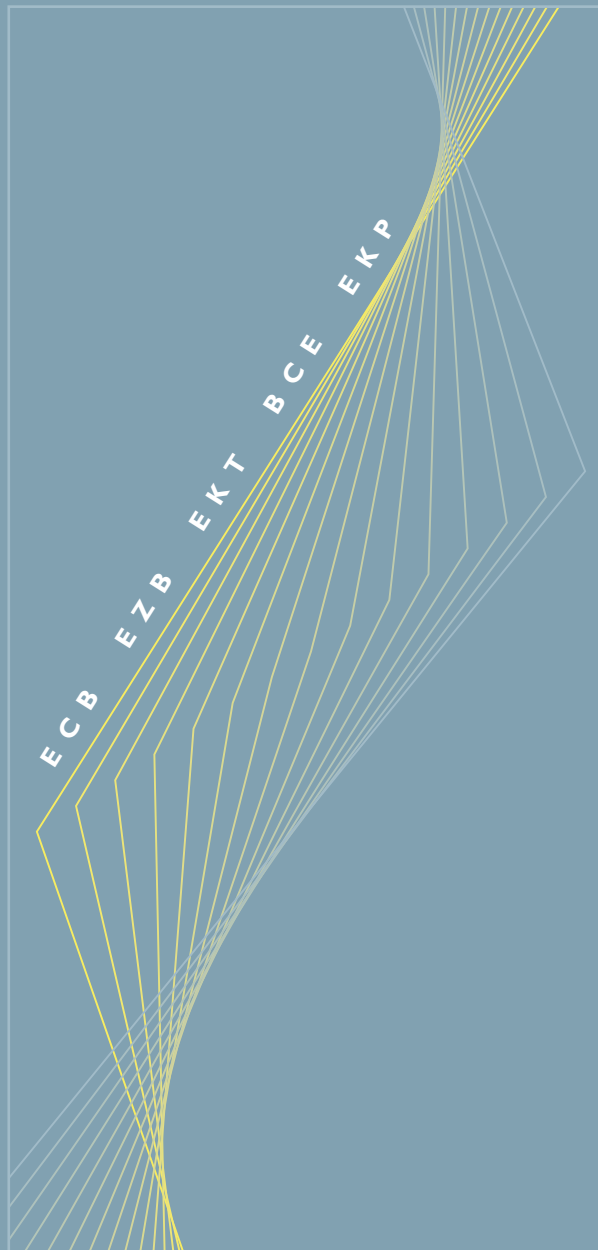




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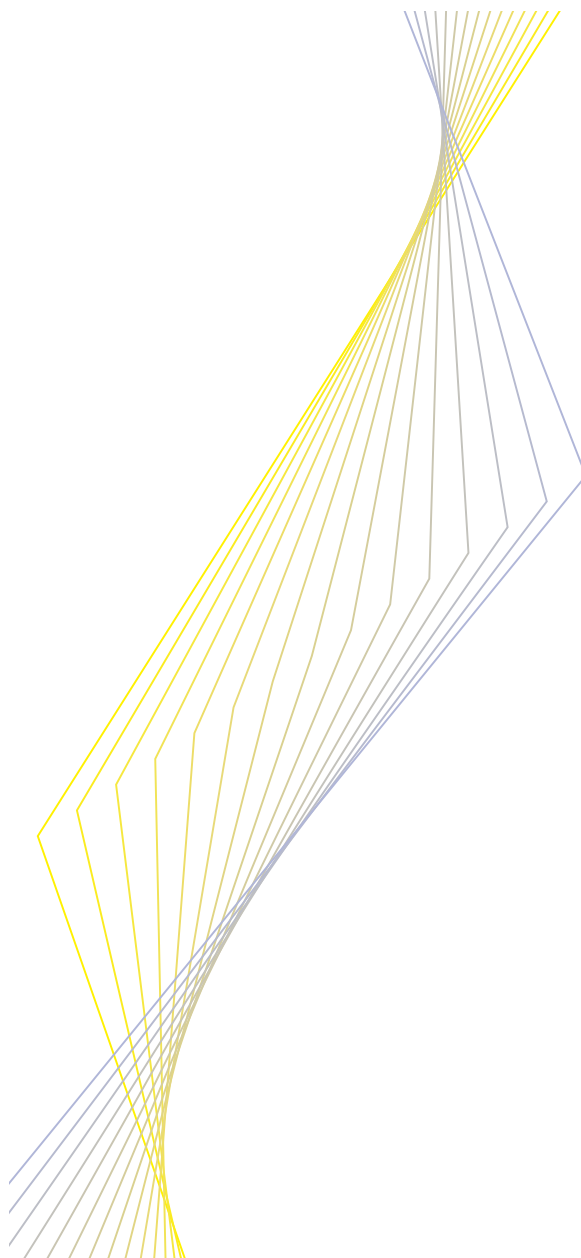


# CONVERGENCE REPORT

2000



EUROPEAN CENTRAL BANK



# **CONVERGENCE REPORT**

**2000**

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## Abbreviations

### Countries

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

### Others

BIS	Bank for International Settlements
BPM4	IMF Balance of Payments Manual (4th edition)
BPM5	IMF Balance of Payments Manual (5th edition)
CDs	certificates of deposit
c.i.f.	cost, insurance and freight at the importer's border
CPI	Consumer Price Index
ECB	European Central Bank
ECU	European Currency Unit
EMI	European Monetary Institute
ESA 95	European System of Accounts 1995
ESCB	European System of Central Banks
EU	European Union
EUR	euro
f.o.b.	free on board at the exporter's border
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
ILO	International Labour Organization
IMF	International Monetary Fund
MFIs	Monetary Financial Institutions
NCBs	national central banks
repos	repurchase agreements
SITC Rev. 3	Standard International Trade Classification (revision 3)

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



## **Introduction and country summaries**



## Introduction

In this year's Report under Article 122 (2) of the Treaty establishing the European Community (the "Treaty"), the European Central Bank (ECB) uses the framework applied in the Convergence Report produced by the European Monetary Institute (EMI) in March 1998 to examine, with regard to Greece and Sweden, the achievement of a high degree of sustainable convergence, as well as compliance with the statutory requirements to be fulfilled in order for national central banks (NCBs) to become an integral part of the European System of Central Banks (ESCB).

With regard to Greece, it is also noted that the Minister of National Economy and Finance of Greece addressed a letter to the President of the ECB on 9 March 2000, requesting the evaluation of Greece's application regarding the abrogation of its status as a Member State with a derogation.

Following the introduction of the euro on 1 January 1999, four EU Member States are not yet full participants in Economic and Monetary Union (EMU). Two of these Member States, namely Denmark and the United Kingdom, have a special status. In accordance with the terms of the relevant protocols, annexed to the Treaty, concerning Denmark and the United Kingdom respectively, these countries gave notification that they would not participate in Stage Three of EMU on 1 January 1999. As a consequence, Convergence Reports for these two Member States only have to be provided if they so request. Since no such request has been made, this year's Convergence Report covers only Greece and Sweden.

In producing this Report, the ECB fulfils the requirement of Article 122 (2) in conjunction

with Article 121 (1) of the Treaty to report to the Council of the European Union (Council) at least once every two years or at the request of a Member State with a derogation "on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of economic and monetary union". The same mandate has been given to the European Commission, and the two reports have been submitted to the Council in parallel. Both reports represent the starting-point of the procedure under Article 122 (2), which will entail the following additional steps:

- the European Commission will prepare a proposal for those Member States whose derogation is to be abrogated;
- the European Parliament will be consulted;
- the Council, meeting in the composition of the Heads of State or Government, will discuss the issues; and, finally,
- the ECOFIN Council, acting by a qualified majority on a proposal of the European Commission, will decide, on the basis of the criteria set out in Article 121 (1), which Member States with a derogation fulfil the necessary conditions to abrogate the derogations for the Member States concerned.

This year's Convergence Report contains three chapters. Chapter I describes the key aspects of the examination of economic convergence in 2000. Chapter II assesses the state of economic convergence in Greece and Sweden, and Chapter III investigates compliance with the statutory requirements to be fulfilled by NCBs in order for them to become an integral part of the ESCB.

## Country summaries

### Greece

Over the reference period from April 1999 to March 2000 Greece achieved a 12-month average rate of HICP inflation of 2.0%, which is below the reference value stipulated by the Treaty. In 1999 as a whole the inflation rate was at the reference value and, since January 2000, Greece has achieved a rate of HICP inflation which is below the reference value. Seen over the period since 1998, HICP inflation in Greece has been reduced significantly and is now closer to a level which can generally be considered to be consistent with price stability. Looking back, a clear trend towards lower inflation is discernible in Greece, with the CPI rate falling from 20.4% in 1990 to 2.6% in 1999 (HICP rate in 1999: 2.1%). At the same time, the increase in compensation per employee decelerated from 12.2% in 1995 to 4.8% in 1999. Due attention needs to be paid to the fact that the recent reduction in inflation rates is partly attributable to temporary factors and that oil price changes have a relatively stronger impact on price developments in Greece than in the EU as a whole.

Looking ahead, recent forecasts suggest inflation rates of between 2.2% and 2.4% in 2000 and of between 2.3% and 2.7% in 2001. Future price developments in Greece are subject to a number of upward risks. In 2000 and 2001 inflation rates will be influenced upwards as the recent cuts in indirect taxes will cease to have an impact. It remains uncertain as to whether the non-renewal of the gentleman's agreements with commercial and industrial enterprises, as well as service providers, will result in upward price pressure. Moreover, an eventual alignment of Greek interest rates with those in the euro area and the depreciation of the drachma towards its conversion rate will exert upward pressure on prices. Therefore, the sustainability of the positive development with regard to the inflation performance is subject to upside risks and continued efforts to support further sustained price stability

are of particular importance for Greece. Containing pressure on compensation and on prices – without further reliance on one-off special measures – crucially hinges upon the credibility of the authorities' overall strategy. In particular, this relates to the conduct of fiscal policies, as well as to structural policies aimed at improving the functioning of product and labour markets.

Looking at fiscal policy, the 1999 general government deficit ratio was 1.6%, falling well below the 3% reference value, and the debt ratio was 104.4%, i.e. far above the 60% reference value. Compared with 1998 the deficit ratio has been reduced by 1.5 percentage points of GDP and the debt ratio by 1 percentage point of GDP. Since 1998 the deficit ratio has not exceeded the ratio of public investment to GDP. In 2000 the deficit ratio is forecast to decrease to 1.3% of GDP, while the debt ratio is projected to decline to 103.7%. However, significant deficit-debt adjustments continue to have an adverse effect on debt developments, with the result that Greece's public debt is falling only slowly, despite high primary surpluses and privatisation receipts. Notwithstanding the efforts and the substantial progress made towards improving the current fiscal situation, there must be an ongoing concern as to whether the ratio of government debt to GDP will be "sufficiently diminishing and approaching the reference value at a satisfactory pace" and whether sustainability of the fiscal position has been achieved. Substantial primary surpluses and persistent, sizeable overall fiscal surpluses outperforming the targets of the Updated Greece Convergence Programme, together with greatly reduced deficit-debt adjustments, will be needed to reduce the debt ratio to 60% within an appropriate period of time. Tight fiscal policy will also be needed in order to contain inflationary pressures stemming from the above-mentioned relaxation of monetary conditions in the run-up to full membership of EMU. The Stability and Growth Pact also requires, as a medium-term objective, a

budgetary position that is close to balance or in surplus.

In the context of population ageing, increased efforts to reform the social security system are needed, while further progress in privatisation would reduce liabilities from the wider public sector. Furthermore, a speedier transposition of Single Market legislation into national law, further progress with regard to the liberalisation of a number of network industries and determined efforts to overcome structural rigidities in the labour market are warranted.

The level of long-term interest rates reached 6.4% on average during the reference period from April 1999 to March 2000, which is below the reference value. In March 2000 the difference between Greek long-term interest rates and the euro area average stood at around 0.8 percentage point; the difference between Greek short-term interest rates and the euro area average in the three months ending in March 2000 was 540 basis points.

The Greek drachma has been participating in the exchange rate mechanism of the European Monetary System (EMS) since 16 March 1998 and it joined ERM II at the start of Stage Three of EMU. During the two-year reference period from April 1998 to March 2000 the drachma normally traded significantly above its central rates. Exchange rate volatility declined significantly during the reference period and the significant short-term interest rate differentials also displayed a gradual decrease from September 1998 onwards. However, relatively high interest rate differentials played an important role during the reference period. Foreign exchange interventions were conducted at times, aimed at limiting exchange rate variability. After a gradual depreciation during most of 1999 and a revaluation of the central rate by 3.5% in January 2000, the drachma was quoted at GRD 333.89 against the euro in March 2000, 2.0% above its new central rate. Throughout the reference period covered by this Report, Greece recorded

current account deficits which can be partly interpreted as a result of the country's need to finance investments.

As far as the compatibility of Greek legislation – including the Statute of the Bank of Greece – with the requirements for the introduction of the euro laid down in the Treaty and the Statute of the ESCB is concerned, the following is noted.

Following the findings of the 1998 EMI Convergence Report, the Statute of the Bank of Greece was amended on 25 April 2000 to meet the requirements of the Treaty and the Statute of the ESCB for the full legal integration of the Bank of Greece into the ESCB. Assuming that the new Statute of the Bank of Greece will be ratified by the Parliament and that it will enter into force on time, as it was presented to the ECB in a consultation procedure, and assuming that Law 2548/1997 will be adapted accordingly (which, in the ECB's view, needs to be accomplished as a matter of urgency), there will be no remaining imperfections in the Statute of the Bank of Greece relating to the requirements of the Treaty and the Statute of the ESCB for the full legal integration of the Bank of Greece into the ESCB.

As far as legislation other than the Statute of the Bank of Greece is concerned, the ECB takes note that such other legislation will be adapted in a law introducing the euro, on which the ECB will have to be consulted in accordance with Article 105 (4), second indent, of the Treaty, as repeated in Article 4 (a), second indent, of the Statute of the ESCB.

### **Sweden**

Over the reference period from April 1999 to March 2000 Sweden achieved a 12-month average rate of HICP inflation of 0.8%, which is well below the reference value stipulated by the Treaty. Sweden has entered a period of high growth in recent years, led predominantly by domestic demand; at the

same time, the fiscal stance has become more neutral, resulting in a rapid closing of the output gap. The closing of the output gap as well as relevant price indices point in the direction of increasing upward pressure on prices and costs. Looking ahead, forecasts indicate that inflation will be around 1.5% in 2000 and around 2% in 2001. The level of long-term interest rates was 5.4%, i.e. below the respective reference value.

Sweden does not participate in ERM II. Sweden is a Member State with a derogation and does not have a clause allowing it to opt out of Stage Three of EMU. Sweden is thus committed by the Treaty to adopting the euro, which implies that it must strive to fulfil all the convergence criteria, including the exchange rate criterion. During the reference period from April 1998 to March 2000 the Swedish krona initially traded at a weaker level than its April 1998 average bilateral exchange rates against most other EU currencies, these being used as a benchmark for illustrative purposes in the absence of central rates. Having depreciated significantly in the second part of 1998, following the global market turbulence caused by the emerging market crisis in August 1998, the krona appreciated by 14.4% against the euro throughout 1999 and until March 2000. This strengthening reflects a normalisation of the situation after the global crisis in autumn 1998 and Sweden's stronger than expected economic performance.

In 1999 Sweden achieved a fiscal surplus of 1.9% of GDP, thereby meeting the 3% reference value, and the outlook is for a surplus of 2.4% of GDP in 2000. The debt-to-GDP ratio is above the 60% reference value. After having reached a peak in 1994, the ratio declined by 12.2 percentage points to stand at 65.5% in 1999. With regard to the sustainability of fiscal developments, the outlook is for a decline in the debt ratio to

61.3% in 2000. Against the background of the trends in the budget balance ratio in recent years, Sweden is expected to comply with the medium-term objective of the Stability and Growth Pact of having a budgetary position which is close to balance or in surplus, according to the assessment undertaken by the European Commission, and as confirmed by the ECOFIN Council.

With regard to other factors, the deficit ratio has not exceeded the ratio of public investment to GDP since 1997. In addition, Sweden recorded current account surpluses, while maintaining a net external liability position. In the context of the ageing of the population, Sweden benefits from a partly funded pension system, which is gradually being supplemented by a new system which will reduce pressures on public finances.

As far as the compatibility of Swedish legislation – including the Statute of Sveriges Riksbank – with the requirements for the introduction of the euro laid down in the Treaty and the Statute of the ESCB is concerned, the following is noted.

Swedish legislation, and in particular the Statute of Sveriges Riksbank, does not anticipate the Bank's legal integration into the ESCB, although Sweden is not a Member State with a special status and must therefore comply with all adaptation requirements under Article 109 of the Treaty. This affects a number of provisions in the Bank's Statute.

As far as legislation other than the Statute of Sveriges Riksbank is concerned, the ECB notes that the legislation on access to public documents and the law on secrecy need to be reviewed in the light of the confidentiality regime under Article 38 of the Statute of the ESCB. The ECB is not aware of any other statutory provisions which would require adaptation under Article 109 of the Treaty.



## **Chapter I**

### **Key aspects of the examination of economic convergence in 2000**

According to Article 122 (2) of the Treaty, the European Commission and the ECB shall, at least once every two years, or at the request of a Member State with a derogation, provide reports on the progress made by such Member States with a view to the fulfilment of their obligations regarding the achievement of Economic and Monetary Union (EMU) ("Convergence Reports"). Four EU Member States are not yet full participants in EMU. Two of these Member States, namely Denmark and the United Kingdom, have a special status which implies that Convergence Reports for these two Member States only have to be provided if these two Member States so request. Since no such request has been made, the examination of economic convergence in 2000 covers only Greece and Sweden.

Chapter II of this Report aims at summarising evidence available for Greece and Sweden from a comprehensive examination of economic convergence; this examination refers to a number of economic criteria related to the development of prices, government fiscal positions, exchange rates and long-term interest rates, and takes other factors into account. Boxes 1 to 4 briefly recall the provisions of the Treaty and

provide methodological details which outline the application of these provisions by the ECB. Furthermore, the main text describes in greater detail the range of indicators which are considered in order to examine the sustainability of developments. Most of these indicators were used in previous reports of the European Monetary Institute (EMI). First, evidence from the 1990s is reviewed from a backward-looking perspective. This should help to determine more accurately whether current achievements are primarily the result of genuine structural adjustments, which in turn should lead to a better assessment of whether economic convergence is of a sustainable nature. Second, and to the extent appropriate, a forward-looking perspective is adopted. In this context, particular attention is drawn to the fact that the sustainability of favourable developments critically hinges on appropriate and lasting policy responses to existing and future challenges. Overall, it is emphasised that ensuring sustainability depends both on the achievement of a sound starting position and on the policies pursued after the adoption of the euro.

As regards price developments, the Treaty provisions and their application by the ECB are outlined in Box I.

## **Box I**

### **Price developments**

#### **1 Treaty provisions**

Article 121 (1), first indent, of the Treaty requires:

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

Article 1 of the Protocol on the convergence criteria referred to in Article 121 of the Treaty stipulates:

"The criterion on price stability referred to in the first indent of Article 121 (1) of this Treaty shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1½ percentage points that of, at most, the three best-performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions."

## 2 Application of Treaty provisions

In the context of this Report the ECB applies the Treaty provisions as outlined below:

- First, with regard to “an average rate of inflation, observed over a period of one year before the examination”, the inflation rate has been calculated using the increase in the latest available 12-month average of the Harmonised Index of Consumer Prices (HICP) over the previous 12-month average. Hence, with regard to the rate of inflation, the reference period considered in this Report is April 1999 to March 2000.
- Second, the notion of “at most, the three best-performing Member States in terms of price stability”, which is used for the definition of the reference value, has been applied by using the unweighted arithmetic average of the rate of inflation in the three countries with the lowest inflation rates, given that these rates are compatible with price stability. Over the reference period considered in this Report, the three countries with the lowest HICP inflation rates were Sweden (0.8%), Austria (0.9%) and France (0.9%); as a result, the average rate is 0.9% and, adding 1½ percentage points, the reference value is 2.4%.

To allow a more detailed examination of the sustainability of price developments, the average rate of HICP inflation achieved over the 12-month reference period from April 1999 to March 2000 is reviewed in the light of the performance during the 1990s in terms of price stability. In this connection, attention is drawn to the orientation of monetary policy, in particular whether the focus of the monetary authorities has been primarily on achieving and maintaining price stability, as well as to the contribution of other areas of economic policy to achieving sustainable price stability. Moreover, the implications of the macroeconomic environment for the achievement of price stability are taken into account. Price developments are examined in the light of demand and supply conditions, focusing on, inter alia, factors influencing unit

labour costs and import prices. Finally, price trends across other relevant price indices (including the national Consumer Price Index (CPI), the private consumption deflator, the GDP deflator and producer prices) are taken into account. From a forward-looking perspective, a view is provided of prospective inflationary developments in the immediate future, including forecasts by major international organisations. Moreover, reference is made to structural aspects which are relevant for maintaining an environment conducive to price stability after accession to EMU.

With regard to fiscal developments, the Treaty provisions and their application by the ECB, together with procedural issues, are outlined in Box 2.

### Box 2

#### Fiscal developments

##### 1 Treaty provisions

Article 121 (1), second indent, of the Treaty requires:

“the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive, as determined in accordance with Article 104 (6)”. Article 2 of the Protocol on the convergence criteria referred to in Article 121 of the Treaty stipulates that this criterion “shall mean that at the time of the examination the Member State is not the subject of a Council decision under Article 104 (6) of this Treaty that an excessive deficit exists”.



Article 104 sets out the excessive deficit procedure. According to Article 104 (2) and (3), the European Commission shall prepare a report if a Member State does not fulfil the requirements for fiscal discipline, in particular if:

- (a) the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds a reference value (defined in the Protocol on the excessive deficit procedure as 3% of GDP), unless:
  - either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively,
  - the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;
- (b) the ratio of government debt to gross domestic product (GDP) exceeds a reference value (defined in the Protocol on the excessive deficit procedure as 60% of GDP), unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

In addition, the report prepared by the European Commission shall take into account whether the government deficit exceeds government investment expenditure and all other relevant factors, including the medium-term economic and budgetary position of the Member State. The European Commission may also prepare a report if, notwithstanding the fulfilment of the requirements under the criteria, it is of the opinion that there is a risk of an excessive deficit in a Member State. The Economic and Financial Committee shall formulate an opinion on the report of the European Commission. Finally, in accordance with Article 104 (6), the EU Council, on the basis of the recommendation from the European Commission and having considered any observations which the Member State concerned may wish to make, shall, acting by qualified majority, decide, after an overall assessment, whether an excessive deficit exists in a Member State.

