According to this calculation, in September 1995 five Member States did not fulfil the interest rate criterion: Greece, Spain, Italy, Portugal and Sweden. Apart from the new Member State (Sweden), this represents a status quo compared to September 1994 (see graph 9), when the same countries were not respecting the criterion.

Closer examination of the evolution of long rates leads to a certain qualification of this standstill and, on average, interest rate convergence deteriorated somewhat. An overall measure for this is the increase of the dispersion[9] around the reference value from 1.5 in 1994 to 2.0 in 1995 (see Table 14). Underlying this overall measure is a broadly similar evolution in some of the divergent and convergent Member States.

First, the divergent Member States, with the exception of Greece, moved further away from the reference value, as can be seen in Graph 10, which also shows that the deterioration mainly happened in the Spring of this year. Compared to September 1994, the interest rate convergence gap (difference between average domestic interest rate and reference value) widened for Spain, Italy and Portugal to respectively 1.1 % (0.2 %), 1.9 % (0.8 %) and 1.3 % (0.7 %). Furthermore, Sweden which fulfilled the criterion in the beginning of the year (see Graph 10) is not anymore in that position. Greece, however,was able to reduce the interest rate convergence gap from 11.4 % to 8.0 %, but it remains the most divergent Member State[10].

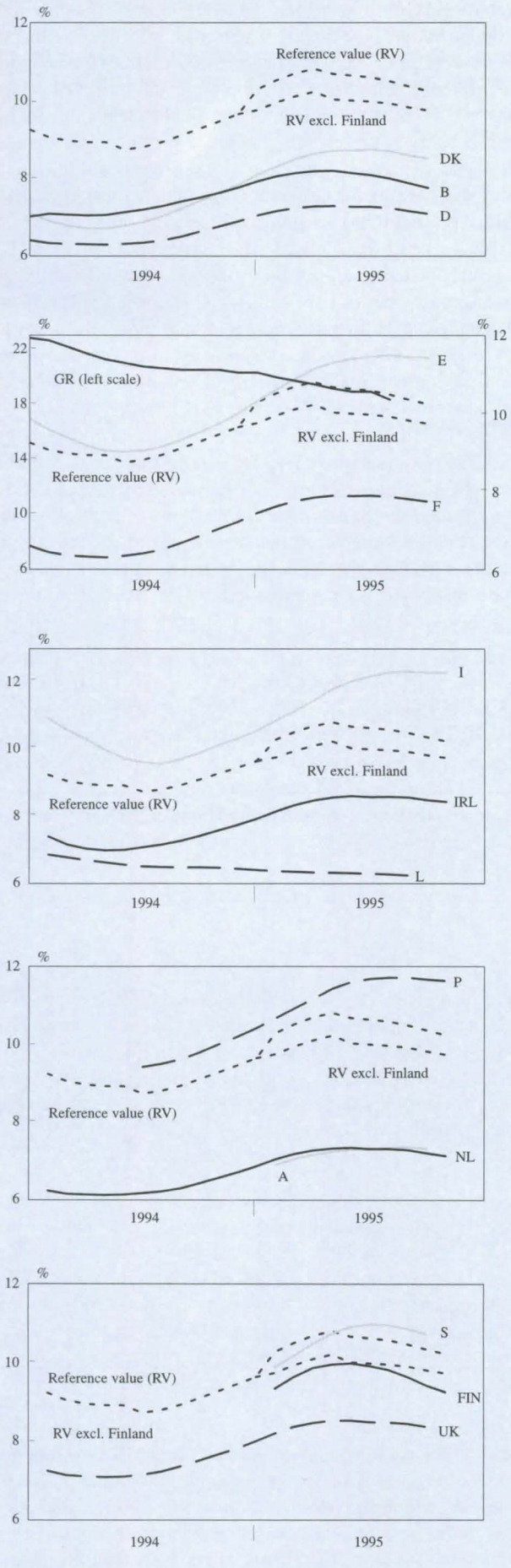
Second, also within the group of convergent countries developments in recent months have been unsatisfactory, since dispersion has increased. This happened mainly on account of the entry of Finland, which, despite strongly falling long–term interest rates, continues having a relatively wide interest rate differential. While the spread between the lowest interest rate (Germany: 6.5 %) and highest interest rate (Denmark 7.2 %) of the convergent Member states was 0.7 % at the time of the previous Convergence Report, it widened to 2.3 % (= 9.4 % – 7.1 %, determined by Finland and Germany). But even leaving Finland aside, the spread widened to 1.5 % (= 8.6 % – 7.1 %, determined by Denmark and Germany). A welcome development was that Austrian long–term interest rates entered the picture at the lower end of the convergent countries.

An important consideration in reviewing interest rate convergence is that sufficient attention ought to be given to outliers (see Box 4). This could imply that the starting point for the analysis (based on a reference value calculated as the average of the three best) may be qualified. Finland represents the characteristics of an outlier in the sense that it has a low inflation rate, while it is faced with relatively high interest rates. If the reference value is calculated leaving Finland outside the sample, the assessment does not radically change: the number of non–convergent Member States remains the same and, most important, Finland remains a convergent Member State. However, this calculation method makes the interest rate convergence gap wider for Greece, Spain, Italy and Portugal; it would also affect the moment at which Sweden would have breached the interest rate reference value (see Graph 10).

9 Note that in 1994 the sample was composed of 12 Member States, which increased to 15 in 1995 implying that on average the three newcomers to the EU did not decrease dispersion.

10 Greece is also divergent in the sense that it does not have comparable long–term interest rates due to the high inflation environment, which prevented the emergence of a fixed interest rate long–term government bond market.

GRAPH 12 : **The evolution of interest rate convergence**
(12 month moving averages)



Source : Commission services.

C.3 Explanatory factors and assessment

Of the divergent Member States only Greece was able to make considerable progress with interest rate convergence, but the interest rate convergence gap remains wide. Spain, Italy, Portugal and Sweden moved somewhat away from the reference value in 1995. There are several factors underlying this development. First, exchange market unrest can probably be singled out as the principal contributor to the widening of interest rate differentials. When the German mark strengthened against the dollar in January 1995 this led to exchange market turbulence, with sensitive currencies falling against the German mark and their long rates rising, despite falling – because of better inflation prospects – long–term interest rate in Germany. This suggests that the exchange rate risk premium may have increased.

Second, the high interest rate countries are characterised by still high public deficits: in 1995 they have the five highest deficit/GDP ratios ranging from 5.6 % (Portugal) to 9.5 % (Greece). Despite the strong commitments made for government deficit consolidation, credibility has not yet been firmly established and markets have imposed an increased credit risk premium.

Third, the worsening inflation outlook has played a role in Italy and Sweden and so did the stubbornly high inflation in Spain. The declining inflation rate in Greece contributed to the better interest rate performance. In Portugal, the recently rapidly decreasing rate of consumer price inflation has not yet had an effect on long rates but constitutes a promising development for the future.

The somewhat disappointing developments in interest rate convergence in some of the converging countries are more difficult to explain solely in terms of inflation or public finances. As for the non–convergent Member States unrest in the exchange markets can be identified as the trigger, but the underlying fundamentals of the convergent Member States on the whole were less critical. In Ireland and the United Kingdom the widening of interest rate differentials can be attributed to the acceleration of inflation, but this occurred against the background of better growth prospects (particularly in Ireland). The widening of nominal interest rate differentials could possibly reflect relatively higher rates of return. In Denmark and France inflation was particularly low and is expected to continue to be so. While in Denmark the government deficit is also low, in France financial markets were unsettled by uncertainties about prospects for fiscal consolidation. In Member States, both convergent and non–convergent, which improved their interest rate performance, EMU is also likely to have played a role as an additional explanatory factor. Finland and Sweden, as newcomers, accepting for the first time the EU monitoring procedures (convergence programmes, excessive deficit procedure, multilateral surveillance), benefited from the disciplinary effect related to the EMU–conditions in reducing interest rate differentials.