## **2 Procedural issues and the application of Treaty provisions**

For the purpose of examining convergence, the ECB expresses its view on fiscal developments. With regard to sustainability, the ECB examines key indicators of fiscal developments from 1990 to 1999, considers the outlook and challenges for public finances and focuses on the links between deficit and debt developments.

With regard to the Treaty provision that a debt ratio of above 60% of GDP should be “sufficiently diminishing and approaching the reference value at a satisfactory pace”, the ECB examines past and current trends and provides a number of calculations based on the analytical framework developed by the EMI in its 1998 Convergence Report.

For Greece, a country with a debt ratio above 100% of GDP, in addition to the above calculations, the overall and primary fiscal balances are shown, which are consistent with a reduction in the debt ratio to 60% of GDP over five, ten and fifteen years from 1999, the reference year for fiscal developments, i.e. in 2004, 2009 and 2014 respectively. For Sweden, the potential future course of the debt ratio is not considered in detail as forecasts indicate that Sweden is likely to have a debt ratio of below 60% of GDP in 2001.

The examination of fiscal developments is based on comparable data compiled on a national accounts basis, in compliance with the European System of Accounts 1995 (see the statistical annex to Chapter II). The main figures presented in this Report were made available by the European Commission in March 2000 and include government financial positions in 1998 and 1999, as well as European Commission estimates for 2000. Furthermore, the relationship between the deficit ratio and government investment expenditure is reported for 1998 and 1999.

With regard to the closer examination of the sustainability of fiscal developments, the outcome in the reference year, 1999, is reviewed in the light of the performance during the 1990s. As a starting-point, the evolution observed in the debt ratio in the past is considered, and the factors underlying this evolution are examined, i.e. the difference between nominal GDP growth and interest rates, the primary balance and deficit-debt adjustments. Such a perspective can offer further information on the extent to which the macroeconomic environment, in particular the combination of growth and interest rates, has affected the dynamics of debt, on the contribution of fiscal consolidation efforts as reflected in the primary balance and on the role played by special factors as included in the deficit-debt adjustment. In addition, the structure of debt is considered, by focusing in particular on the share of debt with a short-term residual maturity and foreign currency debt, as well as their evolution. By linking these shares with the current level of the debt ratio, the sensitivity of fiscal balances to changes in exchange rates and interest rates is highlighted.

In a further step, the evolution of the deficit ratio is investigated. In this context it is considered useful to bear in mind that the change in a country's annual deficit ratio is typically influenced by a variety of underlying forces. These influences are often sub-divided into "cyclical effects" on the one hand, which reflect the reaction of deficits to changes in the output gap, and "non-cyclical effects" on the other, which are often taken to reflect structural or permanent adjustments to fiscal policies. However, such non-cyclical effects, as quantified in this Report, cannot necessarily be seen as entirely reflecting a structural change to fiscal positions, because they will also include any measures and other factors with only temporary effects on the budgetary balance. To the extent possible, a distinction

is made between measures which improve the budgetary outcome in one year only and therefore require compensation in the following year ("one-off" measures), and measures which have the same implication in the short run but which, in addition, lead to extra borrowing in later years, thereby first improving and later burdening the budget ("self-reversing" measures).

Past public expenditure and revenue trends are also considered in more detail. In the light of past trends, a view is put forward of, inter alia, the broad areas on which necessary future consolidation may need to focus.

Turning to a forward-looking perspective, budget plans and recent forecasts for 2000 are recalled and account is taken of the medium-term fiscal strategy as reflected in Convergence Programmes. Thereafter, a number of illustrative calculations are presented (see Box 2). In respect of these calculations, a link between deficit developments and the prospective path of the debt ratio can be established, as well as a link to the objective of the Stability and Growth Pact, applicable from 1999 onwards, of having a budgetary position close to balance or in surplus. Finally, long-term challenges to the sustainability of budgetary positions are emphasised, particularly those related to the issue of unfunded public pension systems in connection with aspects of demographic change.

It should be noted that in assessing the budgetary positions of EU Member States, the impact on national budgets of transfers to and from the EU budget is not taken into account by the ECB.

With regard to exchange rate developments, the Treaty provisions and their application by the ECB are outlined in Box 3.

### **Box 3**

#### **Exchange rate developments**

##### **1 Treaty provisions**

Article 121 (1), third indent, of the Treaty requires:

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

Article 3 of the Protocol on the convergence criteria referred to in Article 121 (1) of the Treaty stipulates:

“The criterion on participation in the exchange-rate mechanism of the European Monetary System referred to in the third indent of Article 121 (1) of this Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency’s bilateral central rate against any other Member State’s currency on its own initiative for the same period.”

##### **2 Application of Treaty provisions**

The Treaty refers to the criterion of participation in the European exchange rate mechanism (ERM until December 1998; superseded by ERM II as of January 1999).

- First, the ECB examines whether the country has participated in the ERM/ERM II “for at least the last two years before the examination”, as stated in the Treaty.
- Second, with regard to the definition of “normal fluctuation margins”, the ECB recalls the formal opinion that was put forward by the EMI Council in October 1994 and its statements in the November 1995 report entitled “Progress towards convergence”:

In the EMI Council’s opinion of October 1994 it was stated that “the wider band has helped to achieve a sustainable degree of exchange rate stability in the ERM”, that “the EMI Council considers it advisable to maintain the present arrangements”, and that “member countries should continue to aim at avoiding significant exchange rate fluctuations by gearing their policies to the achievement of price stability and the reduction of fiscal deficits, thereby contributing to the fulfilment of the requirements set out in Article 121 (1) of the Treaty and the relevant Protocol”.

In the November 1995 report entitled “Progress towards convergence” it was recognised by the EMI that “when the Treaty was conceived, the ‘normal fluctuation margins’ were  $\pm 2.25\%$  around bilateral central parities, whereas a  $\pm 6\%$  band was a derogation from the rule. In August 1993 the decision was taken to widen the fluctuation margins to  $\pm 15\%$ , and the interpretation of the criterion, in particular of the concept of ‘normal fluctuation margins’, became less straightforward”. It was then also proposed that account would need to be taken of “the particular evolution of exchange rates in the European Monetary System (EMS) since 1993 in forming an ex post judgement”.

Against this background, in the assessment of exchange rate developments the emphasis is placed on exchange rates being close to the ERM/ERM II central rates.

- Third, the issue of “severe tensions” is generally addressed by examining the degree of deviation of exchange rates from the ERM central parities against other participating currencies or ERM II central rates against the euro, by using such indicators as short-term interest rate differentials vis-à-vis the group of countries with the lowest money market rates and their evolution, and by considering the role played by foreign exchange interventions.

For Sweden, a Member State which is not participating in ERM II (and did not participate in its forerunner, the ERM), the performance of the Swedish krona is shown against each of the EU member currencies during the period from April to December 1998 and against the euro and other EU member currencies during the period from January 1999 to March 2000.

Apart from reviewing the performance of nominal exchange rates over the reference period from April 1998 to March 2000,

evidence relevant to the sustainability of current exchange rates is briefly reviewed. This is derived from real exchange rate patterns vis-à-vis major trading partners, the current account of the balance of payments, the degree of openness of the Member State, its share of intra-EU trade and net foreign asset positions.

With regard to long-term interest rate developments, the Treaty provisions and their application by the ECB are outlined in Box 4.

#### **Box 4**

##### **Long-term interest rate developments**

###### **1 Treaty provisions**

Article 121 (1), fourth indent, of the Treaty requires:

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

Article 4 of the Protocol on the convergence criteria referred to in Article 121 of the Treaty stipulates:

“The criterion on the convergence of interest rates referred to in the fourth indent of Article 121 (1) of this Treaty shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions.”

###### **2 Application of Treaty provisions**

In the context of this Report the ECB applies the Treaty provisions as outlined below:

– First, with regard to “an average nominal long-term interest rate” observed over “a period of one year before the examination”, the long-term interest rate has been calculated as an arithmetic average over the latest 12 months for which data on HICPs were available. Hence, the reference period considered in this Report is April 1999 to March 2000.

– Second, the notion of “at most, the three best-performing Member States in terms of price stability”, which is used for the definition of the reference value, has been applied by using the unweighted arithmetic average of the long-term interest rates of the three countries with the lowest inflation rates (see Box 1). Over the reference period considered in this Report the long-term interest rates of these three countries were 5.1% (Austria), 5.4% (Sweden) and 5.0% (France); as a result, the average rate is 5.2% and, adding 2 percentage points, the reference value is 7.2%.

Interest rates have been measured on the basis of harmonised long-term interest rates, which were developed for the purpose of assessing convergence (see the statistical annex to Chapter II).

As mentioned above, the Treaty makes explicit reference to the “durability of convergence” being reflected in the level of long-term interest rates. Therefore, developments over the reference period from April 1999 to March 2000 are reviewed in the context of the path of long-term interest rates during the 1990s and the main factors underlying differentials vis-à-vis those interest rates prevailing in the EU countries with the lowest long-term rates.

Finally, Article 121 (1) of the Treaty requires this Report to take account of several other

factors, namely “the development of the ECU, the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices”. These factors are reviewed in the country chapters under the individual criteria listed above. In the light of the launch of the euro on 1 January 1999 there is no longer a specific discussion of the development of the ECU.

## Chapter II

### **Convergence criteria**

## I Greece

### I.1 Price developments

Over the reference period from April 1999 to March 2000 the average rate of HICP inflation in Greece was 2.0%, i.e. 0.4 percentage point below the level of the reference value of 2.4% as defined in Article 121 (1) of the Treaty establishing the European Community and Article 1 of the Protocol on the convergence criteria referred to in that Article. In 1999 as a whole the inflation rate was 2.1%, i.e. at the reference value for that year and, since January 2000, Greece has achieved a rate of HICP inflation which is below the reference value. In 1998 average HICP inflation was 4.5% (see Table 1). Seen over the period since 1998, HICP inflation in Greece has been significantly reduced, and recently came closer to a level which can generally be considered to be consistent with price stability. Due attention needs to be paid to the fact that the recent reduction in inflation rates is partly attributable to temporary factors.

Cuts in indirect taxes were introduced gradually between October 1998 and December 1999. The ECB estimates that the impact of such cuts has reduced Greek consumer price inflation over the reference period from April 1999 to March 2000 by around 0.9 percentage point on average. The direct downward effect of these cuts on inflation will disappear one year after their introduction and the 12-month inflation rate will then be higher again. In this sense, cuts in indirect taxes have only a temporary “one-off” effect on rates of inflation and do not represent a sustainable move towards price stability. Furthermore, such measures also have secondary inflation-reducing effects, because they have contributed to reducing the effect of wage catch-up clauses, thus averting additional private sector wage increases of 0.6 percentage point at the beginning of 1999 and of 1.0 percentage point at the beginning of 2000. Finally, they may have a more lasting effect by lowering inflation expectations, although it is not possible to

quantify the latter with any degree of precision.

Starting in August 1998, the Greek Government also concluded a number of *gentleman's agreements* with commercial and industrial enterprises as well as service providers. The aim of the agreements in 1998 was to reduce the retail prices of a number of goods roughly corresponding to one-tenth of the CPI basket. The agreements in 1999 aimed at keeping retail prices for goods and services, which correspond to roughly one-third of the CPI basket, stable or at restraining their price growth. According to Bank of Greece estimates, price increases for the items covered by such agreements in 1998 remained below the overall rate of increase in consumer prices which translates into a direct inflation-reducing effect of 0.2 percentage point. Such a direct impact cannot be observed for 1999, since price increases for items covered by the agreements were, on average, equal to the overall level of CPI inflation. It is not possible to assess whether the 1999 agreements prevented price increases in these items which, on average, would have exceeded the overall level of CPI inflation.

Looking back beyond the most recent developments, a clear trend towards lower rates of inflation in Greece has been discernible since the early 1990s. Consumer price inflation, as measured on the basis of the CPI, decreased steadily from 20.4% in 1990 to 2.6% in 1999 (see Table 2 and Chart 1). This experience of disinflation reflects a number of important policy choices, most notably the progressive tightening of monetary policy since the start of the 1990s. The primary objective of the monetary policy strategy of the Bank of Greece is to maintain price stability, with the latter being defined as a year-on-year increase in the national consumer price index of below 2%. To this end, the authorities maintained a tight monetary policy stance throughout the 1990s. In April 1999 the Bank of Greece introduced

temporary reserve requirements on the growth of bank credit to the private sector. In 1999 the key 14-day deposit rate was kept at 12% until October. The 14-day rate was then gradually reduced to 9.25% by March 2000, still 575 basis points above the ECB's main refinancing rate. High official interest rates aimed at facilitating the move towards price stability also supported the drachma's position in foreign exchange markets. The reduction in inflation was supported by adjustments in fiscal policy so as to achieve lower deficit ratios. Growth in compensation per employee was reduced from a peak of 12.2% in 1995 to 4.8% in 1999, while growth in unit labour costs declined from 11.6% to 2.5% respectively. These reductions were supported by strong productivity growth and a two-year national general collective agreement reached by the social partners in May 1998 which resulted in moderate wage increases. A reduction in inflation is also indicated by other relevant measures of inflation (see Table 2).

Looking at recent trends and forecasts, 12-month rates for HICP inflation decreased steadily from around 5.1% in April and May 1998 to 1.3% in September 1999. Since then the HICP has increased strongly, reaching 2.8% in March 2000 (see Table 3a). However, most of the recent increase is due to the strong rise in oil prices and the appreciation of the US dollar. In this context it should be noted that oil price changes have a relatively stronger impact on price developments in Greece than in the EU as a whole. Core inflation, as measured by the annual rate of change in the national CPI excluding fuel, fresh fruit and vegetables, has fallen steadily since August 1998 and has remained around 2% since October 1999 (averaging 1.8% over the period from December 1999 to March 2000). Most available forecasts suggest inflation rates of between 2.2% and 2.4% in 2000 and of between 2.3% and 2.7% in 2001 (see Table 3b). Future price developments in Greece are subject to a number of upward risks, which need to be considered when referring to these forecasts.

First, the direct inflation-reducing impact of the recent cuts in indirect taxes will gradually disappear by the end of 2000. This will exert upward pressure on average annual inflation in 2000 and 2001. With regard to the gentleman's agreements between the Government and commercial and industrial enterprises as well as service providers, it remains uncertain as to whether their non-renewal would result in upward price pressure. The extent to which these two measures have helped to lower inflation expectations, thus also having some persistent rather than only a temporary effect on the rate of inflation, is difficult to assess at this juncture. Second, the adoption of the euro would mean that Greek interest rates would be aligned with those in the euro area. However, in the three months ending in March 2000 the average spread of the three-month interest rate was 540 basis points above the euro area average, and long-term interest rates were 80 basis points above those prevailing in the five euro area countries with the lowest bond yields. The easing of liquidity constraints and the resulting monetary stimulus from interest rate convergence with the euro area are likely to be reduced by the contractionary impact of lower interest rates on disposable income, since interest income constitutes an important part of total disposable income in Greece and since households are net creditors. However, the net impact of interest rate convergence is likely to exert upward pressure on prices in Greece. A third upside risk to future price developments comes from the convergence of the drachma towards its conversion rate, a process that has already started. The possible magnitude of this effect has been limited by the revaluation of the drachma's central rate to GRD 340.75 against the euro as of 17 January 2000. As a result, in March 2000 the drachma was quoted only 2.0% above its ERM II central rate. The inflationary impact of the depreciation of the drachma towards its conversion rate on import prices will disappear by the end of 2001.



Looking further ahead, continued marked efforts by the Government to create an environment conducive to the maintenance of price stability are of particular importance for Greece. Containing pressure on compensation per employee and on prices – without further reliance on one-off special measures – crucially hinges upon the credibility of the authorities' overall strategy. This relates first to the conduct of fiscal policies in 2000 and 2001 (see below) and second to national policies aimed at enhancing competition in product and labour markets. Such policies have the potential to produce far-reaching benefits in terms of continued progress towards price stability, growth and employment. Some progress has been made with regard to privatisation and liberalisation. The banking sector, for example, benefited from efficiency gains as a result of increased competition. In the telecommunications sector the dominant national provider rebalanced its pricing policy in view of the forthcoming liberalisation of the market. This resulted in reduced average costs of telephone services to consumers. However, the non-transposition rate of Single Market Directives into national law remains high in relation to other Member States and further progress with regard to the liberalisation of a number of network industries, in particular electricity, gas and transport, appears highly desirable. In this context, it is noted that Greece is committed to liberalising the fixed telephony market in January 2001 and the electricity market by February 2001. Moreover, while some progress has recently been made with regard to privatisation, the relevance of the public sector in the Greek economy is still high compared with other EU Member States. The labour market still suffers from a number of structural rigidities, such as inflexible working hours, an ineffective job-matching mechanism, insufficient wage differentiation and high effective entry wages for first-time job-seekers. New legislation has been introduced and measures are being implemented which target a number of key labour market problems. However, the results so far remain limited owing to problems of implementation and the fact that

a number of measures were only launched very recently. The labour market performance is still somewhat disappointing, despite strong GDP growth in recent years. The total unemployment rate in Greece (10.4% in 1999), which was still above the EU average and has only recently started a slow decline, partly reflects the rapid entry of women and immigrants into the labour force. Employment grew by 3.4% in 1998 and 1.2% in 1999, but the employment rate only increased from 53.4% in 1997 to 54.4% in 1999, still significantly below the EU average of 63.4%. However, the full-time equivalent employment rate in Greece is roughly equal to the EU average, which reflects more widespread part-time employment in the EU as a whole. Further determined efforts are crucial in order to overcome the substantial remaining structural rigidities in the labour market, thereby reducing the risks of future inflationary pressure. Moreover, moderate wage increases in 2000 for both the private sector and the public sector are essential in order to counter inflationary pressure.

## 1.2 Fiscal developments

In the reference year 1999 the general government deficit ratio was 1.6%, well below the 3% reference value, and the debt ratio was 104.4%, i.e. far above the 60% reference value. Compared with the previous year, the deficit ratio was reduced by 1.5 percentage points and the debt ratio by 1 percentage point. In November 1999 the EU Council abrogated its decision that an excessive deficit existed in Greece. In 2000 the deficit ratio is forecast to decrease to 1.3%, while the debt ratio is projected to decline to 103.7%. In 1999 the deficit ratio was below the ratio of public investment expenditure to GDP, as was also the case in 1998 (see Table 4).

Looking back over the years from 1990 to 1999, the Greek *debt-to-GDP ratio* increased by 24.7 percentage points. However, this overall increase masks different developments within that period. Initially, the ratio rose continuously, from 79.7% in 1990 to a first peak of 110.2% in 1993, with a further

increase to 111.3% in 1996. The debt ratio subsequently declined slowly by a total of 6.9 percentage points over the period from 1997 to 1999, reaching 104.4% in 1999 (see Chart 2a and Table 5).

As is shown in greater detail in Chart 2b, since the early 1990s the most significant factor underlying the increase in the debt ratio came from what are known as *deficit-debt adjustments* (see Table 6). They cover all factors having an impact on the debt ratio except government deficits and the effect of changes in GDP. In the case of Greece, the deficit-debt adjustments with an upward effect on government debt came mainly from the revaluation of government debt denominated in foreign currency following the devaluation of the Greek drachma and from transactions in financial assets. Revaluation effects on foreign currency denominated debt had an upward effect on the debt ratio throughout the 1990s. Moreover, in the early part of the period, in order to comply with Articles 101 and 102 of the Treaty, the Greek Government assumed debt obligations of the State to the Bank of Greece, including accumulated foreign exchange valuation losses, previously recorded under miscellaneous accounts. At the same time, the State issued government securities in order to build up a reserve for liquidity purposes, in the context of the abolition of its overdraft facility with the central bank, as of 1 January 1994. From the mid-1990s equity injections in a number of public enterprises and banks and the assumption by the general government of public enterprise debt also had considerable debt-increasing effects. The total cumulative deficit-debt adjustments amounted to GRD 5.4 trillion over the years from 1995 to 1999, or 14% of GDP in 1999. The high significance of such deficit-debt adjustments explains why Greece's public debt has fallen only slowly in recent years, despite continued fiscal consolidation, and they would have been even higher had there not been high privatisation receipts in the order of 3% of GDP per year in 1998 and 1999. Lower nominal GDP growth, when compared with the interest rate to be paid

on outstanding debt (the growth/interest differential), also had an unfavourable impact on the debt ratio in the period from 1993 to 1996 (almost 3% of GDP) and again in 1999 (see Chart 2b). However, since 1994 the primary balance has recorded a surplus which, since 1997, has outweighed debt-increasing effects. This experience underlines the importance of strong, consistent and durable fiscal consolidation for countries with very high ratios of debt to GDP.

Looking at the structural features, the share of debt with initial short-term maturity declined from the high levels of the early 1990s to a share of 9.4% in 1998 and 3.9% in 1999, which is a development in the right direction. Thus fiscal balances are not as sensitive to changes in short-term interest rates as they were in the past. No information is available on the residual maturity of the debt. However, in 1998 the proportion of debt denominated in foreign currency was still relatively high at 31.8%; in 1999 it increased to 33%, of which slightly more than half was denominated in non-euro area currencies (see Table 5). Hence fiscal balances are still sensitive to changes in the exchange rate.

During the 1990s a pattern of first worsening and then improving *deficit-to-GDP ratios* can be observed. Starting from a ratio of 15.9% of GDP in 1990, the deficit declined to 11.4% in 1991 (see Chart 3a and Table 7). However, a renewed deterioration was experienced during the recession of 1992-93, and at the end of that period the deficit increased to 13.6%, partly reversing the improvement achieved in 1991. The deficit subsequently declined steadily, with only a temporary halt in 1995, falling to 3.1% in 1998 and declining further to 1.6% in 1999, i.e. below the Treaty reference value. Since the last peak in 1993, the deficit has declined by 12 percentage points. As is shown in greater detail in Chart 3b, which focuses on the factors underlying the *changes* in deficits, cyclical factors did not play a major role throughout the period from 1994 to 1996, and had thereafter only a small positive effect on budgetary developments.

By contrast, the remaining “non-cyclical” improvements, which are normally associated with more lasting or “structural” moves towards more balanced fiscal positions, played a more substantial role. Available evidence suggests that one-off measures played a noticeable role in reducing the deficit ratio in 1996 (amounting to 0.3% of GDP), with a more limited influence in the following years (of around 0.1% of GDP in 1998 and 1999).

Moving on to examine trends in other fiscal indicators, it can be seen from Chart 4 that the general government *total expenditure ratio*, after declining in 1991, showed an upward movement until 1993. This mainly reflected a steep increase in interest payments as a result of a surge in debt (see Table 7). Thereafter, a downward trend in the total expenditure ratio has been discernible, driven by a sharp reduction in interest payments. Since 1994 the ratio of primary expenditure to GDP has increased substantially. Given this pattern, a balanced continuation of the downward trend of total expenditure to GDP would appear to require adjustments in expenditure items other than interest payments. *Government current receipts* tended to increase in relation to GDP continuously over the period considered, and in 1999 were 4.7 percentage points higher than in 1994. The revenue performance contributed to fiscal consolidation in 1998 and 1999 to a higher degree than initially planned in the Greek Convergence Programme for the period from 1998 to 2000, exceeding the revenue target in both years. In this respect, the positive effect on budget balances of a switch-over in government financial support to public enterprises from *investment grants* to *equity injections* and the partial use of “off-budget facilities” via the public holding DEKA (established in 1997 to manage the privatisation process) is worth noting.

The primary objective of the 1999 Updated Greek Convergence Programme covering the period until 2002 is the fulfilment of the conditions allowing the adoption of the euro from 1 January 2001. Building on favourable

results from previous years, more ambitious targets have been set than in the previous Convergence Programme. The Updated Greek Convergence Programme targets a surplus of 0.2% of GDP in 2002, to be achieved through the containment of primary current expenditure (i.e. expenditure other than interest payments and capital expenditure), while allowing for a rising level of government investment. However, the primary surplus in 2002 will remain at the 1999 level, despite the anticipation of a favourable cyclical environment, thus showing no further enhancement of fiscal consolidation efforts.

In 2000 the deficit is expected to be 1.2% of GDP, 0.5 percentage point below the target set in the previous Convergence Programme. Furthermore, the budget for 2000 includes a tax cut and benefit package (mainly family allowance, tax cuts for low income earners and higher unemployment benefits), the expansionary effects of which are expected to be offset by the higher tax rate on domestic stock exchange market transactions and to be self-financing in the future. The fiscal stance for 2000 is expected to be broadly neutral, yet some expansionary effects cannot be fully ruled out. Hence the Greek Government should make substantial efforts in order to improve upon the targets of the Convergence Programme. If fiscal balances turn out as projected in the Updated Greek Convergence Programme for 1999-2002, Greece would comply with the medium-term objective of the Stability and Growth Pact of having a budgetary position that is close to balance or in surplus, according to the assessment undertaken by the European Commission, and as confirmed by the ECOFIN Council.

Greece’s debt ratio is very high and it is currently assumed in the Updated Greek Convergence Programme that it will decline to 103.3% of GDP in 2000 and to 98% of GDP in 2002. The size of the deficit-debt adjustment expected for 2000 (4.7% of GDP) suggests that there must be an ongoing concern that significant deficit-debt adjustments are continuing to affect debt

developments adversely, with the result that Greece's public debt is falling only slowly, despite high primary surpluses and privatisation receipts. With regard to the future time horizon for reducing the Greek debt ratio to the 60% reference value, two different kinds of calculations are presented. This is in line with the 1998 Convergence Report. Based on the assumption that fiscal balances and debt ratios as projected for 2000 by the European Commission are achieved, the first exercise, as detailed in Table 8, shows the fiscal balances which would be consistent with convergence of the debt ratio to 60% over different time horizons. As an illustration, reducing the debt to 60% at the end of 2009 would imply achieving an overall surplus of 0.8% of GDP per year from 2001 onwards (see Table 8a) or an overall primary surplus of 5.6% of GDP from 2001 onwards (see Table 8b). This compares with an overall deficit ratio of 1.3% of GDP and a primary surplus of 5.8% of GDP projected for 2000, i.e. the difference is 2.1 percentage points and -0.2 percentage point respectively. However, these and the following computations crucially depend on the assumption of zero deficit-debt adjustments. If deficit-debt adjustments continue to increase the debt ratio by similar amounts as in recent years, the primary surplus and the overall surplus will have to be much more ambitious in order to reduce the public debt to 60% of GDP within ten years.

As is shown in Chart 5, the alternative scenario, according to which the overall balance for the year 2000 would be maintained, indicates a slower path of debt reduction. For example, maintaining the overall budget position for 2000 of -1.3% of GDP over subsequent years would reduce the debt ratio to 90% of GDP in 2004 and the 60% reference value would be reached in 2017. Maintaining the 2000 primary surplus of 5.8% would put the debt ratio on a rapidly declining path to below 60% of GDP in 2009. The budget would quickly move into surplus in this scenario as a result of declining interest payments. A constant balanced budget from 2000 onwards would bring the debt

ratio down to 70% in 2008 and to the 60% reference value in 2011.

Such calculations are also based on the normative assumption of a constant nominal rate of interest of 6% (an average real cost of public debt outstanding of 4% and 2% inflation) and the assumption of steady growth of real GDP of 3.1% and of zero deficit-debt adjustments. Such calculations are purely mechanical and can by no means be regarded as forecasts. Indeed, different results would be obtained if underlying assumptions for real GDP growth rates, interest rates, inflation rates and deficit-debt adjustments, as well as assumptions for overall or primary surpluses, were to be amended. Notwithstanding these qualifications, the calculations provide an illustration of why consolidation efforts need to be all the more resolute, the higher the initial stock of debt, in order to reduce debt ratios within a limited period of time to 60% of GDP.

Stressing the need for substantial improvement in the deficit ratio and for sustained consolidation over an extended period of time is indeed critical in the case of Greece. Additional and lasting retrenchment efforts on the expenditure side are needed to ensure that the debt ratio will diminish sufficiently and approach the reference value at a satisfactory pace. The current high level of debt would otherwise impose a continuous burden on fiscal policy and the economy as a whole. Risks stemming from a less favourable economic environment appear to be limited as the cyclical responsiveness of the budget, through the operation of the automatic stabilisers, is estimated to be relatively small in Greece. However, vulnerability could arise from continued high debt if slippages in the country's fiscal performance were to raise the perceived credit risk of public debt. Further improvements in the transparency and quality of statistical data would strengthen the monitoring of fiscal developments. Notwithstanding satisfactory reforms in budgetary procedures and transparency, there would still appear to be room for improvement. Deficit-debt

adjustments (according to the Updated Greek Convergence Programme) are projected to increase over the coming years owing to, inter alia, revaluation effects, equity injections to public enterprises and the partial switch-over of government entities' investments (mainly insurance funds) from government bonds to equities. This must be a cause for concern. An examination of medium-term and long-term risks indicates that the pension system is characterised by the existence of a large number of supplementary and separate funds, which are still immature and therefore record large surpluses for the time being. Social security funds have recently been allowed to invest their surpluses partly in shares. The change in investment policy from government securities to equities adds to the gross debt ratio, but at the same time it increases the revenue and asset value of the public pension system. As highlighted in Table 9, from around 2010 onwards the ageing of the population is expected to accelerate. Public pension expenditure is projected to increase in relation to GDP, particularly if policies regarding benefits continue unchanged. Improvements in the general government fiscal balances and reforms of the pension system are both essential in order to tackle the future burden of population ageing. Limiting the public sector wage bill, improving tax administration and accelerating the privatisation programme in the context of a reform of the wider public sector could also make a significant contribution to both fiscal consolidation and disinflation in the short term, while promoting economic growth in the long term.

### 1.3 Exchange rate developments

The Greek drachma joined the exchange rate mechanism of the EMS on 16 March 1998, i.e. before the beginning of the two-year period covered by this Report (1 April 1998 to 31 March 2000). Its bilateral central parity was GRD 357 against the ECU and the fluctuation bands were  $\pm 15\%$ . At the start of Stage Three of EMU on 1 January 1999 the

drachma joined ERM II, which replaced the exchange rate mechanism of the EMS and is based on central rates against the euro. The ERM II central rate was determined by a method approved in a common procedure.<sup>1</sup> The calculation, carried out on 31 December 1998 after the conversion rates of the euro had been determined, resulted in a central rate for the Greek drachma of GRD 353.109 against the euro, i.e. it was for technical reasons slightly different from the central rate against the ECU. Whereas the fluctuation bands of  $\pm 15\%$  were maintained, the deviations from the central rates were sizeable and the Greek drachma normally traded significantly above its central rates. As of 17 January 2000 the central rate of the drachma was revalued at GRD 340.75 against the euro. The decision to revalue the central rate was taken at the request of the Greek authorities by mutual agreement of the Ministers of Economics and Finance of the euro area Member States, the Ministers of Economics and Finance and central bank governors of the non-euro area Member States participating in ERM II and the ECB. The decision was taken in order to support the aim of the Greek authorities to keep the Greek economy on a path of sustainable growth with price stability. It needs to be accompanied by continuing sound budgetary policies and the continuous pursuit of structural reforms aimed at strengthening the convergence process, especially the fight against inflation for which wage developments are also essential.

Focusing on the two-year reference period, the drachma, benefiting from sizeable interest rate differentials vis-à-vis most partner currencies, consistently traded above its central rates (see Chart 6). The maximum and minimum upward deviations from the central rates against the euro were relatively high at 9.0% and 1.9% respectively, but

<sup>1</sup> The common procedure involved the Ministers of Economics and Finance of the euro area Member States, the ECB, the Ministers of Economics and Finance and central bank governors of Denmark and Greece as the two Member States participating in ERM II, the European Commission and the Monetary Committee.

occurred only above the central parity (see Table 10a). Foreign exchange interventions were conducted at times, aimed at limiting exchange rate variability. Exchange rate volatility, measured by annualised standard deviations of daily percentage changes, ranged between 1.1% and 9.5% over the reporting period (see Table 10b).

The pattern of drachma exchange rate developments over the reporting period can be characterised by two phases with quite distinct trends (see Chart 6c). The first phase ran from the beginning of the reporting period in April 1998 to late January/early February 1999 and was characterised by a tendency towards the appreciation of the drachma against the ECU/euro. The second phase, covering the subsequent period from March 1999 to March 2000, was characterised by a tendency towards the depreciation of the drachma, which reversed, however, only around half of the earlier appreciation.

During the first phase the drachma initially appreciated relatively rapidly against the ECU, being around 6% stronger in early August 1998 than at the beginning of April 1998. This appreciation occurred in the context of a tightening of monetary policy, reflecting the authorities' intention to reduce inflation in line with the requirements to join EMU. During the latter part of August 1998 the drachma fell by almost 4%. However, this fall was temporary, as inflation continued to decline and monetary policy remained tight. Three-month interest rate differentials vis-à-vis euro area Member States widened to a peak of 960 basis points on average in the three months ending in September 1998 (see Table 10b), when short-term interest rates in Greece reached almost 14%. In the subsequent months interest rate differentials declined somewhat, but in January 1999, at 850 basis points, they were only marginally below the differentials at the beginning of the reporting period. In late January/early February 1999 the drachma reached its strongest level over the reporting period, being quoted at around GRD 321 against the euro (see Chart 6c).

During the second phase, from late January/early February 1999 to the end of the reporting period, the drachma followed a gradually depreciating trend against the euro. The main factor underlying this gradual depreciation was narrowing short-term interest rate differentials vis-à-vis the euro area. Spreads in short-term interest rates narrowed from around 760 basis points on average in the three months ending in March 1999 to 540 basis points on average in the three months ending in March 2000 (see Table 10b). The drachma was quoted at GRD 334.70 against the euro at the end of the reporting period on 31 March 2000.

In a longer-term context, real effective exchange rates of the Greek drachma against the currencies of the other EU Member States are typically above historical averages of the past ten or twenty-five years (see Table 11). This also applies to the usual measures of the real effective exchange rate calculated using different deflators. It should be borne in mind, however, that Greece is currently experiencing a "catching-up" process vis-à-vis the rest of the EU. This process normally entails strong output and productivity growth associated with an appreciation of the real exchange rate. In the same vein, the sizeable current account deficits recorded by Greece during the 1990s and the worsening net external liability position since 1996 can be partly interpreted as a result of the country's capital inflows to finance investments (see Table 12). According to estimated data for 1999, Greece has a ratio of foreign trade to GDP of 20.7% for exports and 28.2% for imports. Its intra-EU trade-to-GDP ratio is the lowest in the EU. In 1998 exports to other EU Member States made up 52.3% of total Greek exports and 65.9% of Greek imports originated from other EU countries.

#### **1.4 Long-term interest rate developments**

Over the reference period from April 1999 to March 2000 long-term interest rates in

Greece were 6.4% on average, and thus stood 0.8 percentage point below the reference value for the interest rate criterion of 7.2%, defined as the average long-term interest rate of the three best-performing Member States in terms of price stability plus 2 percentage points. In 1999 as a whole, long-term interest rates in Greece were also somewhat below the reference value, whereas in 1998 long-term interest rates were almost 2% above the reference value (see Table 13).

During the 1990s long-term interest rates followed a broadly declining trend from the very high levels observed in the early 1990s (see Chart 7a). Since 1993 Greek long-term interest rates have tended to converge towards the rates of those EU countries with the lowest bond yields, apart from in the second half of 1997 and again in late 1998, when international financial turbulence interrupted the general trend of convergence (see Chart 7b). At present, the difference between Greek long-term bond yields and the corresponding rates of the EU countries with the lowest bond yields is around 0.8%. The main factors underlying the convergence trend were the significant decline in the inflation differential, which was to a large extent due to Greek monetary policy having a favourable influence on Greek inflation and inflation expectations, as well as to the recent improvement in the country's fiscal position. The substantial decline in long-term interest rates has stimulated the Greek economy and this effect can be expected to continue to exert an expansionary influence on the economy if the convergence of Greek interest rates towards euro area levels continues.

### **1.5 Concluding summary**

Over the reference period Greece achieved a 12-month average rate of HICP inflation of 2.0%, which is below the reference value stipulated by the Treaty. In 1999 as a whole the inflation rate was at the reference value and, since January 2000, Greece has achieved a rate of HICP inflation which is below the reference value. Seen over the period since

1998 HICP inflation in Greece has been reduced significantly and is now closer to a level which can generally be considered to be consistent with price stability. Looking back, a clear trend towards lower inflation is discernible in Greece, with the CPI rate falling from 20.4% in 1990 to 2.6% in 1999 (HICP rate in 1999: 2.1%). At the same time, the increase in compensation per employee decelerated from 12.2% in 1995 to 4.8% in 1999. Due attention needs to be paid to the fact that the recent reduction in inflation rates is partly attributable to temporary factors and that oil price changes have a relatively stronger impact on price developments in Greece than in the EU as a whole.

Looking ahead, recent forecasts suggest inflation rates of between 2.2% and 2.4% in 2000 and of between 2.3% and 2.7% in 2001. Future price developments in Greece are subject to a number of upward risks. In 2000 and 2001 inflation rates will be influenced upwards as the recent cuts in indirect taxes will cease to have an impact. It remains uncertain as to whether the non-renewal of the gentleman's agreements with commercial and industrial enterprises, as well as service providers, will result in upward price pressure. Moreover, an eventual alignment of Greek interest rates with those in the euro area and the remaining depreciation of the drachma towards its conversion rate will exert upward pressure on prices. Therefore, the sustainability of the positive development with regard to the inflation performance is subject to upside risks and continued efforts to support further sustained price stability are of particular importance for Greece. Containing pressure on compensation and on prices – without further reliance on one-off special measures – crucially hinges upon the credibility of the authorities' overall strategy. In particular, this relates to the conduct of fiscal policies, as well as to structural policies aimed at improving the functioning of product and labour markets.

Looking at fiscal policy, the 1999 general government deficit ratio was 1.6%, falling well

below the 3% reference value, and the debt ratio was 104.4%, i.e. far above the 60% reference value. Compared with 1998 the deficit ratio has been reduced by 1.5 percentage points of GDP and the debt ratio by 1 percentage point of GDP. Since 1998 the deficit ratio has not exceeded the ratio of public investment to GDP. In 2000 the deficit ratio is forecast to decrease to 1.3% of GDP, while the debt ratio is projected to decline to 103.7%. However, significant deficit-debt adjustments continue to have an adverse effect on debt developments, with the result that Greece's public debt is falling only slowly, despite high primary surpluses and privatisation receipts. Notwithstanding the efforts and the substantial progress made towards improving the current fiscal situation, there must be an ongoing concern as to whether the ratio of government debt to GDP will be "sufficiently diminishing and approaching the reference value at a satisfactory pace" and whether sustainability of the fiscal position has been achieved. Substantial primary surpluses and persistent, sizeable overall fiscal surpluses outperforming the targets of the Updated Greek Convergence Programme, together with greatly reduced deficit-debt adjustments, will be needed to reduce the debt ratio to 60% within an appropriate period of time. Tight fiscal policy will also be needed in order to contain inflationary pressures stemming from the above-mentioned relaxation of monetary conditions in the run-up to full membership of EMU. The Stability and Growth Pact also requires, as a medium-term objective, a budgetary position that is close to balance or in surplus.

In the context of population ageing, increased efforts to reform the social security system are needed, while further progress in privatisation would reduce liabilities from the

wider public sector. Furthermore, a speedier transposition of Single Market legislation into national law, further progress with regard to the liberalisation of a number of network industries and determined efforts to overcome structural rigidities in the labour market are warranted.

The level of long-term interest rates reached 6.4% on average during the reference period, which is below the reference value. In March 2000 the difference between Greek long-term interest rates and the euro area average stood at around 0.8 percentage point; the difference between Greek short-term interest rates and the euro area average in the three months ending in March 2000 was 540 basis points.

The Greek drachma has been participating in the exchange rate mechanism of the EMS since 16 March 1998 and it joined ERM II at the start of Stage Three of EMU. During the two-year reference period the drachma normally traded significantly above its central rates. Exchange rate volatility declined significantly during the reference period and the significant short-term interest rate differentials also displayed a gradual decrease from September 1998 onwards. However, relatively high interest rate differentials played an important role during the reference period. Foreign exchange interventions were conducted at times, aimed at limiting exchange rate variability. After a gradual depreciation during most of 1999 and a revaluation of the central rate by 3.5% in January 2000, the drachma was quoted at GRD 333.89 against the euro in March 2000, 2.0% above its new central rate. Throughout the reference period covered by this Report, Greece recorded current account deficits which can be partly interpreted as a result of the country's need to finance investments.



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**Table I****Greece: HICP inflation***(annual percentage changes)*

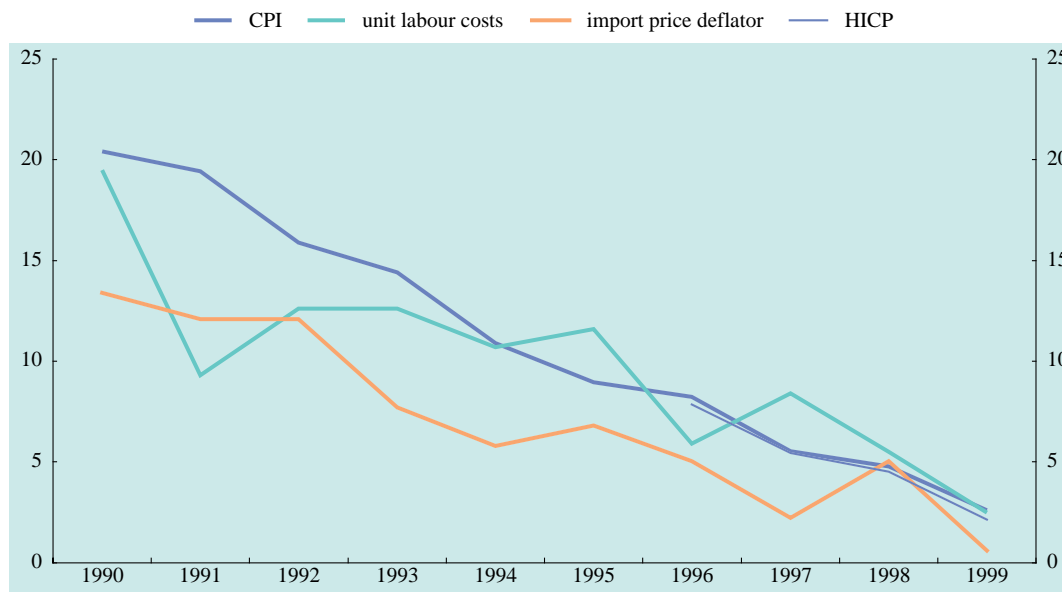
	1996	1997	1998	1999	2000 Jan.	2000 Feb.	2000 Mar.	Apr. 1999 to Mar. 2000
HICP inflation <sup>1)</sup>	7.9	5.4	4.5	2.1	2.4	2.6	2.8	2.0
Reference value <sup>2)</sup>	2.5	2.7	2.2	2.1	.	.	.	2.4
Euro area average <sup>3)</sup>	2.2	1.6	1.1	1.1	1.9	2.0	2.1	1.4

Source: Eurostat.

1) Please note that as from January 2000 the coverage of the HICP has been extended and further harmonised. See the statistical annex for details.

2) Calculation for the April 1999 to March 2000 period is based on the unweighted arithmetic average of annual percentage changes of Sweden, Austria and France, plus 1.5 percentage points.

3) The euro area average is included for information only.

**Chart I****Greece: Price developments***(annual percentage changes)*

Sources: National data and Eurostat.