Box 4: Data and reference value for the interest rate convergence criterion

Data

According to Article 4 of the Protocol on the Convergence criteria "Interest rates shall be measured on the basis of long–term government bonds or comparable securities, taking into account differences in national definitions." According to Article 5 of the same Protocol the Commission shall provide the statistical data for the application of the interest rate convergence criterion. In agreement with the European Monetary Institute, which has a comparative advantage in the analysis of financial statistics and has advised the Commission on the issue, interest rates with the following characteristics were deemed the most appropriate for the examination of the interest rate criterion:

- maturity: residual maturity close to 10 years (9 to 10.5 years)
- issuer: Central government (in Germany including Treuhandanstalt)
- choice of bonds: liquidity is the main selection criterion; the choice between a single benchmark or the average of a sample should be based on this requirement; most (10) Member States choose a benchmark (B, DK, F, IRL, L, NL, AUS, FIN, SW, UK), while four Member States choose an average (D, I, ESP, P)
- aggregation: simple average should be used if there is more than one bond in the sample
- gross of tax
- yield calculation: ISMA–formula for yield to maturity
- coupon: fixed

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

The present evaluation of the long–term interest rate criterion is based on partially harmonised long–term interest rates, representing the above characteristics. At the time of the examination for three Member states data were missing on the agreed harmonised basis and the Commission used the following statistics which broadly correspond to the required characteristics (except in the first case):

- Luxembourg: interest rate on actively traded outstanding bonds, average maturity 4 years; due to the low public debt of Luxembourg trading in the newly created 10–year bond market is limited and data availability poor
- Austria: 10–year benchmark bond (actually 6.875%; 05/2005)
- Sweden: 10–year benchmark bond (actually 6.00%; 02/2005)

Reference value

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

The Treaty is unclear on the calculation of the reference value. As a starting point the unweighted arithmetic average interest rate of the three best performers in terms of price stability is used in this examination of the interest rate criterion. However, the wording in the Treaty ("at most") permits another calculation, presumably because enough flexibility had to be preserved to allow for an adequate treatment of outliers. Therefore, in the text one alternative calculation for the reference value, based on the simple average of just two interest rates, is also presented.

D. Exchange rate stability

D.1 Developments in the ERM

Exchange rate tensions at the international level early in 1995 contributed to an increase in volatility among EMS currencies and tensions emerged within the ERM. The US–Japan trade frictions and the financial crisis in Mexico were the main factors that led to a pronounced weakening of the dollar and fuelled, together with country–specific situations in a number of European countries, a general strengthening of the German mark in Europe. Official interest rates were raised in most EU countries both inside and outside the ERM but continued pressure caused the Spanish peseta and the Portuguese escudo to devalue by 7 and 3.5 percent respectively on 6 March, with the realignment initiated at the request of Spain.

Exchange rates in the EU did not stabilise following the realignment. In mid–March expectations for a interest rate cut in Germany were frustrated and the tensions emerged once more with the British pound, the Irish punt and the Italian lira most effected. However, in late March interest rates were lowered in Germany and in a number of other European countries with relatively strong currencies. This contributed, together with a more stable US dollar, to a stabilisation of foreign exchange markets internationally and allowed for a partial recovery of European currencies against the German mark. Political uncertainty and other country specific factors continued to be reflected in some currencies through April.

In the months through to August, a strengthening of the US dollar and a more stable political and economic environment in Europe added to fostering exchange rate stability in the EU. However, this changed in September. Renewed weakening of the US dollar had an important impact on European currencies and spurred exchange rate volatility. Economic and political factors in some European countries together with general uncertainty about the EMU led, once again, to exchange rate instability.

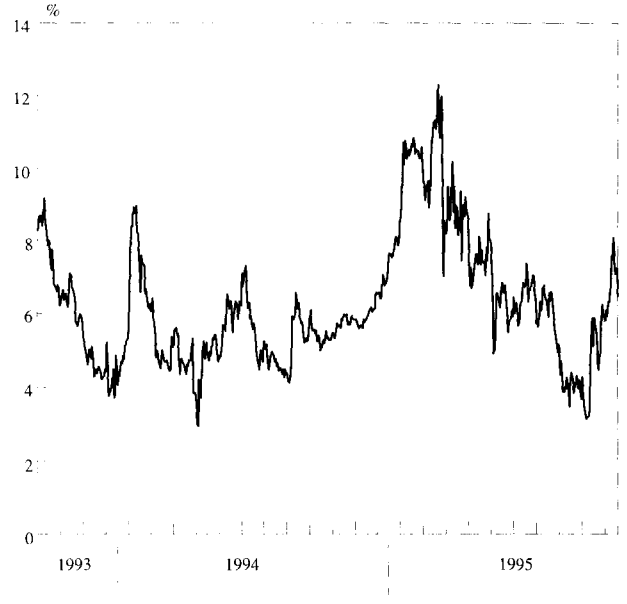
On the whole, in 1995, one of the key factors explaining the exchange rate volatility in Europe seems to be the marked depreciation of the US dollar against the Japanese yen and the German mark. However, uncertainties about the resolve and ability of governments to adhere strictly to planned fiscal consolidation and convergence programmes, and thereby the prospects for EMU, appear also to have played a key role.

Graph 13 shows the volatility of exchange markets within the ERM grid since the end of 1993. After a period of relative calm, in 1994, spreads widened early in 1995 and this became particularly pronounced in late February when the maximum spread reached its highest level at 12.30 percent. Prior to the realignment the spread was just below 12 percent and declined to 7.05 percent after March 6 but widened again to over 10 percent by mid–March. The spread came down with the stabilisation of international foreign exchange markets in the end of March. However, even then the grid spread continued to reflect an underlying sensitivity of exchange rates among ERM currencies and remained wider than in 1994 until the Summer 1995.

The easing of tensions was notable between June and mid–September as the appreciation of the US dollar contributed to the strengthening of many ERM currencies against the German mark, which brought the ERM grid spread down to as low as 3.2 percent by mid–September. Subsequently, the sharp fall of the dollar and concern over EMU caused a widening of the spread. This reached 8% on 23 October before falling back to 6% at the end of October.

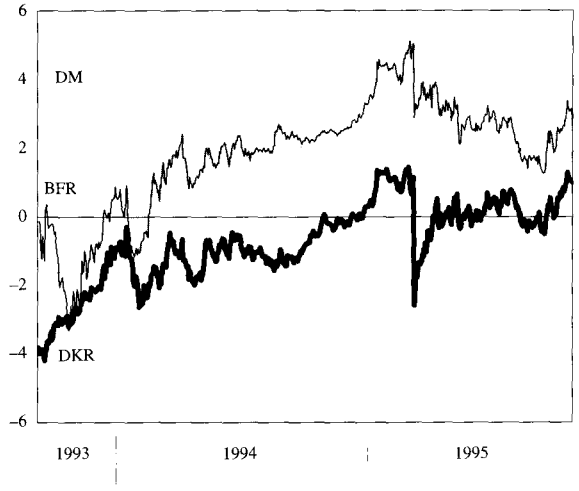
The evolution of the individual currencies in the ERM is illustrated in Graph 14. The Spanish peseta was at or close to the lowest place until the realignment; it remained at the bottom for a short time after the realignment, followed by the Irish punt; subsequently, it recovered to levels prevailing prior to the devaluation. The Irish punt had been strong in the band, but with the renewed tensions in March it took the lowest position; it maintained that position throughout the year, except for the period from mid–May until end–June when the French franc was weaker. The Portuguese escudo was low in the band until April 1994; subsequently, it recovered and has been sustaining a comfortable position in the band. The Dutch guilder, followed by the Belgian franc, has maintained the strongest position in the ERM throughout the period.

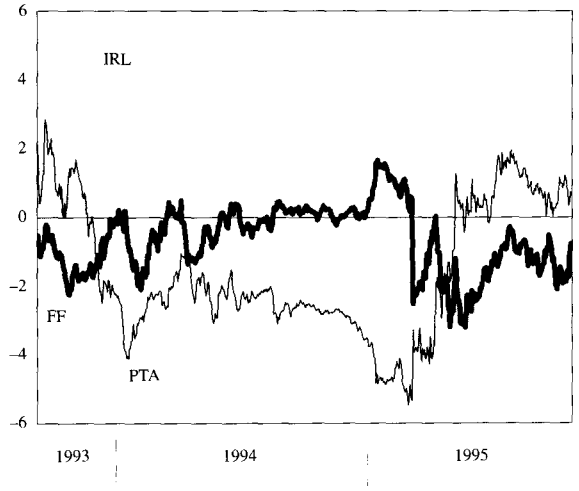
GRAPH 13 : **ERM grid spread – gap against the weakest currency**

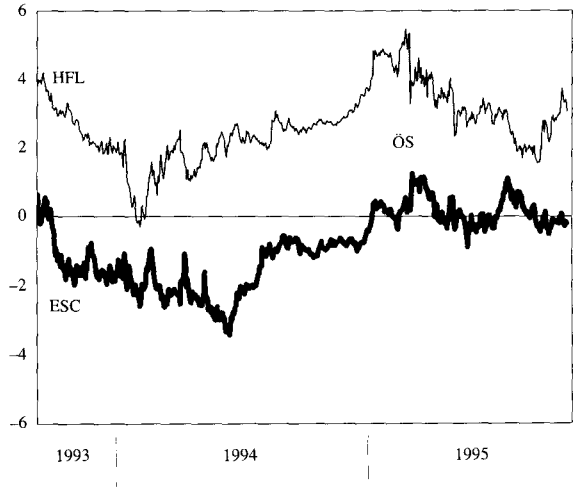


Source: Commission services.