**Table 2****Greece: Measures of inflation and related indicators***(annual percentage changes, unless otherwise stated)*

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
<b>Measures of inflation</b>										
Harmonised index of consumer prices (HICP)	-	-	-	-	-	-	7.9	5.4	4.5	2.1
Consumer price index (CPI)	20.4	19.4	15.9	14.4	10.9	8.9	8.2	5.5	4.8	2.6
CPI excluding changes in net indirect taxes <sup>1)</sup>	18.5	17.9	14.9	15.6	10.8	8.8	7.5	5.1	4.4	2.3
Private consumption deflator <sup>2)</sup>	19.9	19.7	15.6	14.2	11.0	8.9	8.2	5.5	4.7	2.5
GDP deflator <sup>2)</sup>	20.6	19.8	14.8	14.5	11.2	9.8	7.4	6.7	4.9	2.9
Producer prices <sup>3)</sup>	13.9	12.4	12.0	9.3	8.5	9.5	6.6	4.1	3.8	3.2
<b>Related indicators</b>										
Real GDP growth <sup>2)</sup>	0.0	3.1	0.7	-1.6	2.0	2.1	2.4	3.4	3.7	3.5
Output gap (percentage points)	0.5	2.2	1.3	-1.9	-1.8	-1.9	-1.9	-1.1	-0.3	0.1
Unemployment rate (%) <sup>4)</sup>	6.4	7.0	7.9	8.6	8.9	9.2	9.6	9.8	10.7	10.4
Unit labour costs, whole economy <sup>2)</sup>	19.5	9.3	12.6	12.6	10.7	11.6	5.9	8.4	5.5	2.5
Compensation per employee, whole economy <sup>2)</sup>	17.9	15.3	11.8	9.8	10.8	12.2	8.8	12.4	5.8	4.8
Labour productivity, whole economy <sup>2)</sup>	-1.3	5.5	-0.7	-2.4	0.1	1.2	2.8	3.7	0.3	2.2
Import price deflator <sup>2)</sup>	13.4	12.1	12.1	7.7	5.8	6.8	5.0	2.2	5.0	0.6
Exchange rate appreciation <sup>5)</sup>	-8.6	-11.4	-8.0	-8.6	-6.9	-2.9	-1.3	-1.9	-5.2	-1.3
Broad money (M4N)	22.9	21.9	24.2	17.2	14.2	15.3	12.9	11.8	10.2	7.6
Stock prices <sup>6)</sup>	102.9	-13.1	-17.0	42.6	-9.4	5.2	2.1	58.5	85.0	102.2

Sources: National data except the HICP, producer prices, real GDP growth and the unemployment rate (Eurostat), the output gap (European Commission) and the exchange rate (BIS).

1) National estimates.

2) Prior to 1996 national definition, ESA 95 data thereafter.

3) Manufacturing, domestic sales.

4) Eurostat definition. Data for 1999 are estimated (European Commission's spring 2000 forecasts).

5) Nominal effective exchange rate against 26 industrialised countries. Note: a positive (negative) sign indicates an appreciation (depreciation).

6) End of period.

**Table 3****Greece: Recent inflation trends and forecasts***(annual percentage changes, unless otherwise stated)***(a) Recent trends in the Harmonised Index of Consumer Prices**

	1999 Nov.	1999 Dec.	2000 Jan.	2000 Feb.	2000 Mar.
<b>Harmonised Index of Consumer Prices (HICP)</b>					
Annual percentage change	2.0	2.3	2.4	2.6	2.8
Change in the average of the latest 3 months from the previous 3 months, annualised rate, seasonally adjusted	3.1	3.5	3.5	3.5	3.3
Change in the average of the latest 6 months from the previous 6 months, annualised rate, seasonally adjusted	1.9	2.2	2.4	2.7	3.0

Sources: Eurostat and ECB calculations.

**(b) Inflation forecasts**

	2000	2001
European Commission (spring 2000), HICP	2.3	2.3
OECD (December 1999), private consumption deflator	2.2	2.5
IMF (May 2000), CPI	2.4	2.7

Sources: European Commission (spring 2000 forecasts), the OECD and the IMF.

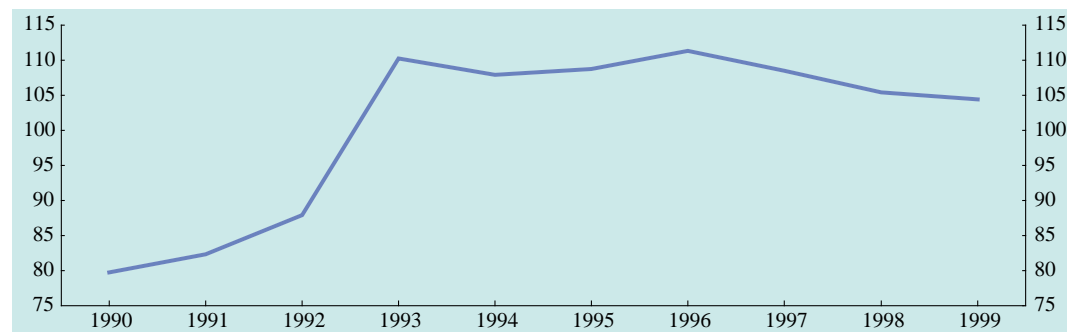
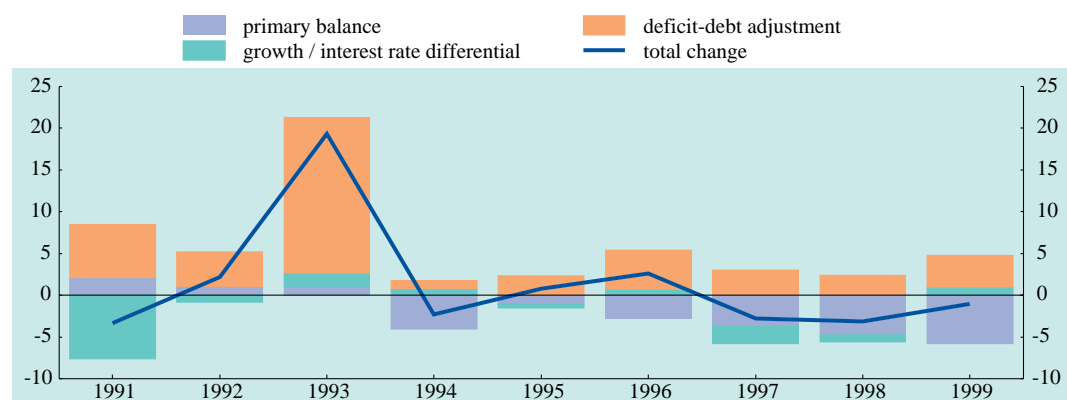
**Table 4****Greece: General government financial position***(as a percentage of GDP)*

	1998	1999	2000 <sup>1)</sup>
General government surplus (+) / deficit (-)	-3.1	-1.6	-1.3
Reference value	-3	-3	-3
Surplus (+) / deficit (-), net of public investment expenditure <sup>2)</sup>	0.6	2.7	2.9
General government gross debt	105.4	104.4	103.7
Reference value	60	60	60

Sources: European Commission (spring 2000 forecasts) and ECB calculations.

1) European Commission forecast.

2) A negative sign indicates that the government deficit is higher than investment expenditure.

**Chart 2****Greece: General government gross debt***(as a percentage of GDP)***(a) Levels****(b) Annual changes and underlying factors**

Sources: European Commission (spring 2000 forecasts) and ECB calculations.

Note: In Chart 2 (b) negative values indicate a contribution of the respective factor to a decrease in the debt ratio, while positive values indicate a contribution to its increase.

**Table 5****Greece: General government gross debt – structural features**

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
<b>Total debt</b> (as a percentage of GDP)	79.7	82.3	87.9	110.2	107.9	108.7	111.3	108.5	105.4	104.4
<b>Composition by currency</b> (% of total)										
In domestic currency	68.8	69.4	70.5	61.9	60.4	63.8	69.6	68.6	68.2	66.9
In foreign currencies	31.2	30.6	29.5	38.1	39.6	36.2	30.4	31.3	31.8	33.0
Participating foreign currencies	15.1	15.2	11.8	15.1	14.5	13.1	10.1	12.7	14.0	15.8
Non participating foreign currencies	16.1	15.4	17.7	23.0	25.1	23.1	20.3	18.6	17.8	17.2
<b>Domestic ownership</b> (% of total)	74.9	75.2	75.5	76.1	74.5	76.6	77.9	76.3	70.5	63.6
<b>Average maturity</b>	.	.	.	.	.	.	.	.	.	.
<b>Composition by maturity</b> <sup>1)</sup> (% of total)										
Short-term (< 1 year)	52.2	41.1	37.9	25.5	26.6	24.2	21.7	13.5	9.4	3.9
Medium and long-term (> 1 year)	47.8	58.9	62.1	74.5	73.4	75.8	78.3	86.5	90.6	96.1

Sources: ESCB, 1999, except for total debt (European Commission (spring 2000 forecasts)). Year-end data.

Note: Differences in the totals are due to rounding.

1) Initial maturity.

**Table 6****Greece: General Government deficit-debt adjustment**

(as a percentage of GDP)

	1995	1996	1997	1998	1999	2000
Change in general government debt	12.5	12.5	7.6	5.5	5.4	5.8
General government surplus (+) / deficit (-)	-10.2	-7.8	-4.6	-3.1	-1.6	-1.3
<b>Deficit-debt adjustment</b>	<b>2.3</b>	<b>4.7</b>	<b>3.0</b>	<b>2.4</b>	<b>3.8</b>	<b>4.5</b>
<b>Acquisitions (+) / sales (-) of financial assets</b>	<b>2.3</b>	<b>4.2</b>	<b>0.6</b>	<b>0.5</b>	<b>0.2</b>	.
Currency and deposits	2.0	1.0	-1.6	-0.5	0.2	.
Loans and securities other than shares	0.0	0.0	0.0	0.0	0.0	.
Shares and other equity	1.0	1.1	0.9	0.0	-1.2	.
Privatisations	-0.1	-0.1	-0.6	-2.3	-3.3	.
Equity injections	0.6	0.8	1.0	1.5	1.2	.
Other	0.4	0.4	0.5	0.8	0.8	.
Other financial assets	-0.7	2.1	1.3	0.9	1.2	.
<b>Valuation changes of general government debt</b>	<b>0.8</b>	<b>0.0</b>	<b>2.1</b>	<b>1.4</b>	<b>3.0</b>	.
Foreign exchange holding gains (-) / losses (+)	0.4	-0.3	1.5	1.8	2.9	.
Other valuation effects <sup>1)</sup>	0.4	0.4	0.6	-0.4	0.1	.
<b>Other changes in general government debt</b> <sup>2)</sup>	<b>-0.8</b>	<b>0.4</b>	<b>0.3</b>	<b>0.6</b>	<b>0.7</b>	.

Sources: ESCB, except general government surplus/deficit and deficit-debt adjustment (European Commission (spring 2000 forecasts)).

1) Includes the difference between the nominal and market valuation of general government debt at issue.

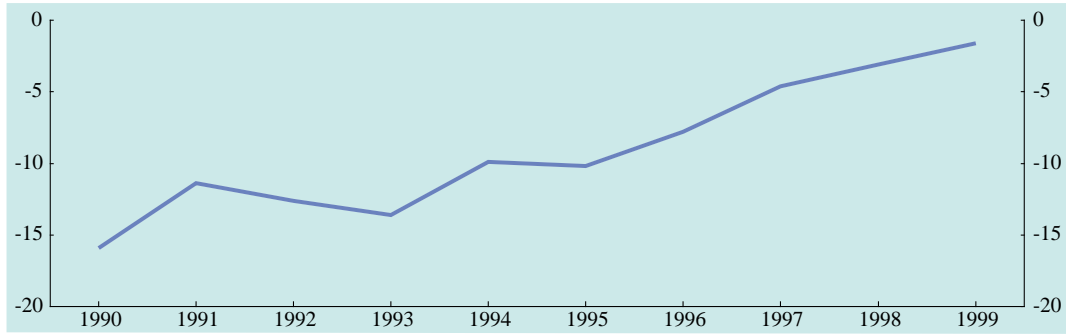
2) Transactions in other accounts payable (government liabilities) and sector reclassifications. This item may also cover certain cases of debt assumption.

### Chart 3

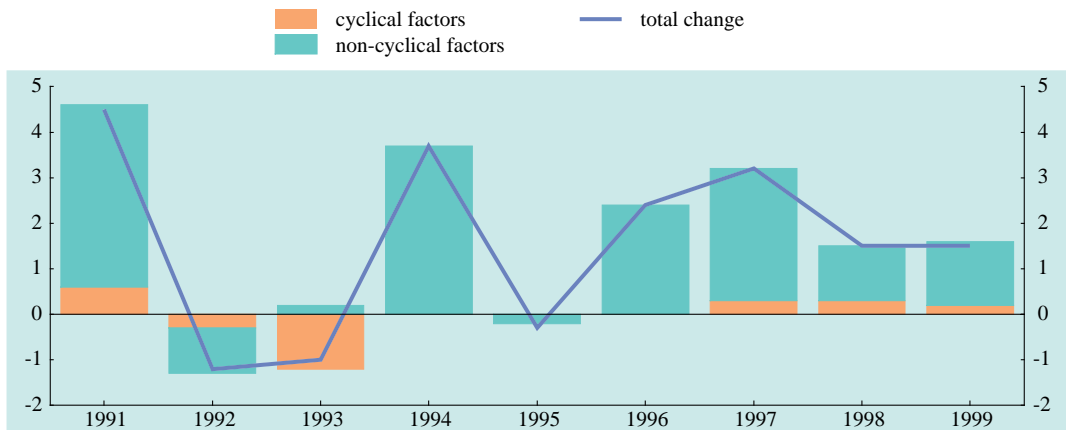
#### Greece: General government surplus (+) / deficit (-)

(as a percentage of GDP)

##### (a) Levels

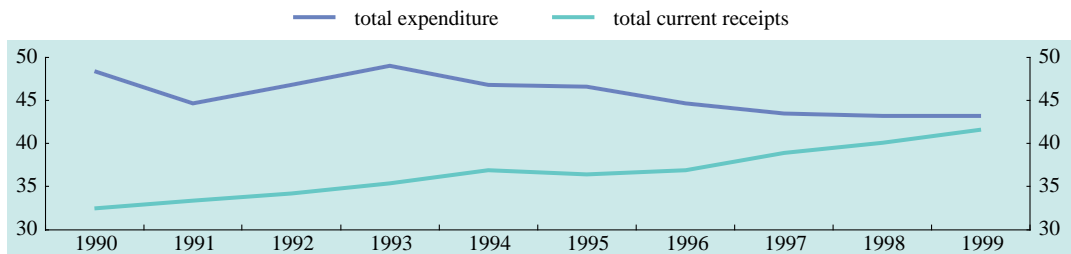


##### (b) Annual changes and underlying factors



Source: European Commission (spring 2000 forecasts).

Note: In Chart 3 (b) negative values indicate a contribution to an increase in deficits, while positive values indicate a contribution to their reduction.

**Chart 4****Greece: General government expenditure and receipts***(as a percentage of GDP)**Source: European Commission (spring 2000 forecasts).***Table 7****Greece: General government budgetary position***(as a percentage of GDP)*

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
<b>Total current receipts</b>	32.5	33.4	34.2	35.4	36.9	36.4	36.9	38.9	40.1	41.6
Direct taxes	5.4	5.5	5.4	5.7	6.8	7.4	7.1	7.9	9.6	9.2
Indirect taxes	13.9	14.6	15.3	14.7	14.3	13.5	14.0	14.2	14.3	14.6
Social security contributions	11.5	11.1	11.0	11.9	12.1	12.6	12.9	13.1	13.2	13.7
Other current receipts	1.7	2.2	2.5	3.1	3.8	2.9	2.9	3.6	2.9	4.1
<b>Total expenditure</b>	48.4	44.7	46.8	49.0	46.8	46.6	44.7	43.5	43.2	43.2
Current transfers	16.8	16.3	15.9	16.4	16.3	16.8	17.1	16.9	17.0	17.2
Interest payable	10.0	9.3	11.5	12.6	13.9	11.1	10.5	8.3	7.8	7.4
Public consumption	15.1	14.2	13.7	14.3	13.8	15.3	14.5	15.1	15.4	14.9
Net capital expenditure	6.5	4.9	5.6	5.6	2.8	3.3	2.5	3.3	3.1	3.6
<b>Surplus (+) or deficit (-)</b>	-15.9	-11.4	-12.6	-13.6	-9.9	-10.2	-7.8	-4.6	-3.1	-1.6
Primary balance	-5.9	-2.1	-1.1	-1.0	4.0	1.0	2.8	3.7	4.7	5.8
Surplus (+) or deficit (-), net of public investment expenditure <sup>1)</sup>	-13.1	-8.3	-9.1	-10.3	-6.8	-6.9	-4.5	-1.1	0.6	2.7

*Source: European Commission (spring 2000 forecasts). Differences in the totals are due to rounding.**1) A negative sign indicates that the government deficit is higher than investment expenditure.*

**Table 8****Greece: Debt convergence calculations****(a) On the basis of overall fiscal balances***(as a percentage of GDP)*

Total gross debt		Overall fiscal balance		Overall balance ratio consistent with reduction of debt level to 60% of GDP in <sup>1)</sup>		
1999	2000	1999	2000	2004	2009	2014
104.4	103.7	-1.6	-1.3	6.7	0.8	-0.8

Sources: European Commission (spring 2000 forecasts) and ECB calculations.

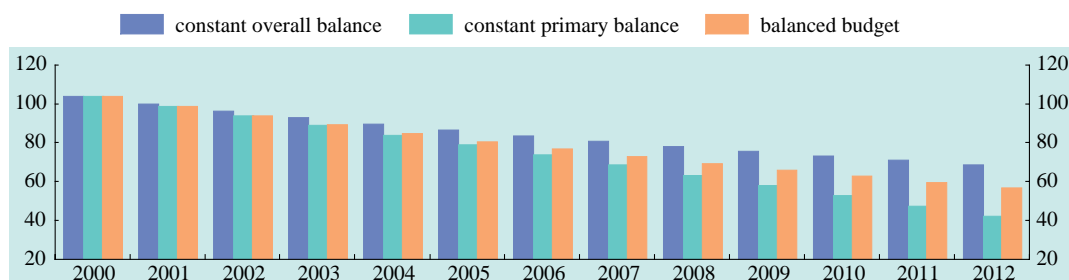
1) Calculations indicate that the debt ratio would fall to 60% in 2004, 2009 and 2014 respectively, if the overall fiscal balance for 2000 is as forecast and the overall fiscal balances were maintained at 6.7%, 0.8% and -0.8% of GDP respectively, from 2001 onwards. The underlying assumptions are a real trend GDP growth rate of 3.1% in 2000, as estimated by the European Commission, and an inflation rate of 2%. Debt-deficit adjustments are assumed to be equal to zero.

**(b) On the basis of primary fiscal balances***(as a percentage of GDP)*

Total gross debt		Primary fiscal balance		Primary balance ratio consistent with reduction of debt level to 60% of GDP in <sup>1)</sup>		
1999	2000	1999	2000	2004	2009	2014
104.4	103.7	5.8	5.8	11.7	5.6	3.9

Sources: European Commission (spring 2000 forecasts) and ECB calculations.

1) Calculations indicate that the debt ratio would fall to 60% in 2004, 2009 and 2014 respectively, if the primary fiscal balance for 2000 is as forecast and the primary fiscal balances were maintained at 11.7%, 5.6% and 3.9% of GDP respectively, from 2001 onwards. The underlying assumptions are a real trend GDP growth rate of 3.1% in 2000, as estimated by the European Commission, an inflation rate of 2% and a nominal interest rate of 6%. Debt-deficit adjustments are assumed to be equal to zero.

**Chart 5****Greece: Potential future debt ratios under alternative assumptions for fiscal balance ratios***(as a percentage of GDP)*

Sources: European Commission (spring 2000 forecasts) and ECB calculations.

Note: The three scenarios assume that the debt ratio of 103.7% of GDP for 2000 is as forecast and that the 2000 overall balance of -1.3% of GDP or the primary balance of 5.8% of GDP will be kept constant over the period considered (as a percentage of GDP), or, alternatively, that a balanced budget is maintained from 2001 onwards. The underlying assumptions are a real trend GDP growth rate in 2000 of 3.1% as estimated by the European Commission; an inflation rate of 2%; and, in the constant primary balance scenario, a nominal interest rate of 6%. Debt-deficit adjustments are assumed to be equal to zero.



**Table 9****Greece: Projections of elderly dependency ratio**

	1990	2000	2010	2020	2030
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	21.2	25.5	28.8	33.3	40.9

Source: Bos, E. (1994), *World population projections 1994-95*, World Bank, Washington, D. C.

**Table 10****(a) Greece: Exchange rate stability**

Membership of the exchange rate mechanism (ERM/ERM II) Membership since Devaluation of bilateral central rate on country's own initiative	Yes March 1998	No
Maximum and minimum upward deviations from central rates in % <sup>1)</sup>	Maximum upward deviation	Minimum upward deviation
<i>1 April 1998 to 31 December 1998 (ERM currencies):</i>		
Belgian franc	8.0	3.2
Danish krone	7.9	3.2
Deutsche Mark	8.0	3.2
Spanish peseta	7.8	3.0
French franc	8.0	3.2
Irish pound	7.0	1.8
Italian lira	7.7	2.9
Dutch guilder	8.1	3.1
Austrian schilling	8.0	3.2
Portuguese escudo	7.9	3.1
Finnish markka	8.0	3.1
<i>4 January 1999 to 31 March 2000 (ERM II currencies):</i>		
euro (4 January 1999 to 16 January 2000)	9.0	5.9
euro (17 January 2000 to 31 March 2000)	2.8	1.9
<i>For information only:</i>		
Danish krone (4 January 1999 to 16 January 2000)	8.7	4.4
Danish krone (17 January 2000 to 31 March 2000)	2.6	1.7

Sources: BIS and ECB calculations.

Note: ERM II replaced the ERM from the beginning of 1999. With effect from 17 January 2000 the central parity for the Greek drachma against the euro was revalued by 3.5%.

1) Daily data at business frequency, ten-day moving average.

**(b) Key indicators of exchange rate pressure for the Greek drachma**

Average of three months ending	1998 June	1998 Sep.	1998 Dec.	1999 Mar.	1999 June	1999 Sep.	1999 Dec.	2000 Mar.
Exchange rate volatility <sup>1)</sup>	9.5	5.8	4.5	3.1	3.1	1.3	1.3	1.1
Short-term interest rate differentials <sup>2)</sup>	9.1	9.6	8.6	7.6	7.2	7.2	7.0	5.4

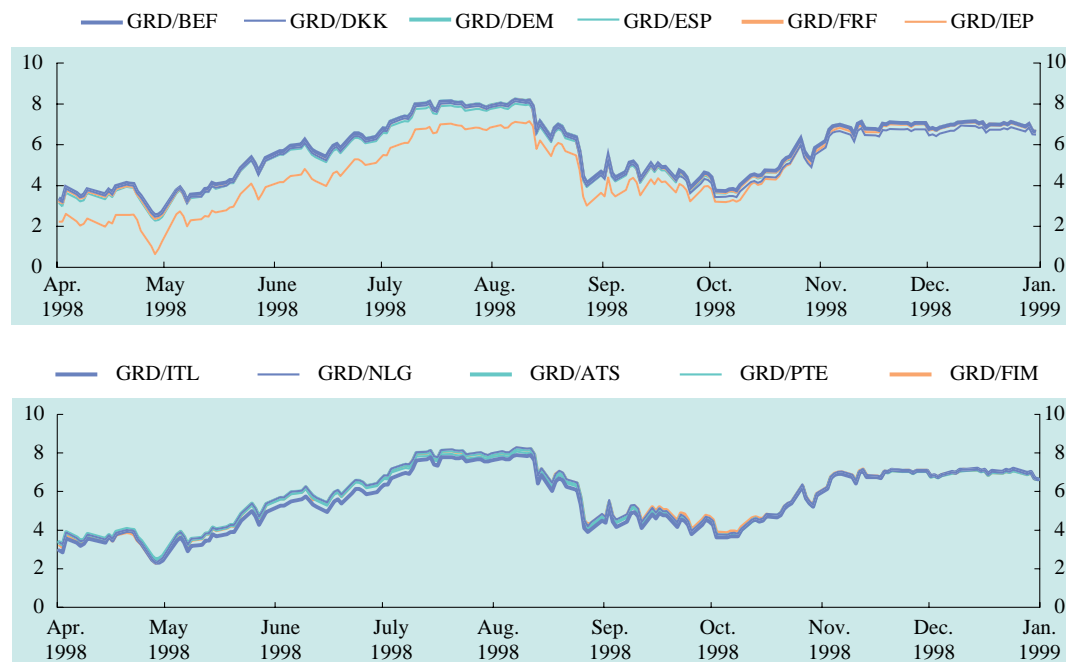
Sources: National data and ECB calculations.

1) Annualised monthly standard deviation of daily percentage changes of the exchange rate against the Deutsche Mark for 1998 and against the euro from 4 January 1999, in percentages.

2) Differential of three-month interbank interest rates against weighted average of euro area interbank deposit bid rates, in percentage points.

**Table 11****Greek drachma: Measures of the real effective exchange rate vis-à-vis EU Member States***(quarterly data; percentage deviations; 1999 Q4 compared with different benchmark periods)*

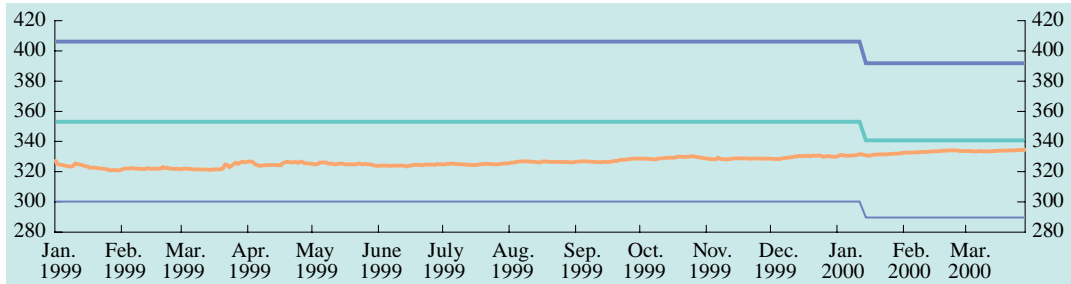
	Average 1974-99	Average 1989-99	Average 1987
<b>Real effective exchange rates:</b>			
Unit wage costs (total economy) – based	12.6	8.0	29.1
Private consumption deflator – based	7.7	5.1	22.8
GDP deflator – based	11.8	7.9	30.2
Exports of goods and services deflator – based	-3.7	4.3	12.0
<b>Memo item:</b>			
Nominal effective exchange rate	-71.0	-20.3	-51.3

*Sources: European Commission and ECB calculations.**Note: A positive (negative) sign indicates an appreciation (depreciation).***Chart 6a****Greek drachma: Deviations from ERM bilateral central rates from April to December 1998***(daily data; percentages; 1 April 1998 to 31 December 1998)**Source: BIS.*

**Chart 6b**

**Greek drachma: Exchange rate against the euro with central parity and fluctuation bands in ERM II from January 1999 to March 2000**

(daily data; 4 January 1999 to 31 March 2000)

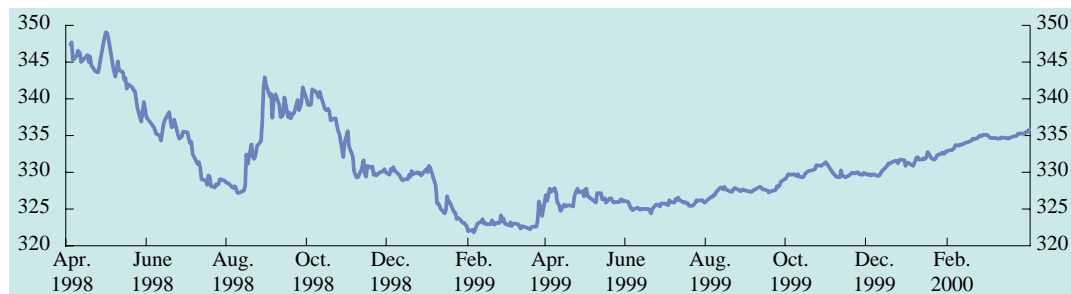


Source: ECB.

**Chart 6c**

**Greek drachma: Exchange rate against the ECU/euro from April 1998 to March 2000**

(daily data; 1 April 1998 to 31 March 2000)



Sources: BIS and ECB.

**Table 12****Greece: external developments***(as a percentage of GDP)*

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current account plus capital account <sup>1)</sup>	-4.3	-1.5	-2.2	-0.8	-0.2	-2.4	-3.7	-4.1	-3.1	-3.2
Net foreign assets (+) or liabilities (-) <sup>2)</sup>	-23.7	-21.8	-23.2	-24.3	-20.8	-18.7	-14.9	-20.8	-23.6	-28.0
Exports of goods and services <sup>1)</sup>	15.4	15.7	14.8	14.3	14.4	13.2	12.3	13.7	14.7	20.7
Imports of goods and services <sup>1)</sup>	23.2	22.2	21.4	20.5	20.3	21.0	20.6	22.7	22.8	28.2
Intra-EU exports (goods only) <sup>3)</sup>	68.3	67.7	69.3	58.9	57.1	60.1	53.8	50.9	52.3	-
Intra-EU imports (goods only) <sup>3)</sup>	67.8	64.0	66.7	63.0	67.9	70.1	64.3	65.0	65.9	-

Sources: European Commission, Eurostat (current account plus capital account, exports and imports of goods and services, 1990-96, and intra-EU exports and imports); national data (current account plus capital account, exports and imports of goods and services, 1997-99, and foreign assets and liabilities) and ECB calculations.

- 1) Data for the fourth quarter of 1999 are estimated. Some differences occur between the data in this Report and the Convergence Report produced by the European Commission which stem from the use of different data sources. While the Commission's Report is based on national accounts (ESA 95) data, the data in this ECB Report are derived from b.o.p. data compiled by the Greek National Institute of Statistics and the Bank of Greece.
- 2) Estimates by the Bank of Greece of the international investment position.
- 3) As a percentage of total exports and imports.

**Table 13****Greece: Long-term interest rates***(percentages)*

	1998	1999	2000 Jan.	2000 Feb.	2000 Mar.	Apr. 1999 to Mar. 2000
Long-term interest rate	8.5	6.3	6.6	6.5	6.2	6.4
Reference value	6.6	6.8	-	-	-	7.2
Euro area average	4.7	4.6	5.7	5.7	5.5	5.0

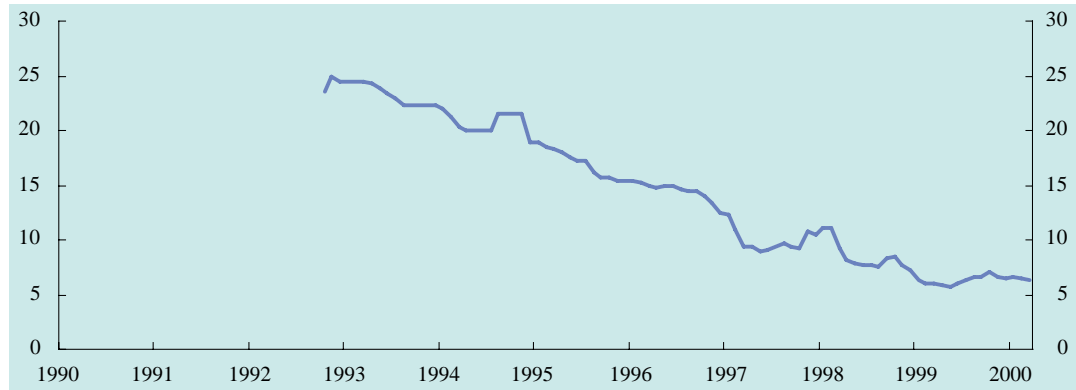
Source: European Commission.

Note: The reference value is based on the three best-performing Member States in terms of price stability (Austria, France and Sweden for the period April 1999 - March 2000) plus 2 percentage points. The euro area average is included for information only.

## Chart 7

### (a) Greece: Long-term interest rate <sup>1)</sup>

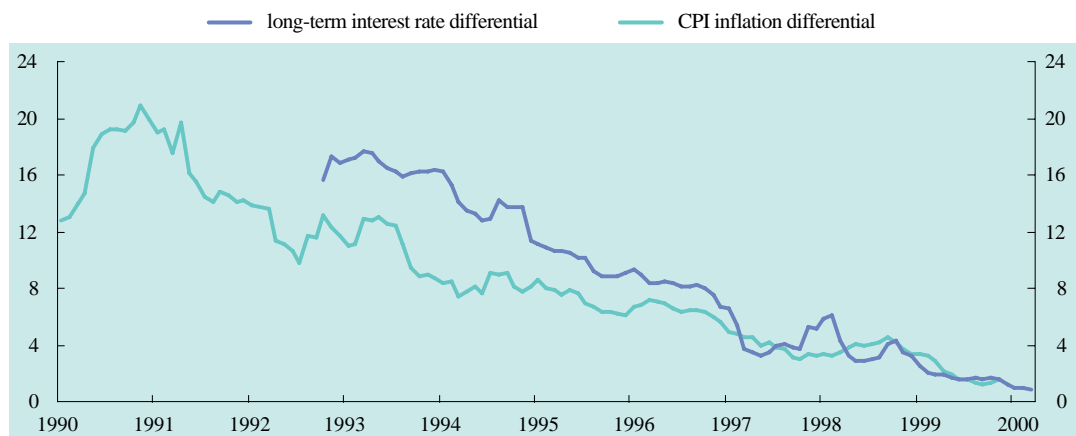
(monthly averages in percentages)



1) Earlier data are not available.

### (b) Greece: Long-term interest rate and CPI inflation differentials vis-à-vis EU Member States with lowest long-term interest rates <sup>1), 2)</sup>

(monthly averages in percentages)



Sources: Interest rates: European Commission (where these are not available, the most comparable data have been used); the CPI data are non-harmonised national data.

1) Includes Austria, France, Germany, Luxembourg and the Netherlands.

2) Earlier interest rate data for Greece are not available.

## 2 Sweden

### 2.1 Price developments

Over the reference period from April 1999 to March 2000 the average rate of HICP inflation in Sweden was 0.8%, i.e. well below the reference value of 2.4% as defined in Article 121 (1) of the Treaty establishing the European Community and Article 1 of the Protocol on the convergence criteria referred to in that Article. This was also the case in 1999 as a whole. In 1998 average HICP inflation was 1.0% (see Table 1). Seen over the past two years, HICP inflation in Sweden has been at levels which are consistent with price stability.

Looking back, consumer price inflation in Sweden, as measured on the basis of the CPI, has followed a marked downward trend since the early 1990s (see Chart 1). From high levels of above 10% at the start of the decade, annual rates of inflation fell sharply in 1992 and have been below 2% since 1996, including occasional periods of negative rates of inflation. Annual average HICP inflation has also been below 2% since 1996, and since the beginning of 1999 Sweden has been among the three best-performing EU Member States in terms of price stability. This experience of progress towards price stability reflects a number of important policy choices, including a shift in the orientation of economic policy towards the primary objective of price stability. Since 1993 the objective for monetary policy has been expressed as an explicit inflation target, since 1995 quantified as a 2% increase in the consumer price index with a symmetric tolerance margin of  $\pm 1$  percentage point. More recently, new central bank legislation, which entered into force in 1999, has confirmed price stability as the overriding objective of monetary policy in Sweden and has assured the independence of Sveriges Riksbank. This shift in monetary policy has been supported by, inter alia, a sizeable consolidation of the public finances and greater product market competition, linked partly to Sweden's accession to the EU in 1995. In markets such as

telecommunications and electricity, liberalisation and increased competition have had noticeable downward effects on inflation. In addition, the macroeconomic environment has contributed to containing upward pressures on prices. In particular, a considerable negative output gap and a historically high unemployment rate (see Table 2) emerged in the aftermath of the severe recession in the early 1990s. Furthermore, a number of temporary factors have contributed to the very low inflation rates since 1996. For instance, lower mortgage interest expenditure, included in the CPI but not in the HICP, contributed to lower inflation from the start of 1996, reflecting declining short-term and long-term interest rates. In 1999 such factors contributed by around 0.5 percentage point to lower rates of CPI inflation. Changes in indirect taxes and subsidies also had significant downward effects on inflation in 1996, the second half of 1998 and the first half of 1999. Finally, declining commodity and import prices, in connection with the crisis in Asia in 1997 and 1998, affected price developments in Sweden, contributing to the very depressed levels of price increases in 1998 and early 1999. Large movements in the exchange rate have occasionally had noticeable effects on price developments. This was particularly the case in 1993 following the significant depreciation of the Swedish krona as a result of the fixed exchange rate regime being abandoned in November 1992.

Against this background, the developments in compensation per employee and labour productivity remained broadly supportive of price stability from 1992 onwards, except in 1996 when compensation per employee jumped to 6.8%. The unemployment rate declined rapidly from the middle of 1997 onwards, initially largely as a result of significant efforts on education, but more recently following the rapid growth of domestic demand. In February 2000 6.6% of the labour force were unemployed according

to Eurostat data.<sup>1</sup> Some signs of labour shortages have emerged, in particular for skilled labour and in fast growing regions. Structural reform in the labour market in recent years has mainly focused on education and, to a lesser extent, on long-term unemployment. While the importance of wage moderation and changes in benefit and taxation systems, as a means of increasing incentives to work, is generally recognised in economic policy, only limited measures have so far been implemented by the Swedish authorities in these fields. However, there are some signs that the level of structural unemployment has declined somewhat in recent years. One possible explanation could be the increased use of temporary contracts since the mid-1990s, which may have increased flexibility in the labour market. At the start of 1999 underlying inflation (UNDIX)<sup>2</sup> was given a more explicit operational role following the central bank's clarification of its monetary policy strategy, stating that departures from the inflation target may be warranted if, for instance, inflation is influenced by temporary factors. This was the case in 1999. UNDIX was below 2% from the end of 1996, but in general remained within the tolerance margin of 1 percentage point. Low rates of inflation in recent years are also apparent when inflation is measured in terms of other relevant price indices (see Table 2).

Looking at recent trends and forecasts, current data for 12-month rates of HICP inflation had increased to 1.4% by March 2000 (see Table 3a) after having been close to zero in the first half of 1999. The increase is mainly explained by rising import and commodity prices, as well as by a fading negative impact of indirect taxes. According to Sveriges Riksbank, the HICP is expected to average 1.5% in 2000 and 1.6% in 2001. Most other inflation forecasts referred to in this Report suggest rates of around 1.5% in 2000 and of around 2% in 2001 (see Table 3b). In order for consumer prices not to increase faster in an environment of relatively high growth in unit labour costs – of around 2-2.5% in 2000 and 2001, according

to forecasts made by Sveriges Riksbank – the profit share and employment growth would in general have to develop less favourably than would have been possible with lower labour cost increases. In 2000 and 2001 real wage increases are expected to remain higher than productivity growth. In addition, GDP growth is expected to remain above trend in the coming years, resulting in a closure of the output gap and potentially increasing the risks of higher wage increases. Other factors, such as an appreciating krona and further market deregulation, could, however, mitigate the upward pressure on prices. In the longer run, a further downward adjustment of wage increases and additional labour market reforms may be warranted – given the early signs of bottlenecks in the labour market despite still relatively high overall unemployment – in order to reduce price pressures and unemployment.

Looking further ahead, maintaining an environment conducive to price stability relates in Sweden to, inter alia, the conduct of balanced monetary and fiscal policies over the medium to long term. With a stability-oriented economic policy framework in place, it is equally important to strengthen national policies aimed at enhancing competition in product markets and improving the functioning of labour markets. Finally, social partners will need to keep wage increases in line with price stability and productivity increases in order to maintain favourable conditions for economic expansion and growth in employment.

## 2.2 Fiscal developments

In the reference year 1999 Sweden recorded a general government surplus of 1.9% of GDP, thereby meeting the 3% reference value for the deficit ratio. At the same time, the debt

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<sup>1</sup> Total unemployment, including labour market programmes, amounted to around 8%.

<sup>2</sup> UNDIX is defined as the CPI excluding mortgage interest costs and the effects of indirect taxes and subsidies.

ratio was 65.5%, i.e. above the 60% reference value. Compared with the previous year, the budget surplus remained constant as a share of GDP and the debt ratio decreased substantially by 6.9 percentage points. In 2000 a surplus of 2.4% of GDP is expected, while the debt ratio is projected to decrease to 61.3% (see Table 4). Since 1997 the deficit ratio has not exceeded the ratio of public investment expenditure to GDP. Looking back over the years from 1990 to 1999, the Swedish *debt-to-GDP ratio* increased on balance by 23.4 percentage points. Initially, the Swedish Government's finances deteriorated sharply, with the debt ratio rising from 42.1% of GDP in 1990 to 77.7% in 1994. This took place against the background of an actual fall in real GDP of almost 5% in three years. Furthermore, as is reflected in the deficit-debt adjustment item of public debt, financial support granted to the banking sector and the revaluation of government debt denominated in foreign currency after the sizeable depreciation of the Swedish krona in the early 1990s had a marked impact. Following the peak reached in 1994, the debt ratio decreased to 65.5% in 1999 (see Chart 2a), i.e. a decline of 12.2 percentage points over five years. Since 1996 the primary balance has been in surplus, more than compensating for the unfavourable growth/interest rate differential since 1997 (see Chart 2b). In 1998 and 1999 sizeable primary surpluses of 8.0% and 7.4% of GDP were recorded. The pattern observed during the early 1990s is an illustration of the powerful effects of a strong deterioration in the macroeconomic environment and exceptional events on the debt ratio, particularly in the absence of a primary surplus sufficient to compensate for these factors. Determined fiscal adjustment in recent years has helped to reverse a considerable part of the previous increase in the debt ratio.

The share of debt with a short-term maturity decreased from the high levels of the early 1990s to 19% in 1999, making fiscal balances less sensitive to changes in interest rates. In addition, the proportion of foreign currency debt fell to 23% in 1999, although fiscal

balances remain sensitive, in principle, to changes in exchange rates.

During the 1990s a pattern of initially sharply deteriorating and subsequently improving outturns can be observed in the *budget balance-to-GDP ratio*. Starting from a surplus position of 4.0% in 1990, a deficit emerged in 1991 and increased sharply to reach a peak of 11.9% of GDP in 1993; the deficit subsequently declined year by year, turning into a surplus of 1.9% of GDP in 1998. The surplus-to-GDP ratio remained constant in 1999 (see Chart 3a). As is shown in greater detail in Chart 3b, which focuses on changes in deficits, cyclical factors contributed substantially to the increase in the deficit until 1993, as well as to its decrease in the following two years. In 1998 cyclical factors played a modest role in improving the budget balance, but rose to around 1 percentage point of GDP in 1999, according to European Commission estimates. The annual non-cyclical improvements of between 1.5 and 5.3 percentage points during the period from 1995 to 1998 largely reflect a lasting, "structural" move towards more balanced fiscal policies and a variety of measures with temporary effects. Available evidence suggests that measures with a temporary effect improved the budget balance in 1998 by 0.9% of GDP, but did not play a role in 1999.

Moving on to examine trends in other fiscal indicators, it can be seen from Chart 4 that the general government *total expenditure-to-GDP ratio* rose sharply between 1990 and 1993 to 70% of GDP, in connection with the absolute fall in real GDP. In particular, current transfers increased steeply, reflecting a marked increase in payments related to unemployment and other social security items; in addition, all other major expenditure items also rose as a percentage of GDP (see Table 7). After 1993 the total expenditure ratio declined rapidly as a consequence of a reduction in all major expenditure categories with the exception of interest expenditure, which started to decline in relation to GDP only after 1996. In 1999 the expenditure ratio decreased further to 58.5%, which was



practically equal to the level observed in 1990. Given this pattern and taking into account the fact that interest expenditure increased in line with the higher debt ratio over the first half of the 1990s and that capital spending was relatively low from 1994 onwards, a continuation of the downward trend of total expenditure to GDP would, in particular, seem to require further emphasis to be placed on current transfers. These are, nevertheless, slightly below the level observed in 1990 and continued to decline as a percentage of GDP in 1999. *Government current receipts* in relation to GDP tended to decrease up to 1994, peaked again in 1998 and fell marginally in 1999. Despite this recent fall, they may currently be at a level which is detrimental to economic growth.