GRAPH 14 : **Movements within the ERM band**

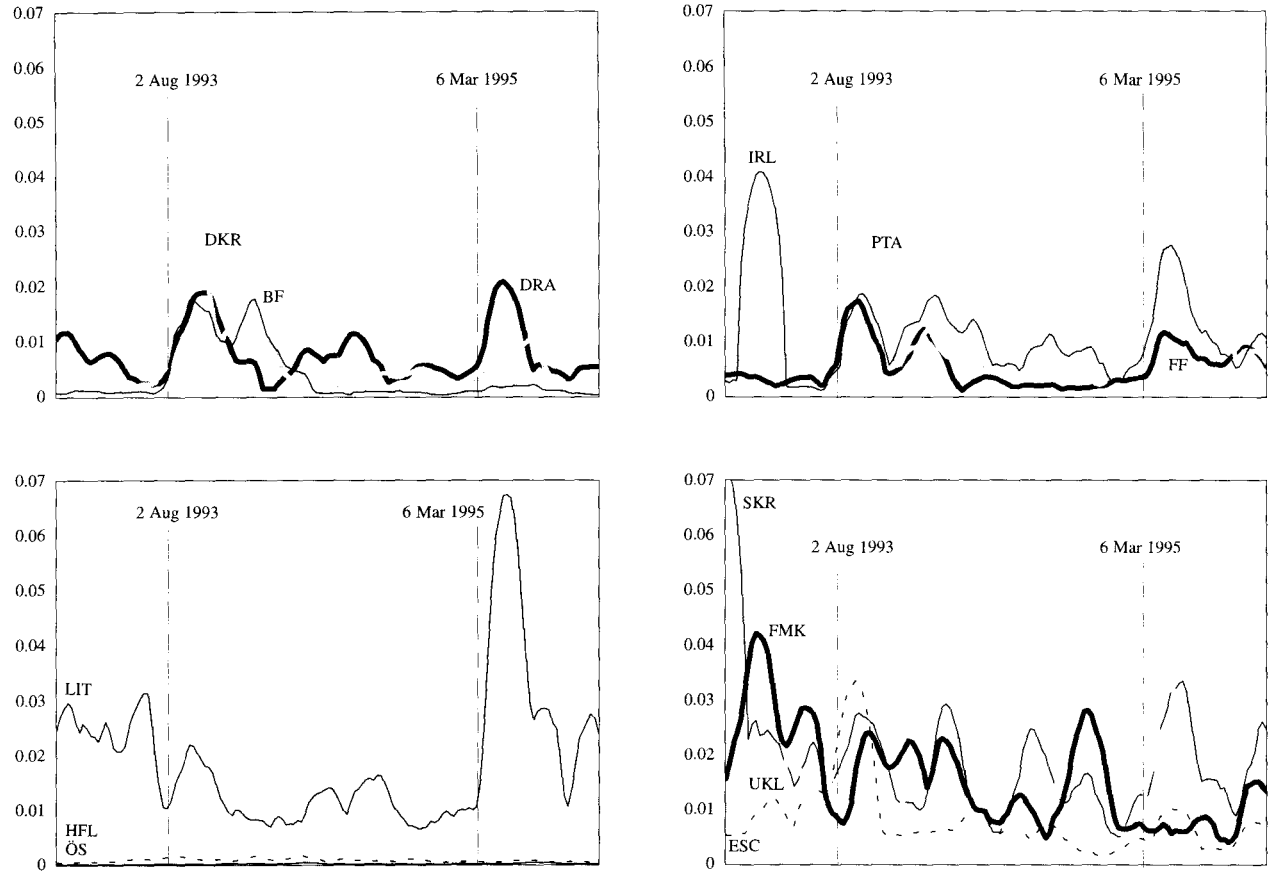






Source: Commission services.

GRAPH 15 : **Stability of exchange rate vis–à–vis the DM: 13–week moving coefficient of variation, January 1993–September 1995**



Source: Commission services.

On 9 January 1995, the Austrian schilling joined the ERM. The currencies of the other new Member States, Sweden and Finland, as well as the Greek drachma, remained outside the ERM; the British pound and the Italian lira did not re–enter. However, during the summer, in a period of relative calm in the foreign exchange markets and against the background of improving fundamentals in Italy, expectations emerged for a re–entry of the lira in the near future; this contributed to a temporary strengthening of the currency.

The stability of exchange rates may be considered in terms of the coefficient of variation of exchange rates[11]. This is presented in Graph 15 for Member States, inside and outside the ERM. The data show that, in the first months of 1995, the pound sterling, the lira, the drachma and the Swedish krona displayed volatility not only higher than in 1994 but also greater than in the Summer of 1993; the Finnish markka was more stable. Among the ERM currencies, volatility increased in early 1995, after a year of relative calm; however, the variation was generally smaller than in the Summer of1993, with the exception of the Irish punt.

D.2 Exchange rate stability and short–term interest rates

Policy efforts to counter the pressures on the exchange rates and the relevant risk premia have meant that exchange rate turbulence was in many cases transmitted to short–term interest rates in the period under consideration. Table 15 presents the stability of exchange rates and short–term interest rates.

In the first nine months of 1995 volatility of exchange rates against the ECU increased compared with 1994 for all Member currencies, except for the Portuguese escudo, Finnish markka and the Greek drachma. Volatility against the German mark provides a mixed picture.

Exchange rate volatility against the German mark increased in most cases in 1995, compared to the relative stability recorded in the previous year. However, the currencies traditionally recording the lowest variations against the German mark, i.e. the Belgian franc, the Dutch guilder and the Austrian schilling, maintained or even reduced their variation. In addition, the Greek drachma and Finnish markka improved their stability. In all other EU currencies, the effects of the turbulence in 1995 are clearly visible as an increase in volatility.

The increase in exchange rate volatility in non–ERM countries has taken place at the same time as short–term interest rate differentials against Germany generally, except in Greece, have increased. Also in Finland, where exchange rate volatility was lower, the interest rate differential increased. Within the ERM there has been an increase in interest rate differentials for France, Spain, Ireland and Denmark but these differentials were lower or stable for Belgium, Portugal and the Netherlands. Generally, in those countries where exchange rate volatility increased between 1994 and 1995, short–term interest rate differentials against Germany in most cases also increased. Conversely, differentials fell in the countries with decreasing exchange rate volatility.

[11] The coefficient of variation, which was defined in footnote 4, provides a normalisation of the exchange rate changes around the average of the data and, consequently, permits cross–currency comparisons.

TABLE 15 : **Stability of exchange rates and short–term interest rates**

	Coefficient of variation of exchange rate				Short–term interest rate differential against the DM			
	against ECU		against DM		average		stand. deviation	
	1994	**1995(1)**	**1994**	**1995(1)**	**1994**	**1995(1)**	**1994**	**1995(1)**
B	0.76	0.92	0.30	0.17	0.48	0.45	0.37	0.46
DK	0.43	1.13	0.49	1.04	0.91	1.71	0.43	0.55
D	0.57	0.94	–	–	–	–	–	–
GR	1.93	0.90	2.44	1.59	19.24	12.00	9.68	0.95
E	0.67	1.79	1.06	2.37	2.70	4.71	0.21	0.62
F	0.33	0.66	0.42	1.14	0.54	2.08	0.12	0.93
IRL	0.94	1.17	1.38	2.04	0.58	1.86	0.31	0.43
I	2.18	4.35	2.65	5.26	3.15	5.64	0.56	0.93
NL	0.59	0.96	0.12	0.08	–0.12	–0.09	0.26	0.17
A	0.53	0.94	0.04	0.04	–0.27	–0.17	0.18	0.12
P	0.85	0.32	0.82	0.93	5.83	5.51	1.44	0.55
FIN	3.14	1.51	2.88	1.60	0.05	1.36	0.66	0.36
S	2.04	2.37	2.45	3.19	2.37	4.21	0.63	0.69
UK	1.85	2.15	2.36	2.87	0.20	2.09	0.59	0.39

(1) January – September 1995
Source: Commission services

TABLE 16 : **Current account balance** (percent of GDP)

	1991	1992	1993	1994	1995
B	1.7	2.1	3.9	4.3	5.0
DK	1.1	2.5	2.9	2.0	1.5
D	–1.1	–1.2	–0.9	–1.3	–1.0
GR	–6.2	–4.0	–3.3	–2.5	–2.7
E	–3.6	–3.6	–1.3	–1.8	–1.3
F	–0.5	0.1	1.0	1.1	1.3
IRL	2.0	3.3	4.9	5.1	6.0
I	–1.8	–2.3	1.2	1.8	1.9
L	24.9	26.4	20.6	30.0	29.6
NL	3.4	3.1	4.4	4.4	4.8
A	0.0	–0.1	–0.5	–1.0	–1.8
P	–1.9	–1.9	–2.1	–1.4	–1.4
FIN	–5.4	–4.6	–1.3	1.1	3.6
S	–2.1	–3.1	–1.1	–0.6	1.6
UK	–2.7	–2.6	–2.3	–2.2	–1.2
EUR 15	–1.3	–1.2	0.0	0.1	0.5

Source: Commission services Autumn 1995 economic forecasts

III. Other aspects of convergence

This section reviews developments in three areas which the Treaty requires should also be considered in evaluating convergence. These are: the situation and developments in the current account; developments in the ECU; and results of the integration of markets; in the latter section two areas are discussed: integration of financial markets, and economic integration and the internal market.