According to the Swedish *medium-term fiscal policy strategy*, as presented in the latest update of the Convergence Programme for 1999 to 2002 dated November 1999, the general government financial position is expected to remain in surplus in 2000 and the debt ratio is planned to reach a level below 60% in 2000 and to decrease further thereafter. The budget plan for 2000 is in line with the Convergence Programme. The Swedish Government has announced the medium-term ambition of achieving a surplus of 2% of GDP over the business cycle by firmly controlling expenditure growth. These budget surplus targets take into account significant tax reductions planned for the period until 2002. The fiscal authorities have also announced their intention to allow automatic stabilisers to work should growth deviate from the budget projections set out in the Updated Swedish Convergence Programme. However, since the growth assumptions for 2001 and 2002 are very cautious and are based on the economy's long-term growth rate, downside risks are very limited. The fiscal stance indicator calculated by the Swedish authorities shows an easing of the fiscal stance in 1999 and 2000, turning into a tightening in 2001 and a neutral stance in 2002. These findings should be seen against the background of above-trend growth in the Swedish economy. If fiscal

balances turn out as projected in the Updated Swedish Convergence Programme for 1999 to 2002, Sweden is expected to comply with the medium-term objective of the Stability and Growth Pact of having a budgetary position that is close to balance or in surplus, according to the assessment undertaken by the European Commission, and as confirmed by the ECOFIN Council.

With regard to the potential future course of the debt ratio, calculations are presented in line with the 1998 Convergence Report. Based on the assumption that fiscal balances and debt ratios as projected by the European Commission for 2000 are achieved, maintaining the overall and primary balance-to-GDP ratios for 2000 of 1.9% and 7.4% would reduce the debt-to-GDP ratio to below 60% in 2001 (see Chart 5). Projected developments for Sweden underline the benefits of the surplus position achieved in 1998, which is forecast to be maintained in the near future, for rapidly reducing the debt ratio. However, it is also appropriate to stress the need for Sweden to maintain sound fiscal balances. As has been seen in the past, unexpected shocks can substantially increase the debt ratio. In addition, as is highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. Therefore, public pension expenditure would increase in relation to GDP if policies regarding benefits were to continue unchanged. The Swedish pension system is partly funded, but is basically of the pay-as-you-go type. The public pension system is gradually being supplemented by a more robust system linked to economic growth and demographic variations, which will reduce the pressure on public finances. The funded part of the pension system currently invests a large part of its surpluses in government paper, thereby reducing the consolidated general government gross debt. As a result, any change in this investment policy would introduce a measure of uncertainty for the future course of the gross debt ratio. The demographic trend over the next few decades will have an adverse effect on the current surpluses in the pension system, thereby

making improvements in the other components of the general government fiscal balance essential. The overall burden of population ageing will be alleviated if public finances have created sufficient room for manoeuvre before entering the period during which the demographic situation is set to worsen.

### 2.3 Exchange rate developments

During the reference period from April 1998 to March 2000 the Swedish krona did not participate in either the ERM or ERM II (see Table 9a). Swedish monetary policy is oriented towards the primary objective of price stability by means of an explicit inflation target of 2% of the CPI under a flexible exchange rate regime. During the reference period the krona initially traded at a weaker level than its April 1998 average bilateral exchange rates against most other EU currencies, which are used as a benchmark for illustrative purposes in the absence of central rates (see Chart 6 and Table 9a). In the second half of 1998 the krona depreciated significantly, by around 8% as measured by daily exchange rates, against most ERM currencies amid the global market turbulence caused by the emerging market crisis in August 1998. After the launch of the euro in January 1999, the krona appreciated by 14.4% against the euro throughout 1999 and until the end of March 2000. This strengthening reflects a normalisation of the situation after the global crisis in autumn 1998 and Sweden's stronger than expected economic performance. For most of 1998 the volatility of the Swedish krona's exchange rate against the ERM currencies, measured by annualised standard deviations of daily percentage changes, remained around 5%, but increased to over 12% on a quarterly basis in the last quarter of 1998 and remained high until the end of the first quarter of 1999. Since then, the volatility of the krona against the euro has mostly fluctuated between 3% and 6%, and in the first quarter of 2000 it was below the average for the current reference period (see Table 9b). Short-term interest rate

differentials against the weighted average of euro area interbank deposit bid rates narrowed significantly in the course of 1998 and in the first quarter of 1999, before rising slightly again in mid-1999 to around 0.5 percentage point higher than the euro area average in the first quarter of 2000 (see Table 9b).

In a longer-term context, when measured in terms of real effective exchange rates, current exchange rate levels of the Swedish krona against other EU currencies are somewhat weaker than historical average values and 1987 average values (see Table 10). As regards other external developments, Sweden has maintained a sizeable current account surplus since 1994 against the background of a relatively large net external liability position (see Table 11). It may also be recalled that Sweden is a small open economy with, according to the most recent data available for 1999, a ratio of foreign trade to GDP of 43.7% for exports and 38% for imports, and a share of intra-EU trade of 56% for exports and 67.8% for imports in 1998.

### 2.4 Long-term interest rate developments

Over the reference period from April 1999 to March 2000 *long-term interest rates* in Sweden were 5.4% on average, and thus stood well below the reference value for the interest rate criterion of 7.2%, defined as the average long-term interest rate of the three best-performing Member States in terms of price stability plus 2 percentage points. Swedish long-term interest rates were also well below the reference value in 1998 as well as in 1999 as a whole (see Table 12).

With the exception of 1994, long-term interest rates were on a declining trend between the early 1990s and the beginning of 1999, when euro area bond yields reached the lowest levels observed in 50 years (see Chart 7a). Subsequently, Swedish bond yields began to increase broadly in line with long-term interest rates in the euro area. This

increase in long-term Swedish yields reflected influences from rising international yields as well as a gradual improvement in the economic outlook in Sweden. From the early 1990s and until around 1998 Swedish long-term bond yields tended to converge towards the rates of those EU countries with the lowest bond yields. During 1998 and 1999 the differential remained relatively stable at levels close to 0.5%, while in recent months the differential has narrowed further (see Chart 7b). The main factors underlying the observed convergence trend were the comparatively low rates of inflation and the improvement in the country's public finances. However, the interest rate differential has displayed a tendency to widen somewhat during episodes of global financial turbulence, as was the case during the emerging market crisis in the second half of 1998, for example. Furthermore, a weakening of the Swedish krona has typically been associated with a widening of the interest rate differential.

## 2.5 Concluding summary

Over the reference period Sweden achieved a 12-month average rate of HICP inflation of 0.8%, which is well below the reference value stipulated by the Treaty. Sweden has entered a period of high growth in recent years, led predominantly by domestic demand; at the same time, the fiscal stance has become more neutral, resulting in a rapid closing of the output gap. The closing of the output gap as well as relevant price indices point in the direction of increasing upward pressure on prices and costs. Looking ahead, forecasts indicate that inflation will be around 1.5% in 2000 and around 2% in 2001. The level of long-term interest rates was 5.4%, i.e. below the respective reference value.

Sweden does not participate in ERM II. Sweden is a Member State with a derogation and does not have a clause allowing it to opt out of Stage Three of EMU. Sweden is thus committed by the Treaty to adopting the

euro, which implies that it must strive to fulfil all the convergence criteria, including the exchange rate criterion. During the reference period the Swedish krona initially traded at a weaker level than its April 1998 average bilateral exchange rates against most other EU currencies, these being used as a benchmark for illustrative purposes in the absence of central rates. Having depreciated significantly in the second part of 1998, following the global market turbulence caused by the emerging market crisis in August 1998, the krona appreciated by 14.4% against the euro throughout 1999 and until March 2000. This strengthening reflects a normalisation of the situation after the global crisis in autumn 1998 and Sweden's stronger than expected economic performance.

In 1999 Sweden achieved a fiscal surplus of 1.9% of GDP, thereby meeting the 3% reference value, and the outlook is for a surplus of 2.4% of GDP in 2000. The debt-to-GDP ratio is above the 60% reference value. After having reached a peak in 1994, the ratio declined by 12.2 percentage points to stand at 65.5% in 1999. With regard to the sustainability of fiscal developments, the outlook is for a decline in the debt ratio to 61.3% in 2000. Against the background of the trends in the budget balance ratio in recent years, Sweden is expected to comply with the medium-term objective of the Stability and Growth Pact of having a budgetary position which is close to balance or in surplus, according to the assessment undertaken by the European Commission, and as confirmed by the ECOFIN Council.

With regard to other factors, the deficit ratio has not exceeded the ratio of public investment to GDP since 1997. In addition, Sweden recorded current account surpluses, while maintaining a net external liability position. In the context of the ageing of the population, Sweden benefits from a partly funded pension system, which is gradually being supplemented by a new system which will reduce pressures on public finances.

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#### IV Long-term interest rate developments

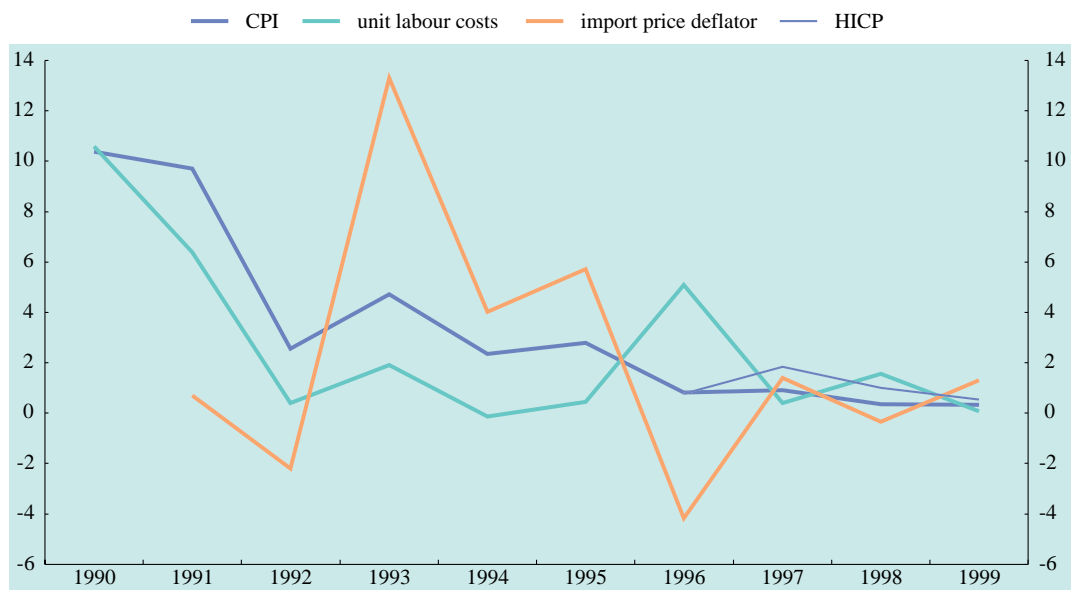
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**Table I****Sweden: HICP inflation***(annual percentage changes)*

	1996	1997	1998	1999	2000 Jan.	2000 Feb.	2000 Mar.	Apr. 1999 to Mar. 2000
HICP inflation <sup>1)</sup>	0.8	1.8	1.0	0.6	1.0	1.4	1.4	0.8
Reference value <sup>2)</sup>	2.5	2.7	2.2	2.1	.	.	.	2.4
Euro area average <sup>3)</sup>	2.2	1.6	1.1	1.1	1.9	2.0	2.1	1.4

Source: Eurostat.

- 1) Please note that as from January 2000 the coverage of the HICP has been extended and further harmonised. See the statistical annex for details.
- 2) Calculation for the April 1999 to March 2000 period is based on the unweighted arithmetic average of annual percentage changes of Sweden, Austria and France, plus 1.5 percentage points.
- 3) The euro area average is included for information only.

**Chart I****Sweden: Price developments***(annual percentage changes)*

Sources: National data and Eurostat.

**Table 2****Sweden: Measures of inflation and related indicators***(annual percentage changes, unless otherwise stated)*

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
<b>Measures of inflation</b>										
Harmonised index of consumer prices (HICP)	-	-	-	-	-	-	0.8	1.8	1.0	0.6
Consumer price index (CPI)	10.4	9.7	2.6	4.7	2.3	2.8	0.8	0.9	0.4	0.3
CPI excluding changes in net indirect taxes <sup>1)</sup>	7.5	5.7	3.4	4.0	2.4	1.9	0.5	-	-	-
Private consumption deflator <sup>2)</sup>	9.9	10.3	2.2	5.7	2.8	2.9	1.4	2.2	1.0	0.7
GDP deflator <sup>2)</sup>	8.9	7.6	1.0	2.6	2.4	3.5	1.4	1.2	1.3	0.5
Producer prices <sup>3)</sup>	4.2	2.4	-0.2	2.0	4.2	8.0	0.7	1.1	-0.4	0.1
<b>Related indicators</b>										
Real GDP growth <sup>2)</sup>	1.4	-1.1	-1.4	-2.2	4.1	3.7	1.1	2.0	3.0	3.8
Output gap (percentage points)	3.6	1.3	-1.4	-4.8	-2.5	-0.6	-1.2	-1.5	-1.2	0.0
Unemployment rate (%) <sup>4)</sup>	1.7	3.1	5.6	9.1	9.4	8.8	9.6	9.9	8.3	7.2
Unit labour costs, whole economy <sup>2)</sup>	10.6	6.4	0.4	1.9	-0.1	0.5	5.1	0.4	1.6	0.1
Compensation per employee, whole economy <sup>2)</sup>	11.3	6.8	4.0	4.4	4.8	2.8	6.8	3.0	3.3	1.5
Labour productivity, whole economy <sup>2)</sup>	0.6	0.4	3.5	2.5	4.9	2.3	1.7	2.6	1.7	1.4
Import price deflator	-	0.7	-2.2	13.3	4.0	5.7	-4.2	1.4	-0.3	1.3
Exchange rate appreciation <sup>5)</sup>	-1.3	-0.5	1.4	-19.2	-1.4	-0.5	9.8	-3.7	-1.2	-2.2
Broad money (M4N)	9.1	9.9	1.3	7.0	4.5	-1.3	10.0	4.2	3.5	6.8
Stock prices <sup>6)</sup>	-31.1	5.4	-0.5	53.7	4.8	18.0	38.4	24.8	10.5	65.9
House prices <sup>7)</sup>	11.8	6.9	-9.4	-11.1	4.9	0.0	0.8	6.6	9.5	9.4

Sources: National data except the HICP, producer prices, real GDP growth and the unemployment rate (Eurostat), the output gap (European Commission) and the exchange rate (BIS).

1) National estimates.

2) Prior to 1994 national definition, ESA 95 data thereafter.

3) Manufacturing, domestic sales.

4) Eurostat definition.

5) Nominal effective exchange rate against 26 industrialised countries. Note: a positive (negative) sign indicates an appreciation (depreciation).

6) End of period.

7) Residential property prices, owner occupied dwellings.

**Table 3****Sweden: Recent inflation trends and forecasts***(annual percentage changes, unless otherwise stated)***(a) Recent trends in the Harmonised Index of Consumer Prices**

	1999 Nov.	1999 Dec.	2000 Jan.	2000 Feb.	2000 Mar.
<b>Harmonised Index of Consumer Prices (HICP)</b>					
Annual percentage change	0.8	1.2	1.0	1.4	1.4
Change in the average of the latest 3 months from the previous 3 months, annualised rate, seasonally adjusted	1.2	1.4	1.1	1.7	1.7
Change in the average of the latest 6 months from the previous 6 months, annualised rate, seasonally adjusted	1.0	1.1	1.2	1.3	1.4

*Sources: Eurostat and ECB calculations.***(b) Inflation forecasts**

	2000	2001
European Commission (spring 2000), HICP	1.6	2.0
OECD (December 1999), private consumption deflator	1.4	1.8
IMF (May 2000), CPI	1.4	1.8

*Sources: European Commission (spring 2000 forecasts), the OECD and the IMF.*

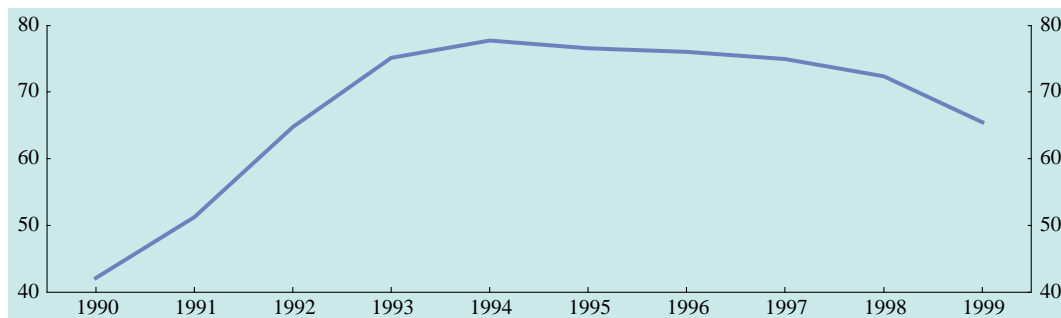
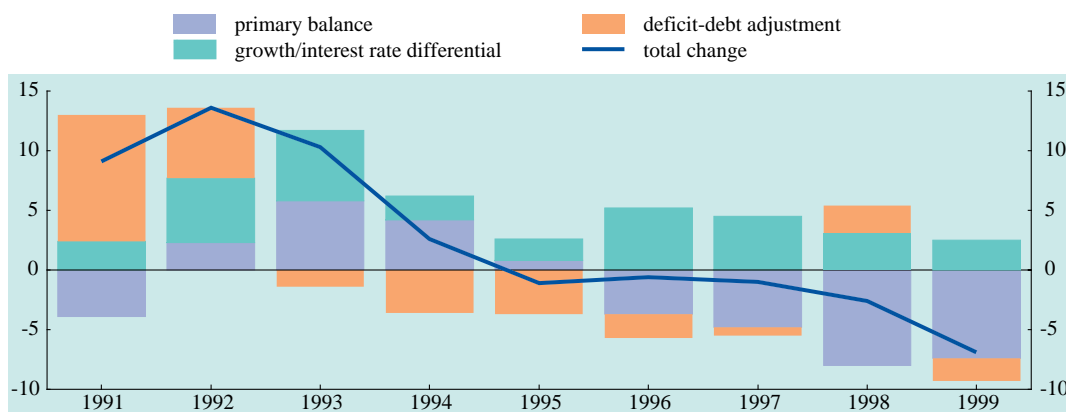
**Table 4****Sweden: General government financial position***(as a percentage of GDP)*

	1998	1999	2000 <sup>1)</sup>
General government surplus (+) / deficit (-)	1.9	1.9	2.4
Reference value	-3	-3	-3
Surplus (+) / deficit (-), net of public investment expenditure <sup>2)</sup>	4.6	4.6	4.9
General government gross debt	72.4	65.5	61.3
Reference value	60	60	60

Sources: European Commission (spring 2000 forecasts) and ECB calculations.

1) European Commission forecast.

2) A negative sign indicates that the government deficit is higher than investment expenditure.

**Chart 2****Sweden: General government gross debt***(as a percentage of GDP)***(a) Levels****(b) Annual changes and underlying factors**

Sources: European Commission (spring 2000 forecasts) and ECB calculations.

Note: In Chart 2 (b) negative values indicate a contribution of the respective factor to a decrease in the debt ratio, while positive values indicate a contribution to its increase.



**Table 5****Sweden: General government gross debt – structural features**

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
<b>Total debt</b> (as a percentage of GDP)	42.1	51.2	64.8	75.1	77.7	76.6	76.0	75.0	72.4	65.5
<b>Composition by currency</b> (% of total)										
In domestic currency	.	.	.	.	68.6	70.0	69.9	71.3	73.3	77.3
In foreign currencies	.	.	.	.	31.4	30.0	30.1	28.7	26.7	22.7
Participating foreign currencies	.	.	.	.	.	.	.	.	.	.
Non participating foreign currencies	.	.	.	.	.	.	.	.	.	.
<b>Domestic ownership</b> (% of total)	.	.	.	.	54.5	56.2	54.0	53.0	52.3	.
<b>Average maturity</b>	.	.	.	.	.	.	.	.	.	.
<b>Composition by maturity</b> <sup>1)</sup> (% of total)										
Short-term (<1 year)	.	.	.	.	32.4	24.4	23.2	19.4	20.4	18.5
Medium and long-term (>1 year)	.	.	.	.	67.6	75.6	76.8	80.6	79.6	81.5

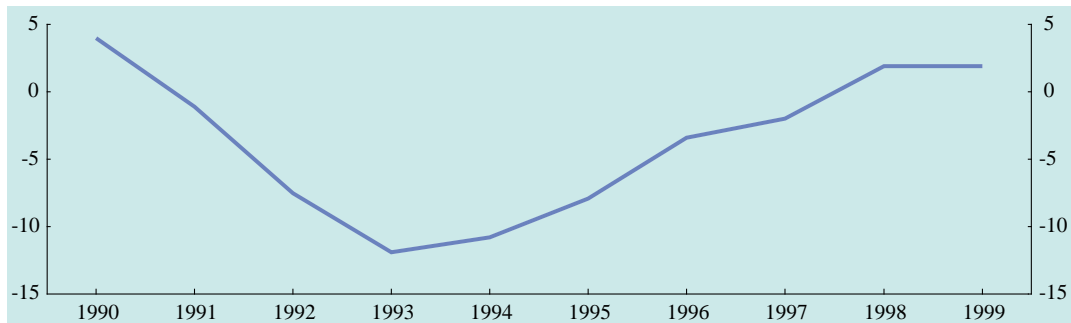
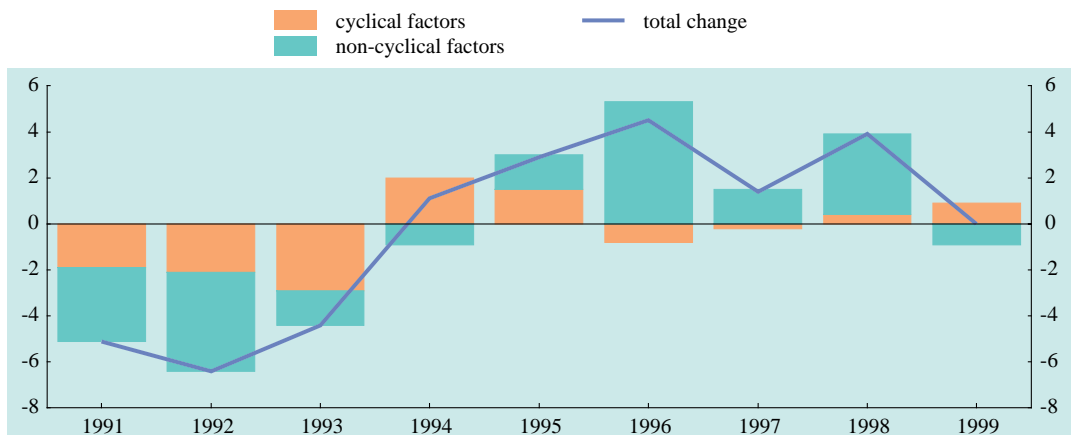
Sources: ESCB, 1999, except for total debt (European Commission (spring 2000 forecasts)). Year-end data.