1. The situation and developments in the current account

The importance of the current account in the present financial environment of the Union has been changing. No Member State is pursuing current account targets; on the contrary, the state of the current account is primarily seen as reflecting, in the short run, domestic absorption relative to domestic production and, in the long run, trends in domestic savings relative to opportunities for investment in the domestic economy. Moreover, all the Member States have abolished exchange controls, and international capital mobility is unrestricted while financial integration has notably progressed. As a result, the financing of current account deficits and the recycling of surpluses is efficiently performed through the process of international intermediation.

The Union as a whole has recorded small current account deficits in 1991 and 1992, its current account was in balance in 1993 and in 1994, and a small surplus emerged in 1995. In 1994 and 1995 eight Member States (B, DK, F, IRL, I, L, NL, FIN) recorded current account surpluses, and in Spain the deficit as percent of GDP has been reduced substantially between 1991 and 1994. The cohesion Member States (GR, E, IRL, and P) would be expected to record balance of payments deficits, a reflection of the catching–up process. This has indeed been the case, with the exception of Ireland, where the investment ratio has been lower than in the other catching–up Member States.

Persistent surpluses are shown by Belgium, Denmark, France, Ireland, Luxembourg, and the Netherlands. On the other hand, the increased need for international savings, associated with the unification needs, is reflected in Germany's current account deficit, which in 1995 had declined to around 1 percent of GDP. Over all, it appears that the easing of fiscal imbalances since 1993 and the general rise in gross national saving in GDP in virtually all the Member States is broadly mirrored in the improvement in the current account.

The current account positions recorded since 1993 are not atypical of, and they in fact represent an improvement over, the historical data for the Member States. Although there have been instances where some Member States have encountered difficulties in financing external deficits (most notably in the case of Greece where twice over the past ten years, in 1985 and in 1991, Community balance of payments assistance was granted to avert a balance of payments crisis) these have occurred prior to the 1990s. With the essentially full integration of the Member States' financial markets with the international financial system and the easing of external imbalances, there appears to be no presumption that these deficits would be inconsistent with nominal convergence.

2. Developments in the ECU

Since the height of primary ECU bond market activity in 1991, the market has suffered from problems in the ERM in September 1992 and in July/August 1993; at the same time, increasingly EMU–related matters have come to play an important part in forming market perception of the ECU. During 1994 and 1995 primary issue activity remained depressed, partly as a result of volatility in the currency markets, but also due to the a general weakness in the primary bond markets, and due to uncertainty over the feasibility of EMU. This set of circumstances has underpinned, throughout 1994 and 1995, the modest decrease in ECU issuing activity. In the past maturing paper provided opportunities for primary issue activity; however, in recent months not all funds released by maturing paper have been reinvested in ECU. With the market over–reliant on reinvestment funds the likelihood for an increase in issuing activity is slight.

During 1994, bond issues denominated in ECU were slightly lower than maturing paper with the result that the stock of outstanding debt in ECU declined by 0.7 percent to ECU 135.2 bn (excluding Greek ECU–linked bonds) compared to a historic peak of ECU 140 billion stock outstanding in 1993. In the first six months of 1995 there were periods during which there were no or few issues in ECU; however, demand for ECU from institutional investors progressively increased reflecting demand from professional curve trading and secondary swap activity. End users of ECU

have contributed little to this demand. The ECU bond market continued to contract further in 1995. Issues of ECU bonds during the first six months of 1995 came to ECU 8.2 bn compared with ECU 13.4 bn over the same period in 1994. With ECU 13.4 bn of maturing paper the stock of outstanding ECU denominated debt fell to ECU 129.9 billion by the end of June 1995.

In the secondary market, average turnover in ECU bonds rose in value terms by 16 percent in 1994, returning to its 1992 level, and in the first six months of 1995 it registered a rise of 3 percent. Nevertheless, as a percentage of total secondary market turnover the ECU declined from 5.6 percent of the total in 1993 to 5.2 percent in 1994 and 4.6 percent in June 1995. In recent years, the development of secondary turnover in ECU assets has been less robust than that exhibited by certain other currencies. The ECU has not regained the activity lost in the aftermath of the difficulties in the exchange rate mechanism in 1992 and 1993, and current turnover is still some 20 percent lower than at the end of 1992.

While bond market performance has been modest, other ECU markets have performed well. The approximate measure of commercial and financial activity provided by the daily average turnover in the EBA ECU Clearing System has shown consistent growth, reaching ECU 50.1 bn during 1994, a year on year increase of 5.4 percent, and ECU 49.8 bn during the first half of 1995, a growth of 3 percent over the average daily turnover in the previous six months.

During 1994 it was agreed that the Commission, in conjunction with the EMI, would carry out a study of the ECU flows passing through the ECU Banking Association's private ECU Clearing System. The preliminary findings of the study suggest that commercial ECU payments are in the region of ECU 50 billion to ECU 75 billion.

3. Results of the integration of markets

3.a Integration of Financial Markets

The interaction of capital liberalisation, deregulation of domestic financial markets and financial innovation has led to considerable changes in international capital flows and the structure and behaviour of financial markets in the Union.

Capital Movements

The Treaty on European Union introduced a new regime in regard to capital movements and payments as from 1 January 1994. Freedom of capital and payments is now a directly applicable right under the Treaty. Also under the new regime, the obligation for liberalisation was extended, with limited exceptions, to transactions with third countries.

The last Member State with a derogation from the general obligation to permit free movement of capital, Greece, lifted, with effect from 16 May 1994, all remaining restrictions on the movement of capital which that Member State was authorised to maintain until 30 June 1994. Consequently a regime of free movement of capital is now in place throughout the Union. According to the Commission's monitoring of the movement of capital and the freedom of payments within the Union, progress has been, in general, satisfactory. Community law on capital movements has been transposed by Member States and transitional derogations have lapsed.

Free mobility of capital has provided the conditions for progress towards integrating national financial markets to the benefit of the users of financial services and of the European financial industry. Cross–border flows of capital within the Union, as well as capital inflow from third countries have risen considerably in recent years. These capital movements include direct investment, motivated mainly by industrial and commercial considerations of companies in the unified European market, as well as portfolio investment, principally attracted by the opportunities offered by government bond markets.

Indirect obstacles to capital movements remain, however, in some areas. Such impediments can take the form of constraints on investment abroad by institutional investors not justified by prudential considerations, tax discrimination not compatible with Community law, rules concerning the issue of securities, the transfer of means of payments and other. The Commission has taken action in order to eliminate such impediments.

Financial Markets: changes in structure, behaviour, and competitive conditions

The degree of integration of financial markets in the European Union and their effects on the users of financial services and on the financial industry itself are the subject of ongoing studies being undertaken on behalf of the Commission, the results of which are expected to be known by mid–1996. Also, important Community legislation such as the third generation of insurance directives and investment services directives has been introduced only recently and it is thus somewhat early to assess their full effect. However, the existing evidence allows the identification of several common trends regarding the Union's financial markets.

The massive flows of portfolio capital give a measure of the integration and globalization of markets and reflect also profound changes in the structure and behaviour of financial markets. The most notable examples of such structural change are the phenomena of "securitization" (the wide range of financial assets that can be readily traded) the dominant position of institutional investors and the increasing internationalisation of portfolios.

The world–wide trend of financial market integration and international diversification of portfolios has been much more pronounced in the Union. The Single Market programme, harmonised minimum rules for the financial services industry and progress toward EMU have been important contributing factors to these developments. The overwhelming importance of portfolio capital flows in the European Union is an indicator of a high degree of integration (gross flows of portfolio capital in Union countries accounted in 1993 for around 80 percent of the industrial countries' total; data for 1994 point to lower but still sizeable shares).