Note: Differences in the totals are due to rounding.

1) Initial maturity.

**Chart 3****Sweden: General government surplus (+) / deficit (-)**

(as a percentage of GDP)

**(a) Levels****(b) Annual changes and underlying factors**

Source: European Commission (spring 2000 forecasts).

Note: In Chart 3 (b) negative values indicate a contribution to an increase in deficits, while positive values indicate a contribution to their reduction.

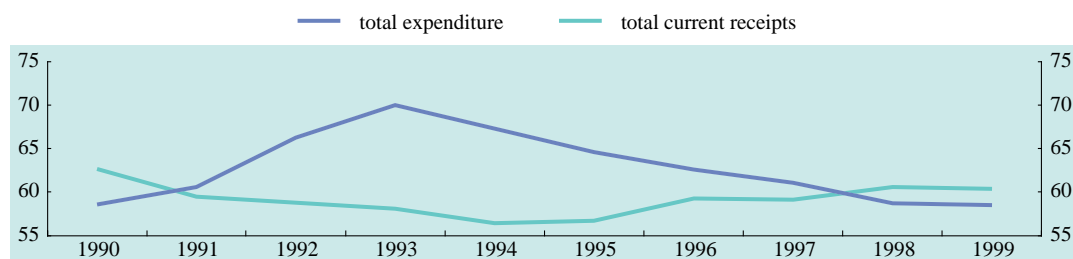
**Table 6****Sweden: General Government deficit-debt adjustment***(as a percentage of GDP)*

	1995	1996	1997	1998	1999	2000
Change in general government debt	4.2	1.4	1.3	0.5	-3.8	-0.6
General government surplus (+) / deficit (-)	-7.9	-3.4	-2.0	1.9	1.9	2.4
<b>Deficit-debt adjustment</b>	<b>-3.7</b>	<b>-2.0</b>	<b>-0.7</b>	<b>2.3</b>	<b>-1.9</b>	<b>1.8</b>
<b>Acquisitions (+) / sales (-) of financial assets</b>	<b>-0.5</b>	<b>-2.0</b>	<b>0.2</b>	<b>2.8</b>	<b>-0.8</b>	<b>.</b>
Currency and deposits	1.1	-1.6	-0.3	0.0	0.0	.
Loans and securities other than shares	-1.8	0.7	1.2	1.6	-0.9	.
Shares and other equity	-0.3	-0.2	-0.9	1.0	0.3	.
Privatisations	-0.4	0.0	-0.8	-0.7	0.0	.
Equity injections	-0.1	-0.3	0.0	0.0	0.0	.
Other	0.2	0.1	-0.2	1.7	0.3	.
Other financial assets	0.5	-0.9	0.3	0.2	-0.2	.
<b>Valuation changes of general government debt</b>	<b>-2.1</b>	<b>1.2</b>	<b>0.0</b>	<b>0.6</b>	<b>0.0</b>	<b>.</b>
Foreign exchange holding gains (-) / losses (+)	.	.	.	0.1	-0.4	.
Other valuation effects <sup>1)</sup>	.	.	.	0.5	0.4	.
<b>Other changes in general government debt <sup>2)</sup></b>	<b>-1.1</b>	<b>-1.1</b>	<b>-0.9</b>	<b>-1.1</b>	<b>-1.3</b>	<b>.</b>

Sources: ESCB, except general government surplus/deficit and deficit-debt adjustment (European Commission (spring 2000 forecasts)).

1) Includes the difference between the nominal and market valuation of general government debt at issue.

2) Transactions in other accounts payable (government liabilities) and sector reclassifications. This item may also cover certain cases of debt assumption.

**Chart 4****Sweden: General government expenditure and receipts***(as a percentage of GDP)*

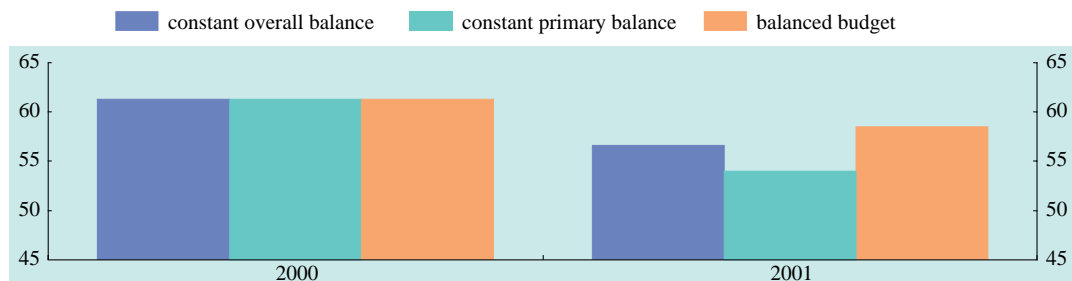
Source: European Commission (spring 2000 forecasts).

**Table 7****Sweden: General government budgetary position***(as a percentage of GDP)*

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
<b>Total current receipts</b>	62.7	59.5	58.8	58.1	56.4	56.7	59.3	59.1	60.6	60.4
Direct taxes	22.6	19.2	19.8	19.9	19.7	20.2	21.6	21.8	22.6	22.4
Indirect taxes	16.6	17.1	15.7	15.1	14.4	13.7	14.3	14.8	15.5	17.0
Social security contributions	15.0	14.9	14.3	15.0	15.0	15.3	16.3	16.1	16.1	15.1
Other current receipts	8.4	8.2	9.0	7.9	7.2	7.3	6.9	6.2	6.2	5.7
<b>Total expenditure</b>	58.6	60.6	66.3	70.0	67.3	64.6	62.6	61.1	58.7	58.5
Current transfers	25.1	26.8	29.9	30.0	29.2	27.3	25.6	24.5	24.0	23.2
Interest payable	4.8	5.0	5.2	6.1	6.6	7.1	7.1	6.9	6.2	5.5
Public consumption	26.4	26.3	27.0	28.4	27.4	26.3	27.1	26.7	26.7	27.0
Net capital expenditure	2.3	2.5	4.2	5.6	4.0	3.8	2.9	3.0	1.8	2.8
<b>Surplus (+) or deficit (-)</b>	4.0	-1.1	-7.5	-11.9	-10.8	-7.9	-3.4	-2.0	1.9	1.9
Primary balance	8.9	3.9	-2.3	-5.8	-4.2	-0.8	3.7	4.8	8.0	7.4
Surplus (+) or deficit (-), net of public investment expenditure <sup>1)</sup>	6.4	1.1	-4.9	-8.7	-7.3	-4.5	-0.3	0.6	4.6	4.6

Source: European Commission (spring 2000 forecasts). Differences in the totals are due to rounding.

1) A negative sign indicates that the government deficit is higher than investment expenditure.

**Chart 5****Sweden: Potential future debt ratios under alternative assumptions for fiscal balance ratios***(as a percentage of GDP)*

Sources: European Commission (spring 2000 forecasts) and ECB calculations.

Note: The three scenarios assume that the debt ratio of 61.3% of GDP for 2000 is as forecast and that the 2000 overall balance of 2.4% of GDP or the primary balance of 7.1% of GDP will be kept constant over the period considered (as a percentage of GDP), or, alternatively, that a balanced budget is maintained from 2001 onwards. The underlying assumptions are a real trend GDP growth rate in 2000 of 2.8% as estimated by the European Commission; an inflation rate of 2%; and, in the constant primary balance scenario, a nominal interest rate of 6%. Debt-deficit adjustments are assumed to be equal to zero.

**Table 8****Projections of elderly dependency ratio**

	1990	2000	2010	2020	2030
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	27.6	26.9	29.1	35.6	39.4

Source: Bos, E. (1994), World population projections 1994-95, World Bank, Washington, D. C.

**Table 9****(a) Sweden: Exchange rate stability**

Membership of the exchange rate mechanism (ERM)	No	
Devaluation of bilateral central rate on country's own initiative	No	
Maximum and minimum upward deviations <sup>1)</sup>	Maximum upward deviation	Maximum downward deviation
<i>1 April 1998 to 31 December 1998 (ERM currencies): <sup>2)</sup></i>		
Belgian franc	0.4	-12.6
Danish krone	0.4	-12.9
Deutsche Mark	0.4	-12.6
Spanish peseta	0.5	-12.5
French franc	0.4	-12.6
Irish pound	0.4	-11.5
Italian lira	0.5	-12.4
Dutch guilder	0.4	-12.4
Austrian schilling	0.4	-12.6
Portuguese escudo	0.4	-12.5
Finnish markka	0.4	-12.3
<i>Non-ERM currencies:</i>		
Greek drachma	0.5	-16.8
Pound sterling	4.2	-3.2
<i>4 January 1999 to 31 March 2000 (ERM II currencies): <sup>3)</sup></i>		
euro	8.3	-1.5
<i>For information only:</i>		
Danish krone	8.3	-1.4
Greek drachma	11.2	-1.1
Pound sterling	0.9	-9.0

Sources: BIS and ECB calculations.

Note: ERM II replaced the ERM from the beginning of 1999.

1) Daily data at business frequency, ten-day moving average.

2) Maximum upward (+) and downward (-) deviations from April 1998 in bilateral exchange rates against the currencies shown (in %).

3) Maximum upward (+) and downward (-) deviations from January 1999 in bilateral exchange rates against the currencies shown (in %).

**(b) Key indicators of exchange rate pressure for the Swedish krona**

Average of three months ending	1998 June	1998 Sep.	1998 Dec.	1999 Mar.	1999 June	1999 Sep.	1999 Dec.	2000 Mar.
Exchange rate volatility <sup>1)</sup>	5.2	8.1	12.4	7.2	5.1	4.5	5.5	5.7
Short-term interest rate differentials <sup>2)</sup>	0.5	0.4	0.3	0.2	0.3	0.4	0.3	0.5

Sources: National data and ECB calculations.

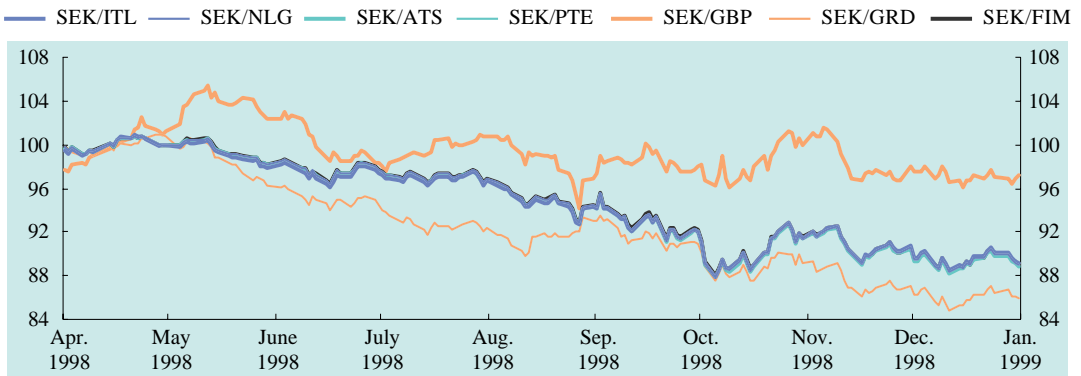
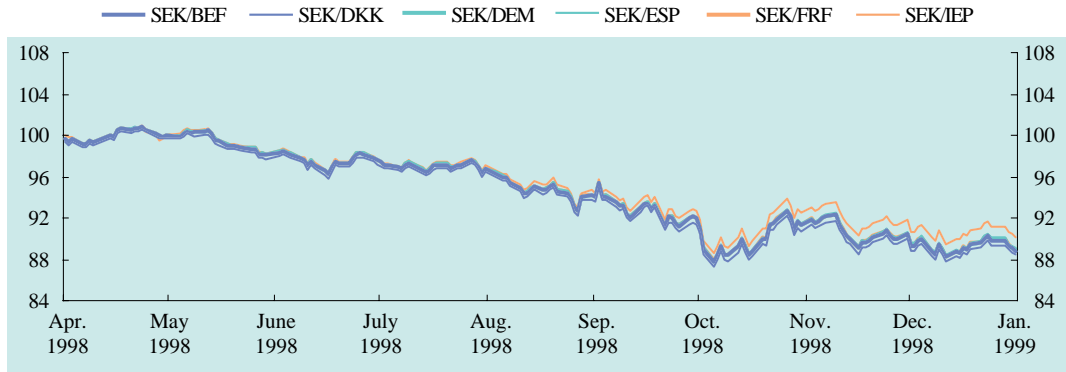
1) Annualised monthly standard deviation of daily percentage changes of the exchange rate against the Deutsche Mark for 1998 and against the euro from 4 January 1999, in percentages.

2) Differential of three-month interbank interest rates against weighted average of euro area interbank deposit bid rates, in percentage points.

### Chart 6a

#### Swedish krona: Bilateral exchange rates 1998

(daily data; average of April 1998=100; 1 April 1998 to 31 December 1998)

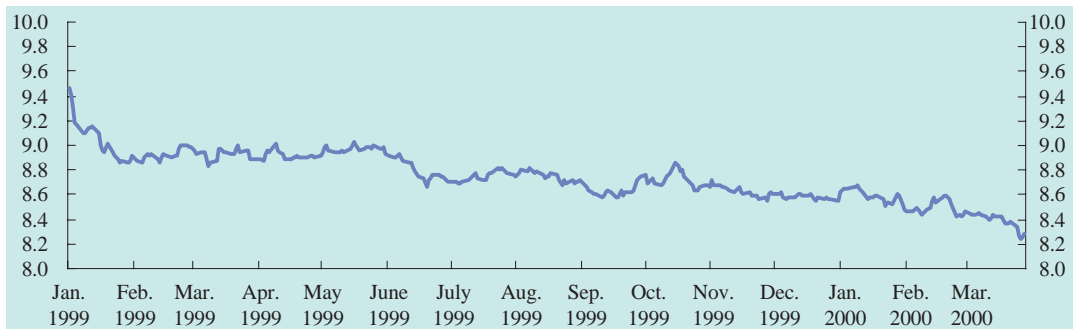


Source: BIS.

### Chart 6b

#### Swedish krona: Exchange rate against the euro from January 1999 to March 2000

(daily data; 4 January 1999 to 31 March 2000)

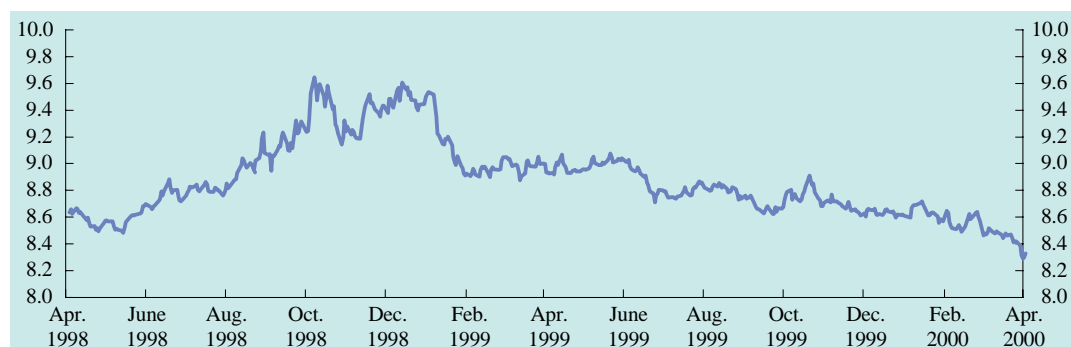


Source: ECB.

### Chart 6c

#### Swedish krona: Exchange rate against the ECU/euro from April 1998 to March 2000

(daily data; 1 April 1998 to 31 March 2000)



Sources: BIS and ECB.

### Table 10

#### Swedish krona: Measures of the real effective exchange rate vis-à-vis EU Member States

(quarterly data; percentage deviations; 1999 Q4 compared with different benchmark periods)

	Average 1974-99	Average 1989-99	Average 1987
Real effective exchange rates:			
Unit wage costs (total economy)-based	-6.6	-2.0	0.9
Private consumption deflator-based	-6.7	-5.1	-3.4
GDP deflator-based	-12.8	-6.8	-9.0
Exports of goods and services deflator-based	-12.2	-5.8	-10.4
Memo item:			
Nominal effective exchange rate	-20.5	-5.4	-15.7

Sources: European Commission and ECB calculations.

Note: A positive (negative) sign indicates an appreciation (depreciation).

**Table 11****Sweden: External developments***(as a percentage of GDP)*

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current account plus capital account	-2.8	-1.9	-3.4	-2.1	0.4	2.0	2.7	2.9	3.4	1.9
Net foreign assets (+) or liabilities (-)	n.a.	n.a.	-36.8	-43.8	-42.1	-33.5	-39.3	-42.6	-39.2	-34.0
Exports of goods and services	29.6	27.9	27.9	32.2	35.8	39.6	39.1	42.5	43.9	43.7
Imports of goods and services	29.6	26.4	26.3	28.6	31.6	33.7	32.3	35.8	37.5	38.0
Intra-EU exports (goods only) <sup>1)</sup>	62.0	62.0	68.4	64.6	58.6	59.6	57.1	55.6	56.0	-
Intra-EU imports (goods only) <sup>1)</sup>	62.9	63.1	69.4	68.6	64.8	68.6	68.5	67.7	67.8	-

Sources: Eurostat (current account plus capital account, exports and imports of goods and services, 1990-97, intra-EU exports and imports), national data (exports and imports of goods and services, current account, 1998-99, foreign assets and liabilities) and ECB calculations.

1) As a percentage of total exports and imports.

**Table 12****Sweden: Long-term interest rates***(percentages)*

	1998	1999	2000 Jan.	2000 Feb.	2000 Mar.	Apr. 1999 to Mar. 2000
Long-term interest rate	5.0	5.0	6.0	5.9	5.5	5.4
Reference value	6.6	6.8	-	-	-	7.2
Euro area average	4.7	4.6	5.7	5.7	5.5	5.0

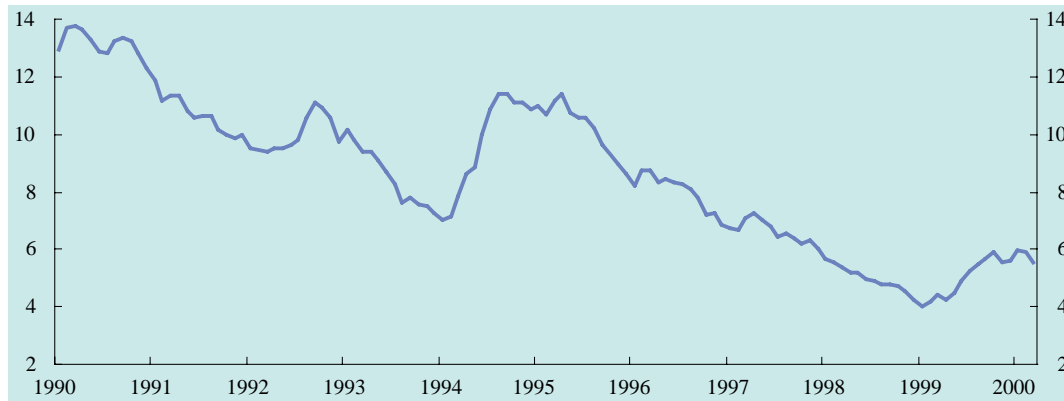
Source: European Commission.

Note: The reference value is based on the three best-performing Member States in terms of price stability (Austria, France and Sweden for the period from April 1999 to March 2000) plus 2 percentage points. The euro area average is included for information only.

## Chart 7

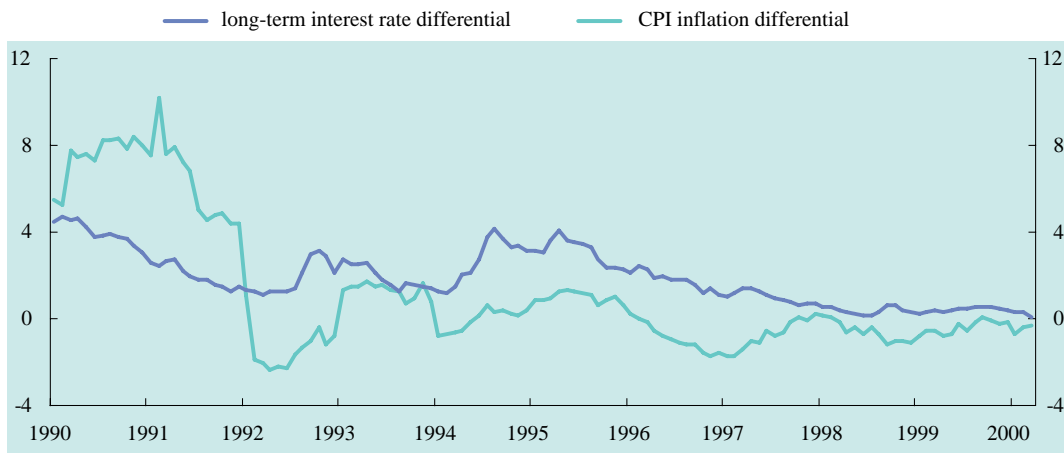
### (a) Sweden: Long-term interest rate

(monthly averages in percentages)



### (b) Sweden: Long-term interest rate and CPI inflation differentials vis-à-vis EU Member States with the lowest long-term interest rates<sup>1)</sup>

(monthly averages in percentages)



Sources: Interest rates: European Commission (where these are not available, the most comparable data have been used); the CPI data are non-harmonised national data.