The growth of portfolio investment capital reflects also the increasing sophistication and attractiveness of national equity and bond markets, notably government bond markets. The need to tap the international market also had beneficial effects on domestic financial markets: extensive reforms have been introduced and the liquidity, transparency and efficiency of the markets were improved. A substantial share of portfolio capital investment in the Union appears to reflect the increased acquisition of government paper by non–residents.

The rapid growth of *derivatives* activity over the past decade has been one of the most noteworthy economic and financial developments world–wide, but also within the Union. Derivatives have an impact on, and interact with, the free mobility of capital, thus

enhancing the integration of financial markets: the availability of a whole range of instruments for the management of financial and foreign exchange risks has encouraged international portfolio diversification while, on the other hand, massive cross–border flows of funds generate a growing use of financial derivatives for risk management purposes.

Intensified *competition* has been a common feature in all national financial markets as well as between financial centres within the Union. A result of this development was the availability of a much wider range of financial instruments to the users of financial services for borrowing, investing and risk management purposes. Interest rate spreads narrowed and the profit margins of financial institutions and traders diminished in several market segments. The effect of these developments on the cost of financial services for each particular market (wholesale, retail) and market participant requires however a more refined analysis which will be the subject of the research already being undertaken.

The *restructuring* of bank operations through the reduction of operational costs, the re–orientation of activities and mergers have also been common features of financial institutions in the Union. The increased number of mergers, already in anticipation of the Single Market, aimed at rationalising costs, strengthening competitive positions in the domestic and the European market and in achieving an optimum size in terms of economies of scope and scale. There was also a general effort by banks in the Union to strengthen their capital base in view of the new capital adequacy requirements of Community legislation.

3.b Economic integration and the internal market.

In September 1995, the global rate of transposition of White Paper directives in the Member States, including the three new ones, was 92.5 percent. However, as shown in Table 17, this conceals important differences between Member States, with Denmark having transposed 99.1 percent of these directives and Austria and Greece having transposed 80.5 percent and 89.6 percent, respectively. Concerning the situation by sector, performance also differs widely; while directives on excise duties or transport are transposed completely, the implementation of public procurement or company law directives remains approximately 80 percent.

TABLE 17 : **State of implementation of White Paper directives**
(breakdown of situation by Member State, in percent)

Denmark	99.1
Sweden	96.8
Luxembourg	96.4
Netherlands	95.5
United Kingdom	95.0
Portugal	95.0
France	94.6
Spain	94.6
Italy	91.9
Belgium	91.0
Ireland	91.0
Germany	90.0
Greece	89.6
Finland	86.0
Austria	80.5

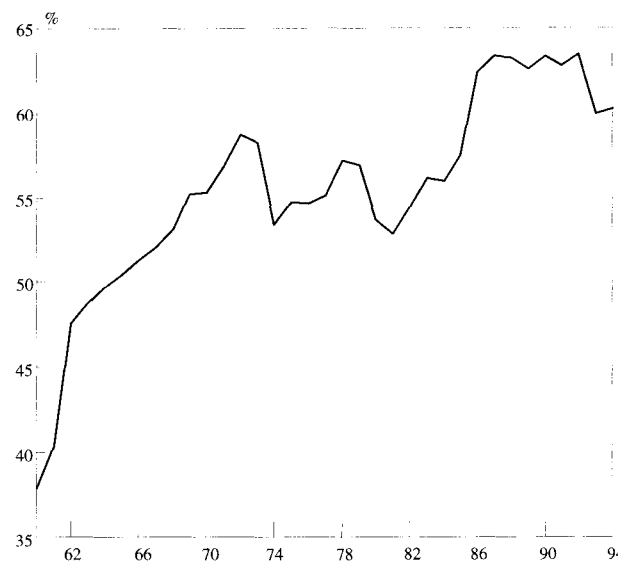
Source: Report on the implementation of White Paper directives on the completion of the Internal Market, situation on September 20, 1995

In the context of the 1996 Internal Market review exercise, the Commission is currently examining various indicators measuring the degree of economic integration attained to date as a result of the Internal Market Programme. These indicators concern trade developments, foreign direct investment and price convergence.

Trade indicators of economic integration

When the Internal Market Programme was launched, it was expected that the removal of trade barriers would translate into an increase in trade flows within the Union. Graph 16 compares the evolution of intra–Union imports with total Union imports between 1960 and 1994. Between 1960 and 1972 the intra–Union share of imports rose from 37.9 percent to 58.7 percent. After a sharp decline in 1973, this share stabilised at around 55 percent until 1984. Between 1984 and 1986 the share of intra–Union imports in total imports increased by almost 7 points (from 56 percent in 1984 to 62.4 percent in 1986) and then remained stable at around 63 percent. While data for 1993 and 1994 are not directly comparable with earlier ones (due to the introduction of the new reporting system of intra–Union trade statistics), it is evident that there may have been an impact on intra–Union imports between 1985 and 1988 associated with prospects for the Internal Market. However, other cyclical and structural factors have undoubtedly also played a role in determining these developments. A principal goal of the studies under way is to isolate the Internal Market effect. Indicators for trade creation and trade diversion, as well as for intra–industry flows, which are currently being developed, will be essential in the assessment of progress in economic integration.

GRAPH 16 : **The share of intra–EUR 15 imports in total imports of EUR 15, 1960 to 1994.**



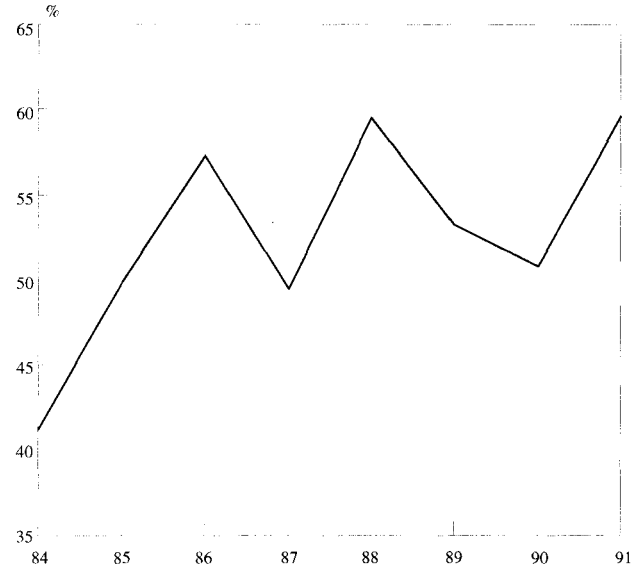
Source: AMECO databank

Foreign direct investment as an indicator of integration.

There has been a broad consensus that creating the Internal Market would stimulate foreign direct investment, both between Member States and from outside the Union, for at least two rea-

sons: firstly, because it would have a positive impact on the macroeconomic performance, and therefore wealth, of the European Union; and, secondly, because it provides firms with the possibility to concentrate on "core" activities whilst expanding their geographic range. Exploiting either of these requires significant investment.

GRAPH 17 : **Share of intra–EUR12 foreign direct investment (FDI) in total FDI received by EUR 12, 1984 to 1991.**



Source: Eurostat.

Graph 17 shows the share of intra–Union foreign direct investment in the total received by Union countries between 1984 and 1991. Intra–Union direct investment increased from 41.3 percent of total direct investment in 1984 to 57.4 percent in 1986. After that year the share has fluctuated between 50 and 60 per cent. Such direct investment flows are closely associated with the level of total trans–border acquisitions throughout the Union. These built up in 1987 and 1988, nearly tripled in 1989, and then rose in 1990, when the number of such mergers was four–and–a–half times the level of 1986–1988. Since then, activity has slowed down, which might be suggesting that the bulk of the initial production rationalisation possibilities opened up by the Internal Market programme has now been exploited. Studies under way on the impact of the Internal Market Programme on direct investment flows will review this.

Indicators of convergence of prices

The removal of barriers to trade and the free mobility of goods, services and factors of production was expected to increase competitive pressures, thereby reducing prices paid by consumers and price–cost margins. This increased pressure was expected to be a powerful means to make prices converge to levels more consistent with economic and technical efficiency.

Examination of these sets of indicators will provide a good basis to determine the degree of market integration attained to date and it will help identify the obstacles or forces hindering market integration in Europe.

3 January 1996

ANNEX A: INTEREST RATE AND CPI STATISTICS

Consumer price indices

whole

	B	DK	D	GR	E	F	IRL	I	L	NL	A	P	FIN	S	UK
Jan–92	116.01	125.07		290.41	150.64	121.74	124.00	144.32	114.48	109.83	117.26	197.20	135.12	149.72	143.34
Feb–92	116.37	125.68		291.22	151.64	122.21	124.00	144.98	114.48	110.35	118.38	199.70	135.50	149.79	144.08
Mar–92	116.41	126.16		297.07	152.22	122.67	124.00	145.64	114.95	111.09	118.68	201.60	135.88	150.44	144.50
Apr–92	116.53	126.37		301.63	152.14	122.91	124.90	146.03	115.13	111.61	118.68	204.80	136.52	150.83	146.72
May–92	116.96	127.25		301.63	152.47	123.26	124.90	146.83	115.69	111.61	119.09	206.90	136.65	150.89	147.25
Jun–92	117.33	127.25		306.67	152.47	123.26	124.90	147.22	115.92	111.30	119.50	207.70	137.16	150.57	147.25
Jul–92	117.87	126.71		300.98	152.97	123.14	125.70	147.48	116.19	111.72	120.92	208.70	136.77	150.37	146.72
Aug–92	117.68	126.84		305.20	154.30	123.02	125.70	147.88	116.30	111.93	121.43	209.70	136.52	150.44	146.83
Sep–92	117.89	127.32		317.72	155.64	123.37	125.70	148.14	116.44	112.87	120.62	209.90	137.41	152.59	147.36
Oct–92	118.13	127.19		325.37	155.72	123.72	125.90	148.93	116.99	112.87	120.41	210.50	137.79	152.91	147.88
Nov–92	118.51	127.46		327.97	155.80	123.84	125.90	149.86	117.36	112.87	120.51	211.30	137.92	152.20	147.67
Dec–92	118.50	127.19		331.71	156.30	123.84	125.90	149.99	117.37	112.56	120.62	212.10	137.54	152.78	147.14
Jan–93	119.30	126.98	108.00	332.52	157.78	124.31	126.40	150.78	118.52	112.56	122.04	214.00	138.94	156.75	145.77
Feb–93	119.60	127.32	108.80	333.50	157.78	124.77	126.40	151.44	118.86	113.19	122.75	215.70	139.45	157.14	146.72
Mar–93	119.81	127.60	109.10	345.85	158.39	125.35	126.40	151.83	119.20	113.92	123.26	216.40	139.58	157.85	147.25
Apr–93	119.91	127.73	109.40	350.41	159.01	125.47	126.10	152.49	119.46	114.34	123.26	217.50	140.08	158.50	148.62
May–93	120.10	128.48	109.60	351.22	159.46	125.70	126.10	153.15	119.71	114.24	123.46	218.60	140.21	158.11	149.15
Jun–93	120.12	128.42	109.90	355.12	159.92	125.59	126.10	153.94	119.79	113.82	123.77	219.10	139.96	157.59	149.05
Jul–93	120.91	128.21	110.40	348.29	160.53	125.70	127.30	154.34	120.22	114.55	125.19	220.60	139.70	157.33	148.73
Aug–93	121.43	128.42	110.40	349.76	161.45	125.70	127.30	154.60	120.58	115.29	125.60	221.50	139.45	157.59	149.36
Sep–93	121.21	128.83	110.20	358.54	162.37	126.17	127.30	154.86	120.72	116.02	124.68	222.20	139.70	159.02	150.00
Oct–93	121.35	129.17	110.20	365.37	162.98	126.40	127.70	155.79	121.08	116.02	124.58	223.40	139.96	159.48	149.89
Nov–93	121.51	129.37	110.40	368.29	163.29	126.52	127.70	156.31	121.49	116.02	124.68	225.00	139.83	159.54	149.68
Dec–93	121.70	129.10	110.60	371.87	164.05	126.40	127.70	156.45	121.61	115.50	124.89	225.60	139.70	158.89	150.00
Jan–94	122.18	129.10	111.40	369.27	165.58	126.64	127.70	157.37	121.64	115.92	125.80	227.40	139.32	159.41	149.36
Feb–94	122.59	129.64	112.10	370.08	165.73	126.98	128.50	157.90	121.96	116.55	126.62	228.80	139.83	159.93	150.21
Mar–94	122.58	129.78	112.20	380.98	166.19	127.22	128.50	158.42	121.92	117.28	127.02	229.30	140.08	160.52	150.63
Apr–94	122.81	130.33	112.30	386.83	166.96	127.57	128.50	158.69	122.03	117.49	126.92	230.60	140.34	161.17	152.43
May–94	123.18	130.94	112.60	389.92	167.26	127.80	129.50	159.35	122.27	117.60	127.12	231.10	140.47	161.50	152.96
Jun–94	123.44	131.08	112.90	393.66	167.41	127.80	129.50	159.74	122.30	117.28	127.33	231.50	141.74	161.50	152.96
Jul–94	124.19	130.81	113.20	387.32	168.03	127.80	129.50	160.14	122.80	117.70	128.75	231.90	141.87	161.56	152.22
Aug–94	124.39	131.28	113.40	388.45	169.25	127.80	130.50	160.40	123.00	118.23	129.57	232.20	142.12	161.63	152.96
Sep–94	124.19	131.42	113.20	401.14	169.71	128.15	130.50	160.93	123.40	119.17	128.55	232.70	142.38	163.06	153.28
Oct–94	123.92	131.69	113.10	406.02	170.01	128.50	130.50	161.70	123.60	119.28	128.24	233.60	142.50	163.25	153.49
Nov–94	123.92	132.00	113.20	407.32	170.32	128.50	130.70	162.40	123.90	119.00	128.10	234.00	142.12	163.12	153.59
Dec–94	124.00	132.00	113.40	411.90	171.10	128.40	130.70	163.00	124.10	118.50	128.10	234.70	142.00	162.90	154.30
Jan–95	124.50	132.10	113.80	410.20	172.90	128.70	130.70	163.40	124.50	118.80	129.10	237.50	141.90	163.50	154.30
Feb–95	124.80	132.70	114.30	408.50	173.70	129.20	131.80	164.80	124.70	119.40	129.70	239.20	142.40	164.10	155.30
Mar–95	124.70	133.10	114.30	420.20	174.80	129.50	131.80	165.80	124.80	120.00	130.10	240.40	142.40	164.80	155.90
Apr–95	124.90	133.50	114.60	425.20	175.70	129.60	131.80	166.60	124.80	120.20	130.20	241.30	142.50	165.90	157.50
May–95	124.90	134.00	114.60	428.10	175.70	129.90	133.20	167.70	125.00	120.00	130.20	241.10	142.60	166.10	158.10
Jun–95	125.00	133.80	115.10	431.90	176.00	129.90	133.20	168.30	125.10	119.80	130.70	240.40	143.10	165.90	158.40
Jul–95	125.70	133.20	115.20	421.80	176.00	129.60	133.20	168.40	125.2	119.80	131.60	240.40	143.00	165.70	157.60
Aug–95	126.00	133.40	115.30	422.10	176.40	130.20	133.80	169.40	125.10	120.00	132.30	241.60	142.80	165.50	158.50
Sep–95	125.70	134.20	115.20	434.60	177.20	130.70	133.80	169.90	125.30	121.00	131.20	242.10	142.90	166.60	159.20
Oct–95															
Nov–95															
Dec–95															

Inflation based on 12–month moving averages **(Note: x.xx% = 3 best inflation performers)**

	B	DK	D	GR	E	F	IRL	I	L	NL	A	P	FIN	S	UK
Dec–93	2.75%	1.26%		14.42%	4.60%	2.11%	1.40%	4.45%	3.59%	2.60%	3.63%	6.43%	2.18%	4.65%	1.56%
Jan–94	2.72%	1.27%		14.11%	4.62%	2.09%	1.32%	4.44%	3.51%	2.64%	3.54%	6.25%	1.97%	4.39%	1.63%
Feb–94	2.69%	1.31%		13.80%	4.70%	2.06%	1.30%	4.43%	3.41%	2.67%	3.50%	6.10%	1.75%	4.12%	1.67%
Mar–94	2.64%	1.36%		13.27%	4.77%	2.00%	1.28%	4.43%	3.29%	2.71%	3.43%	5.99%	1.55%	3.85%	1.71%
Apr–94	2.60%	1.44%		12.79%	4.81%	1.97%	1.36%	4.40%	3.16%	2.73%	3.36%	5.97%	1.34%	3.56%	1.81%
May–94	2.59%	1.52%		12.35%	4.84%	1.94%	1.50%	4.38%	3.04%	2.78%	3.30%	5.98%	1.14%	3.34%	1.92%
Jun–94	2.63%	1.62%		11.95%	4.82%	1.93%	1.65%	4.31%	2.94%	2.85%	3.24%	5.99%	1.08%	3.16%	2.04%
Jul–94	2.64%	1.69%		11.60%	4.80%	1.89%	1.68%	4.24%	2.83%	2.86%	3.18%	5.94%	1.03%	3.00%	2.12%
Aug–94	2.57%	1.77%		11.33%	4.81%	1.85%	1.79%	4.17%	2.69%	2.83%	3.16%	5.87%	1.01%	2.82%	2.18%
Sep–94	2.54%	1.84%		11.26%	4.83%	1.79%	1.89%	4.12%	2.57%	2.82%	3.14%	5.77%	1.04%	2.69%	2.21%
Oct–94	2.49%	1.87%		11.17%	4.80%	1.75%	1.96%	4.05%	2.45%	2.82%	3.09%	5.64%	1.06%	2.53%	2.29%
Nov–94	2.45%	1.92%		11.03%	4.75%	1.70%	2.03%	4.02%	2.33%	2.80%	3.03%	5.43%	1.08%	2.32%	2.40%
Dec–94	2.38%	1.98%	2.73%	10.92%	4.70%	1.66%	2.11%	4.01%	2.20%	2.80%	2.95%	5.24%	1.09%	2.20%	2.48%
Jan–95	2.34%	2.03%	2.80%	10.93%	4.65%	1.64%	2.22%	3.97%	2.18%	2.76%	2.92%	5.08%	1.22%	2.27%	2.55%
Feb–95	2.28%	2.08%	2.67%	10.88%	4.64%	1.64%	2.29%	3.98%	2.15%	2.72%	2.86%	4.96%	1.35%	2.34%	2.63%
Mar–95	2.23%	2.15%	2.58%	10.88%	4.66%	1.67%	2.37%	4.01%	2.15%	2.66%	2.80%	4.87%	1.46%	2.42%	2.73%
Apr–95	2.17%	2.18%	2.53%	10.84%	4.68%	1.66%	2.42%	4.08%	2.16%	2.63%	2.77%	4.75%	1.57%	2.53%	2.80%
May–95	2.07%	2.22%	2.35%	10.73%	4.70%	1.66%	2.44%	4.18%	2.17%	2.55%	2.73%	4.64%	1.68%	2.59%	2.86%
Jun–95	1.95%	2.22%	2.28%	10.63%	4.73%	1.65%	2.45%	4.32%	2.19%	2.48%	2.71%	4.49%	1.65%	2.61%	2.94%
Jul–95	1.82%	2.20%	2.22%	10.44%	4.74%	1.63%	2.55%	4.44%	2.17%	2.40%	2.65%	4.37%	1.59%	2.60%	3.04%
Aug–95	1.73%	2.15%	2.13%	10.24%	4.69%	1.64%	2.55%	4.59%	2.15%	2.31%	2.56%	4.30%	1.47%	2.58%	3.14%
Sep–95	1.62%	2.16%	2.05%	9.94%	4.68%	1.68%	2.55%	4.73%	2.09%	2.21%	2.48%	4.25%	1.34%	2.55%	3.28%
Oct–95															
Nov–95															
Dec–95															

Long–term interest rates (monthly averages of daily rates)
(Note: average maturity: 10 years except Luxembourg (4 years) and Greece (5 years))

	B	DK	D	GR	E	F	IRL	I	L	NL	A	P	FIN	S	UK
Jan–93		8.65	7.13		12.15	7.92	9.88	13.44	7.28	7.13	7.26		10.93	10.14	8.32
Feb–93	7.67	8.64	6.90		11.44	7.78	9.26	13.07	7.28	6.87	7.13		10.28	9.80	7.92
Mar–93	7.39	8.17	6.64	24.50	11.35	7.33	8.57	12.98	7.24	6.56	6.81		9.88	9.37	7.65
Apr–93	7.44	7.79	6.68	24.38	11.49	7.15	8.11	13.15	7.20	6.60	6.81		9.78	9.41	7.83
May–93	7.42	7.56	6.83	23.88	11.22	7.18	7.83	12.50	7.22	6.67	6.91		9.47	9.12	8.08
Jun–93	7.23	7.18	6.81	23.38	10.57	6.95	7.61	11.89	6.99	6.59	6.90		9.07	8.74	7.88
Jul–93	7.06	7.05	6.61	22.88	10.22	6.76	7.32	11.21	6.64	6.43	6.67	10.40	8.61	8.22	7.49
Aug–93	7.08	6.73	6.37	22.38	9.48	6.31	7.11	10.05	6.56	6.18	6.51	10.12	7.87	7.76	6.98
Sep–93	7.24	6.77	6.20	22.25	9.09	6.13	7.01	9.64	6.62	5.98	6.39	9.51	7.99	7.78	6.91
Oct–93	7.19	6.47	5.98		8.69	5.96	6.71	9.03	6.67	5.82	6.27	9.07	7.67	7.59	6.81
Nov–93	6.94	6.40	6.00		8.56	6.04	6.57	9.59	6.71	5.81	6.08	9.09	7.40	7.47	6.77
Dec–93	6.61	6.22	5.83		8.28	5.80	6.38	9.18	6.65	5.68	5.91	8.94	7.02	7.58	6.28
Jan–94	6.53	6.02	5.82	19.00	7.99	5.67	6.15	8.79	6.42	5.61	5.68	8.75	6.54	6.77	6.23
Feb–94	6.67	6.26	6.13	21.25	8.07	5.94	6.43	8.97	6.29	5.86	5.81	8.44	6.57	6.97	6.61
Mar–94	7.14	6.69	6.35	20.38	8.83	6.38	7.07	9.63	6.36	6.29	6.24	8.88	7.47	7.67	7.29
Apr–94	7.28	7.03	6.61	20.00	9.06	6.69	7.57	9.27	6.36	6.54	6.37	9.09	8.30	8.44	7.66
May–94	7.54	7.41	6.66	20.00	9.55	6.97	7.96	9.57	6.32	6.75	6.59	9.90	8.52	8.79	8.14
Jun–94	7.98	8.17	7.06		10.28	7.49	8.50	10.53	6.35	7.11	6.91	10.87	9.54	9.84	8.54
Jul–94	7.95	8.15	6.90		10.59	7.40	8.34	10.73	6.44	6.91	6.71	11.35	9.90	10.67	8.38
Aug–94	8.21	8.57	7.09	21.50	10.68	7.61	8.43	11.46	6.45	7.12	6.89	11.40	10.60	11.25	8.52
Sep–94	8.58	9.09	7.51	21.50	11.22	8.09	8.82	11.91	6.57	7.49	7.23	11.76	10.54	11.36	8.80
Oct–94	8.45	8.92	7.53		11.14	8.19	8.68	11.94	6.54	7.55	7.33	11.58	10.08	11.15	8.70
Nov–94	8.33	8.83	7.49		11.18	8.14	8.51	11.87	6.35	7.54	7.30	11.48	10.24	11.03	8.58
Dec–94	8.30	8.77	7.46	19.00	11.38	8.02	8.57	12.09	6.21	7.59	7.59	11.53	10.21	10.73	8.53
Jan–95	8.45	9.06	7.60	19.00	11.86	8.23	8.79	12.36	6.08	7.71	7.73	11.75	10.24	10.87	8.66
Feb–95	8.26	8.85	7.42	18.50	11.59	8.00	8.67	12.38	6.06	7.54	7.68	11.61	10.22	10.60	8.60
Mar–95	8.16	8.96	7.28	18.25	12.26	8.02	8.80	13.44	6.14	7.42	7.55	11.89	10.18	11.21	8.54
Apr–95	7.85	8.75	7.09	18.00	12.09	7.82	8.70	13.40	6.19	7.17	7.36	12.13	9.42	11.45	8.38
May–95	7.59	8.32	6.86	17.50	11.41	7.52	8.34	12.31	6.23	6.92	7.17	11.93	8.84	10.84	8.13
Jun–95	7.33	8.27	6.80	17.25	11.54	7.45	8.26	12.39	6.13	6.83	7.09	11.91	8.70	10.54	8.09
Jul–95	7.33	8.34	6.86		11.33	7.42	8.39	12.21	6.15	6.85	7.13	11.71	8.74	10.53	8.23
Aug–95	7.19	8.08	6.75	16.25	10.97	7.33	8.15	11.65	6.15	6.74	7.00	11.34	8.34	10.17	8.10
Sep–95	7.04	7.84	6.58		10.80	7.35	7.96	11.55		6.58	6.89	11.15	7.98	9.70	7.92
Oct–95	7.09	7.92	6.60		10.89	7.51	8.01	11.91		6.63		11.21	7.97		

Long–term interest rates: 12–month moving averages

	B	DK	D	GR	E	F	IRL	I	L	NL	A	P	FIN	S	UK	Reference value: Unweighted average + 2pts
Jan–94	7.15	7.08	6.39	22.83	9.86	6.59	7.39	10.92	6.85	6.23	6.51		8.46	8.30	7.24	9.24
Feb–94	7.07	6.89	6.32	22.65	9.58	6.43	7.15	10.58	6.77	6.15	6.40		8.15	8.07	7.13	9.05
Mar–94	7.05	6.76	6.30	22.19	9.37	6.35	7.03	10.30	6.69	6.13	6.35		7.95	7.92	7.10	8.96
Apr–94	7.03	6.70	6.29	21.71	9.17	6.32	6.98	9.98	6.62	6.12	6.31		7.83	7.84	7.08	8.92
May–94	7.04	6.69	6.28	21.28	9.03	6.30	6.99	9.73	6.55	6.13	6.29		7.75	7.82	7.09	8.92
Jun–94	7.11	6.77	6.30	21.02	9.01	6.34	7.07	9.62	6.50	6.17	6.29	9.42	7.79	7.91	7.14	8.73
Jul–94	7.18	6.86	6.33	20.75	9.04	6.40	7.15	9.58	6.48	6.21	6.29	9.50	7.90	8.11	7.22	8.80
Aug–94	7.27	7.01	6.39	20.63	9.14	6.50	7.26	9.70	6.47	6.29	6.32	9.61	8.13	8.40	7.35	8.93
Sep–94	7.39	7.21	6.49	20.52	9.32	6.67	7.41	9.89	6.47	6.42	6.39	9.79	8.34	8.70	7.50	9.10
Oct–94	7.49	7.41	6.62	20.52	9.52	6.85	7.58	10.13	6.46	6.56	6.48	10.00	8.54	9.00	7.66	9.28
Nov–94	7.61	7.61	6.75	20.52	9.74	7.03	7.74	10.32	6.43	6.70	6.58	10.20	8.78	9.29	7.81	9.46
Dec–94	7.75	7.82	6.88	20.33	10.00	7.21	7.92	10.56	6.39	6.86	6.72	10.42	9.04	9.56	8.00	9.65
Jan–95	7.91	8.08	7.03	20.33	10.32	7.43	8.14	10.86	6.36	7.04	6.89	10.67	9.35	9.90	8.20	10.29
Feb–95	8.04	8.29	7.14	19.98	10.61	7.60	8.33	11.15	6.34	7.18	7.05	10.93	9.65	10.20	8.37	10.52
Mar–95	8.12	8.48	7.22	19.72	10.90	7.74	8.47	11.46	6.32	7.27	7.16	11.18	9.88	10.50	8.47	10.70
Apr–95	8.17	8.63	7.26	19.47	11.15	7.83	8.56	11.81	6.31	7.32	7.24	11.44	9.97	10.75	8.53	10.81
May–95	8.18	8.70	7.27	19.16	11.31	7.88	8.60	12.04	6.30	7.34	7.29	11.61	10.00	10.92	8.53	10.68
Jun–95	8.12	8.71	7.25	18.94	11.41	7.87	8.57	12.19	6.28	7.31	7.30	11.69	9.93	10.98	8.49	10.64
Jul–95	8.07	8.73	7.25	18.94	11.47	7.88	8.58	12.31	6.26	7.31	7.34	11.72	9.83	10.96	8.48	10.59
Aug–95	7.98	8.69	7.22	18.36	11.50	7.85	8.56	12.33	6.23	7.28	7.35	11.72	9.65	10.87	8.45	10.49
Sep–95	7.86	8.58	7.14		11.46	7.79	8.48	12.30		7.20	7.32	11.67	9.43	10.74	8.37	10.36
Oct–95	7.74	8.50	7.07		11.44	7.73	8.43	12.30		7.13		11.64	9.26			10.24

Principal economic policy measures – November 1995

Community (EUR–15)

None.

Belgium (B)

2.11 The central bank reduces its central rate from 4.05% to 4% and the rate on advances within the ceiling from 5.30% to 5.25%.

22.11 The central bank reduces its central rate from 4% to 3.95% and the rate on advances within the ceiling from 5.25% to 5.20%.

Denmark (DK)

8.11 The central bank reduces its discount rate by 25 basis points to 4.75%. The repo rate is cut by 15 basis points to 5.15%.

23.11 The repo rate is cut by 15 basis points to 5.00%

29.11 The government reaches an agreement with the conservative party on the 1996 budget law, which will reduce central government net borrowing and introduce tighter eligibility rules for unemployment benefits.

Germany (D)

10.11 The Bundestag approves the Federal budget for 1996: expenditure is set at DM 451.3 billion, 1.4% less than in 1995, while the deficit increases by DM 10 billion to just under DM 60 billion.

Greece (GR)

30.11 The 1996 budget is presented to Parliament: the target for the central government deficit is set at 8.7% of GDP, down from 10.2% of GDP in 1995, while a primary surplus is projected at 3.2% of GDP (2.6% of GDP in 1995). The proposed fiscal adjustment of 1.5 percentage points of GDP will come mainly from lower debt servicing costs (down 0.9% of GDP), while the improvement in budget revenues (up 1.5% of GDP) will be partly offset by a real increase in primary expenditure (up 0.9% of GDP).

Spain (E)

None.

France (F)

2.11 The Bank of France cuts its 24–hour lending rate to 6.60% from 7.00%.

9.11 The Bank of France reintroduces its five–to–ten day lending rate and reduces it from 6.60% to 6.35%.

15.11 The government adopts additional measures to keep the central government deficit at the level set by the Supplementary Finance Law for 1995 (i.e. 4.15% of GDP): non–tax revenues will be increased by FF 18 billion and some FF 3 billion will be saved to offset a FF 24.1 billion shortfall in tax revenues. The rest of the shortfall will be covered by a FF 2.1 billion reduction in European Union payments. The mini–budget also includes FF 16.2 billion in new spending which is covered by cancelling other credit lines.

16.11 The National Assembly adopts the 1996 budget bill, which cuts the central budget deficit from FF 321.6 billion (4.15% of GDP) in 1995 to FF 287.4 billion (3.55% of GDP) in 1996. The government has agreed to revise its original text, following a request from Parliament for spending cuts of FF 2 billion .

16.11 The Bank of France cuts its intervention rate, which sets the floor for money market rates, from 5.00% to 4.80%. It also reduces its five–to–ten day lending rate, which sets the money market ceiling, from 6.35% to 6.10%.

29.11 The government approves a bill allowing it to take measures by decree during a four–month period in order to reform the welfare system. Five major reforms will be introduced by this procedure:

- the creation of a fund to cushion the social security debt (caisse d'amortissement de la dette sociale) and of a 0.5% tax on most incomes;
- immediate measures to bring the social security accounts back to financial balance over the next two years;
- reform of the management of the social security organizations ("caisses")
- hospital reform;
- the introduction of new instruments to control health spending.

Ireland (IRL)

None.

Italy (I)

23.11 The Senate approves the 1996 draft budget, which has now to be ratified and forwarded to the Chamber of Deputies.

Luxembourg (L)

None.

Austria (A)

17.11 Parliament met in extraordinary session to pass some urgent laws, including a law adapting Austrian vehicle road tax to the EU level, a law to fix subsidies for agriculture and laws concerning transfers for hospitals and support for private housing.

Netherlands (NL)

16.11 The central bank reduces its rate for special advances from 3.70% à 3.60% and its central rate from 3.50% to 3.25%.

Portugal (P)

None.

Finland (FIN)

1.11 The Bank of Finland cuts its tender rate from 5.5% to 5.0%.

Sweden (S)

6.11 In its first review of the convergence programme, the Swedish government concludes that economic developments have been more favourable than the programme had forecast. It is now estimated that the public sector deficit will be 2.5% of GDP in 1997 and that the debt ratio will stabilize this year.

6.11 The government presents a bill on work, welfare and growth, outlining the government's agenda for the next three years.

United Kingdom (UK)

28.11 Taxes are cut by UKL 3¼ billion in 1996/97 in the budget presented to parliament by the Chancellor of the Exchequer. The main measures are: the basic rate of income tax is cut from 25% to 24%; the basic personal allowance (the first part of income on which no tax is paid) is increased by UKL 240; the threshold for the lower rate income tax band (20%) is raised by UKL 700; on investment income the basic rate of tax is reduced from 25% to 20%; the threshold for higher–rate income tax (40%) is raised by UKL 1 200; spirits duty is reduced by 4%, cutting the price of a bottle of whisky by UKL 0.27; the price of cigarettes is increased by UKL 0.15 for a packet of 20; the tax cuts are exactly matched by public expenditure cuts of UKL 3¼ billion, achieved largely by a cut in the contingency reserve from UKL 6 billion to UKL 3 billion; elsewhere, expenditure cuts in roads, defence and housing are matched by increases of UKL 1.3 billion on health, UKL 0.9 billion on education and UKL 0.1 billion on the police; the government forecasts that the general government deficit will fall to 4¾% of GDP in 1995/96, 3½% in 1996/97 and 2% in 1997/98.

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CM-AS-96-001-EN-C