1) Includes Austria, France, Germany, Luxembourg and the Netherlands.



## **Annex: Statistical methodology on convergence indicators**

This annex provides information on the statistical methodology of the convergence indicators and details of the harmonisation achieved in these statistics.

### ***Consumer prices***

Protocol No. 21 on the convergence criteria referred to in Article 121 of the Treaty establishing the European Community (the "Treaty") requires price convergence to be measured by means of the Consumer Price Index on a comparable basis, taking into account differences in national definitions. Although current consumer price statistics in the Member States are largely based on similar principles, there are considerable differences of detail and these affect the comparability of the national results.

The conceptual work on the harmonisation of Consumer Price Indices is carried out by the European Commission (Eurostat) in close liaison with the National Statistical Institutes (NSIs). As a key user, the ECB has been closely involved in this work, as was its predecessor, the EMI. In October 1995 the EU Council adopted a Regulation concerning Harmonised Indices of Consumer Prices (HICPs), which serves as the framework for further detailed harmonisation measures.

The first HICPs were released by Eurostat in 1997. The harmonisation measures introduced for HICPs have been based on several European Commission and EU Council Regulations. HICPs use a common coverage in terms of the items, the territory and the population included (all three issues are major reasons for differences between national Consumer Price Indices). Further common standards have been established in several areas (for example, the treatment of new goods and services). Some of these common rules are minimum standards and are expected to be further developed in the years ahead.

According to two EU Council Regulations adopted in July 1998, the coverage of HICPs has been further extended and harmonised in all Member States with effect from January 2000. The annual rates of inflation from January to March 2000 reflect this change only partially, since the change in coverage was incorporated in January 2000 and, in general, no revision of data for 1999 or earlier periods has been carried out.

The HICP for Greece was also revised for 1999 in order to reflect more up-to-date expenditure weights referring to 1998 and the entire domestic consumption. The revision of the weighting pattern of the index from 1999 had a downward effect of around 0.2 percentage point on the annual inflation rate in 1999 compared with 1998.

HICPs are used for measuring consumer price convergence in this Report. Furthermore, the HICP covering the euro area as a whole is the main measure of consumer prices for the single monetary policy of the ECB from January 1999 onwards.

### ***Public finances***

Protocol No. 20 on the excessive deficit procedure annexed to the Treaty, together with an EU Council Regulation of November 1993 as amended in February 2000, define "government", "surplus/deficit", "interest expenditure", "investment", "debt" and "gross domestic product (GDP)" by reference to the European System of Accounts (ESA). While the ESA, second edition, was the statistical standard for the first Convergence Report, from 2000 onwards the excessive deficit procedure is to be based on the new European System of Accounts 1995 (ESA 95), as laid down in a Council Regulation. The ESA 95 is consistent with other international standards such as the System of National Accounts 1993 (SNA 93).

“Government” comprises central government, state government (in Member States with a federal structure), regional or local government and social security funds. It does not include public enterprises and is therefore to be distinguished from a more broadly defined public sector.

“Government surplus/deficit” is the net lending/net borrowing. It is the difference between government receipts and government expenditure. “Government debt” is the sum of the outstanding gross liabilities at nominal value as classified in the ESA 95 categories currency and deposits, securities other than shares excluding financial derivatives (e.g. government bills, notes and bonds), and loans. Government debt does not cover financial derivatives such as swaps, trade credits and other liabilities which are not represented by a financial document such as overpaid tax advances, nor does it include contingent liabilities such as government guarantees and pension commitments. While government debt is a gross concept in the sense that assets are not deducted from liabilities, it is consolidated within the government sector and does not therefore include government debt held by other government units.

The definitions of government deficit and government debt imply that the change in government debt outstanding at the end of two consecutive years may differ substantially from the size of the government deficit for the year under consideration. For example, government debt may be reduced by using the receipts from privatising public enterprises or by selling other financial assets without any (immediate) impact on the government deficit. Conversely, the government deficit may be reduced by substituting loans provided by government or the participation of government in public enterprises for transfers payable without any immediate impact on government debt. The explanation of the difference between the deficit and the change in government debt, the “deficit-debt adjustment”, is also important for assessing the statistical quality of the reported data.

The “gross domestic product (GDP)” used for compiling deficit and debt ratios is the ESA 95 GDP.

Since the beginning of 1994 EU Member States have been reporting data related to the government deficit and government debt to the European Commission at least twice a year. The Treaty gives responsibility for providing the statistical data to be used for the excessive deficit procedure to the European Commission. Against this background, the Statistical Office of the European Communities (Eurostat) monitors the consistency of the statistical data reported in accordance with the ESA 95. A detailed explanation of the application of the ESA 95 is provided in the Manual on Government Deficit and Debt issued at the beginning of 2000 after approval by the Committee on Monetary, Financial and Balance of Payments Statistics (CMFB), which includes representatives of Member States’ national central banks and NSIs.

### **Exchange rates**

Exchange rates of the currencies of the Member States under review vis-à-vis the euro are daily reference rates recorded by the ECB at 2.15 p.m. (following the daily concertation procedure between central banks). These reference exchange rates are published by the ECB on its website and are also available via electronic market information providers. Exchange rates vis-à-vis the ECU are daily official rates as published in the Official Journal of the European Communities. European cross rates used throughout this Report are derived from these euro/ECU exchange rates. The nominal and real effective exchange rates, to which the Report refers, are based on series calculated by the European Commission.

### **Long-term interest rates**

Protocol No. 21 on the convergence criteria referred to in Article 121 of the Treaty

requires interest rate convergence to be assessed on the basis of long-term government bonds, or comparable securities, observed over a period of one year before the assessment, taking into account differences in national definitions.

While Article 5 of Protocol No. 21 assigns responsibility for providing the statistical data for the application of the Protocol to the European Commission, assistance was provided by the EMI in defining representative long-term interest rate statistics, given its expertise in the area, and in collecting the data from the central banks for transmission to the European Commission. The ECB has continued the EMI's assistance.

Although the methodology for calculating the yields of bonds is similar across Member States, considerable differences existed in long-term interest rate statistics in respect of the choice of securities, the yield formulae used, the maturities chosen, the treatment of taxation and adjustments for coupon effects. The purpose of the harmonisation exercise carried out by the EMI was to make recommendations, in particular with regard to these choices, which would be general enough to allow for differences in national markets and yet flexible enough to allow those markets to evolve, without the comparability of data being impaired.

The harmonisation principles were that the issuer of bonds should be the central government, with fixed coupon securities of close to ten years to maturity, and that yields should be measured gross of tax. To ensure that the depth of the market is taken into account, and that no liquidity premium is carried into the yield, the representative securities should be chosen on the basis of their high liquidity. Responsibility for this choice is a matter for the Member States. Since end-December 1997 11 countries have been using a benchmark bond and four a sample of bonds, taking the liquidity of the market at the ten-year point as the determining factor. "Special feature" bonds (e.g. embedded option and zero coupon) are

excluded from the assessment. The selection of highly liquid bonds is also seen as an effective indirect means by which to minimise the effects of different coupon values. Finally, a uniform formula was chosen from existing international standards, namely formula 6.3 from the "formulae for yield and other calculations" of the International Securities Market Association. Where there is more than one bond in the sample, the liquidity of the selected bonds warrants the use of a simple average of the yields to produce the representative rate. The aim of these changes was to focus on the statistical measurement of the perceived durability of convergence. As mentioned above, the production of the harmonised representative long-term interest rates has been implemented by the central banks, and fully harmonised data are used in this Report.

#### **Other factors**

The last paragraph of Article 121 (1) of the Treaty states that the reports of the European Commission and the ECB shall, in addition to the four main criteria, also take account of the development of the ECU, the results of the integration of markets, the situation and development of the balances of payments on the current account and an examination of the development of unit labour costs and other price indices.

Whereas for the four main criteria Protocol No. 21 describes the data to be used in more detail and stipulates that the European Commission will provide the data to be used for the assessment of compliance with these criteria, there is no reference to these "other factors" in the Protocol.

With regard to balance of payments and net foreign assets and liabilities, the data used are compiled by the respective national central bank following the IMF Balance of Payments Manual, fifth edition, for recent years (1997 to 1999 for Greece, and 1998 and 1999 for Sweden). Previous years have been compiled by the European Commission

(Eurostat) according to previous standards (fourth edition of the IMF Balance of Payments Manual) and proxies.

Unit labour cost data as well as national accounts deflators are derived from data provided under the ESA 95. Producer price indices are based on definitions, which provide broadly comparable results among Member States and refer to domestic sales of the manufacturing sector.

**Cut-off date**

The cut-off date for the statistics included in this Convergence Report was 14 April 2000, with the exception of the HICPs published by the European Commission (Eurostat) on 18 April 2000.



## **Chapter III**

# **Compatibility of national legislation with the Treaty**

## I Introduction

### I.1 General remarks

Article 122 (2) of the Treaty,<sup>1</sup> read in conjunction with Article 121 (1), requires the ECB (as well as the European Commission) to report at least once every two years on, inter alia, the compatibility between the national legislation of each Member State with a derogation, including the statutes of its national central bank (NCB), and Articles 108 and 109 of the Treaty and the Statute of the ESCB<sup>2</sup> (in this Report also referred to as “legal convergence”). In the light of these Treaty provisions, the ECB has examined the legal situation in Greece and Sweden and the legislative measures which have been taken and/or need to be taken by these Member States with a view to achieving compatibility of their national legislation with the Treaty and the Statute of the ESCB. The results of this examination are presented below.

This Report draws on the EMI’s previous reports on legal convergence: in particular, the EMI’s Convergence Report of March 1998, but also the 1995 and 1996 reports on “Progress towards convergence” and the legal update thereof dated October 1997. For the sake of brevity, the content of this chapter is deliberately condensed; the examination of the compatibility of national legislation takes, as a starting-point, the observations made in the 1998 EMI Convergence Report and goes on to consider the legislative amendments enacted, or in the process of being enacted, in Greece and Sweden. Accordingly, the following text should be read in conjunction with the relevant parts of the EMI’s previous reports on legal convergence in the EU Member States and, in particular, the 1998 EMI Convergence Report for further clarification.

### I.2 Denmark and the United Kingdom

This Report is restricted to Greece and Sweden, since Denmark and the United Kingdom are Member States with a special status.

Protocol No. 26 of the Treaty on certain provisions relating to Denmark states that the Danish Government shall notify the EU Council of its position concerning participation in Stage Three of EMU before the Council makes its assessment under Article 121 (2) of the Treaty. Denmark has already given notification of the fact that it will not participate in Stage Three of EMU. In accordance with Article 2 of Protocol No. 26, this means that Denmark is treated as a Member State with a derogation. Implications thereof for Denmark were elaborated in a Decision taken by the Heads of State or Government at their Edinburgh summit meeting on 11 and 12 December 1992. This Decision states that Denmark retains its existing powers in the field of monetary policy according to its national laws and regulations, including the powers of Danmarks Nationalbank in the field of monetary policy. As Article 108 of the Treaty, in accordance with Article 122 (3) of the Treaty, applies to Denmark, Danmarks Nationalbank has to fulfil the requirements of central bank independence. In the 1998 EMI Convergence Report it was concluded that this requirement had been fulfilled; this position has not changed. The legal integration of Danmarks Nationalbank does not need to be provided for and other legislation does not need to be adapted as long as Denmark does not notify that it intends to adopt the single currency.

According to Protocol No. 25 of the Treaty on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland, the United Kingdom shall be under no obligation to move to Stage Three of EMU unless it notifies the Council that it intends to do so. Pursuant to the notification given by the United Kingdom to the Council on 30 October 1997 that it did not intend to

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<sup>1</sup> References to the Treaty and to the Statute of the ESCB are references to the Treaty establishing the European Community (as amended by the Treaty of Amsterdam) and to the Statute of the European System of Central Banks and of the European Central Bank, unless otherwise indicated.

<sup>2</sup> See footnote 1.

adopt the single currency on 1 January 1999 (a situation which has not changed), certain provisions of the Treaty (including Articles 108 and 109) and of the Statute of the ESCB do not apply to the United

Kingdom. Accordingly, there is no current legal requirement to ensure that national legislation (including the Statute of the Bank of England) is compatible with the Treaty and the Statute of the ESCB.

## 2 Scope of adaptation

### 2.1 Areas of adaptation

For the purpose of identifying those areas in which adaptation of national legislation is necessary, a distinction is made between:

- the independence of NCBs (see in particular Article 108 of the Treaty and Articles 7 and 14.2 of the Statute of the ESCB);
- the legal integration of NCBs into the ESCB (see in particular Articles 12.1 and 14.3 of the Statute of the ESCB); and
- legislation other than statutes of NCBs.

### 2.2 Central bank independence

The 1998 EMI Convergence Report dealt extensively with central bank independence. It stated, inter alia, that incompatibilities in this area needed to be effectively removed at the latest on the date of the ESCB's establishment (i.e. on 1 June 1998), which implied that the respective amendments should not only have been adopted, but should also have entered into force by that date. With regard to Greece, the EMI concluded that this requirement had been fulfilled and that there were no remaining incompatibilities in the area of central bank independence. A review of the present situation (see Section 5.1 below) shows that this has not changed. With regard to Sweden, the EMI noted that the above requirement had not been fulfilled, since amendments to the Statute of Sveriges Riksbank, purported to ensure its independence, were still pending before Parliament and would only enter into force on 1 January 1999. The EMI also

concluded that, if the amendments entered into force as they were presented to the EMI in a consultation procedure under Article 117 of the Treaty, there would be no remaining incompatibilities in the area of central bank independence. A review of the present situation (see Section 5.2 below) shows that, although minor changes of a mainly presentational nature have occurred, the amendments indeed entered into force on 1 January 1999 and there are, therefore, no remaining incompatibilities in the area of central bank independence. Therefore, this Report will not reproduce the features of central bank independence described extensively in the 1998 EMI Convergence Report to which reference may be made.

### 2.3 'Compatibility' versus 'harmonisation'

Article 109 of the Treaty requires national legislation to be "compatible" with the Treaty and the Statute of the ESCB. The term "compatible" indicates that the Treaty does not require "harmonisation" of the statutes of the NCBs, either inter se or with that of the ESCB. National particularities may continue to exist. Indeed, Article 14.4 of the Statute of the ESCB permits NCBs to perform functions other than those specified in the Statute of the ESCB, to the extent that these do not interfere with the objectives and tasks of the ESCB. Provisions enabling such additional functions would be a clear example of circumstances in which differences in the statutes of NCBs may continue to exist. Rather, the term "compatible" implies that national legislation and the statutes of the NCBs need to be adjusted in order to eliminate inconsistencies with the Treaty and



the Statute of the ESCB and to ensure the necessary degree of integration of the NCBs into the ESCB. In particular, while national traditions may continue to exist, all provisions which infringe on an NCB's independence as defined in the Treaty and its role as an integral part of the ESCB have to be adjusted. The Treaty and the Statute of the ESCB require the removal of incompatibilities with the Treaty and the Statute of the ESCB in national legislation. Neither the supremacy of the Treaty and the Statute of the ESCB over national legislation nor the nature of the incompatibility affects this obligation.

The obligation in Article 109 of the Treaty extends only to incompatibilities with the provisions of the Treaty and Statute of the ESCB. Therefore, this Report does not, for instance, address the necessary adaptations of national legislation relating to the

introduction of the euro flowing from the EU Council Regulations on this topic, such as the replacement of national banknotes and coins by euro banknotes and coins and the legal aspects thereof.<sup>3</sup> However, national legislation which is incompatible with secondary EC or ECB legislation will, of course, also have to be brought into line with such secondary legislation. This general requirement derives from the case law of the European Court of Justice.

Finally, the Treaty and the Statute of the ESCB do not prescribe the manner in which national legislation needs to be adapted. This may be achieved by references to the Treaty and the Statute of the ESCB, by the incorporation of provisions thereof, by the simple deletion of incompatibilities or by a combination of these methods.

### 3 Legal integration of NCBs into the ESCB

Article 14.3 of the Statute of the ESCB states, inter alia, that fully participating NCBs shall be an integral part of the ESCB and shall act in accordance with the guidelines and instructions of the ECB. Provisions in national legislation (particularly in the statutes of NCBs) which would prevent the execution of ESCB-related tasks or compliance with decisions of the ECB would be incompatible with the effective operation of the ESCB. Therefore, adaptations to national legislation and NCB statutes are necessary to ensure compatibility with the Treaty and the Statute of the ESCB. In order to comply with Article 109 of the Treaty, national legislative procedures had to be accomplished in such a way that the compatibility of national legislation is ensured by the date of the establishment of the ESCB. However, such statutory requirements relating to the full legal integration of NCBs into the ESCB need only enter into force at the moment that full integration of an NCB into the ESCB becomes effective, i.e. in the case of a Member State with a derogation, the date on which it adopts the single currency. The main areas for

attention are those in which statutory provisions may obstruct compliance by an NCB with the requirements of the ESCB or fulfilment by a governor of his or her duties as a member of the Governing Council of the ECB, or where statutory provisions do not respect the prerogatives of the ECB. Below, a distinction is made between those areas of which the statutes of NCBs are usually composed: statutory objectives, tasks, instruments, organisation and financial provisions.

#### 3.1 Statutory objectives

The full integration of NCBs into the ESCB requires that their (primary and secondary) statutory objectives be compatible with the ESCB's objectives as laid down in Article 2 of the Statute of the ESCB. This means, inter alia, that statutory objectives with a "national

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<sup>3</sup> See Council Regulation (EC) No. 1103/97 of 17 June 1997 on certain provisions relating to the introduction of the euro and Council Regulation (EC) No. 974/98 of 3 May 1998 on the introduction of the euro.

flavour” – for example, those referring to an obligation to conduct monetary policy within the framework of the general economic policy of the Member State concerned – need to be adapted.

### 3.2 Tasks

The tasks of an NCB of a fully participating Member State are predominantly determined by its status as an integral part of the ESCB and, thus, by the Treaty and the Statute of the ESCB. In order to comply with Article 109 of the Treaty, provisions on tasks in the statutes of NCBs therefore need to be compared with the relevant provisions of the Treaty and the Statute of the ESCB<sup>4</sup> and incompatibilities need to be removed. This applies to any provisions which, after adoption of the euro and integration into the ESCB, constitute an impediment to the execution of ESCB-related tasks and, in particular, to provisions which do not respect the ECB’s competences under Chapter IV of the Statute of the ESCB.

### 3.3 Instruments

The statute of an NCB will naturally contain provisions on monetary policy instruments. Again, national provisions on such instruments are to be compared with those contained in the Treaty and the Statute of the ESCB. Incompatibilities need to be removed in order to comply with Article 109 of the Treaty.

### 3.4 Organisation

In addition to the prohibition on giving, accepting or soliciting instructions as laid

down in Article 108 of the Treaty, there must be no mechanisms in the statutes of NCBs which could either bind a governor in his or her voting behaviour in the Governing Council of the ECB in which he or she acts in the separate capacity as a member of that Council, or prevent an NCB’s decision-making bodies from complying with rules adopted at the level of the ECB.

### 3.5 Financial provisions

Financial provisions in the Statute of the ESCB, which may be of particular relevance as far as the identification of incompatibilities in the statutes of NCBs is concerned, may be divided into rules on accounting,<sup>5</sup> auditing,<sup>6</sup> capital subscriptions,<sup>7</sup> the transfer of foreign reserve assets<sup>8</sup> and monetary income.<sup>9</sup> These rules imply that NCBs need to be able to comply with their obligations under the relevant Articles of the Treaty and the Statute of the ESCB.

### 3.6 Miscellaneous

In addition to the above-mentioned issues, there may be other areas in which the adaptation of the statutes of NCBs is required. For example, the obligation of professional secrecy for staff of the ECB and NCBs as laid down in Article 38 of the Statute of the ESCB may also have an impact on similar provisions in the statutes of NCBs.

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4 In particular Articles 105 and 106 of the Treaty and Articles 3 to 6 of the Statute of the ESCB.

5 Article 26 of the Statute of the ESCB.

6 Article 27 of the Statute of the ESCB.

7 Article 28 of the Statute of the ESCB.

8 Article 30 of the Statute of the ESCB.

9 Article 32 of the Statute of the ESCB.

## 4 Legislation other than the statutes of NCBs

The obligation of legal convergence under Article 109 of the Treaty, which is incorporated in a chapter entitled “Monetary policy”, applies to those areas of legislation which are affected by the full participation of a Member State in Stage Three of EMU and which would be incompatible with the Treaty and Statute of the ESCB if they were to remain unchanged. The ECB’s assessment in this field focuses in particular on laws with an impact on an NCB’s performance of ESCB-related tasks and laws in the monetary field. Again, in order to comply with Article 109, national legislative procedures had to be accomplished in such a way that the compatibility of national legislation was ensured by the date of the establishment of the ESCB. However, any incompatibilities will need to be effectively removed by the date on which a Member State adopts the euro. Relevant legislation requiring adaptation may, in particular, be found in the following areas.

### 4.1 Banknotes

The currency acts and other legal provisions of a Member State assigning the exclusive right to issue banknotes to their NCBs must recognise the Governing Council’s exclusive right to authorise the issuance of banknotes as laid down in Article 106 (1) of the Treaty and repeated in Article 16 of the Statute of the ESCB. In addition, provisions enabling governments to exert influence on issues such as the denominations, production, volume and withdrawal of banknotes must recognise the ECB’s powers with regard to the euro banknotes as laid down in the aforementioned Articles of the Treaty and Statute of the ESCB.

### 4.2 Coins

A Member State may have laws on the issuance, production and distribution of coins. The government or, more specifically, the minister of finance may have the exclusive

right to mint coins, while the NCBs may be involved in their distribution. Alternatively, the right to print banknotes and mint coins may be combined within an NCB. Irrespective of the division of responsibilities in this field between governments and NCBs, the relevant provisions have to recognise the ECB’s power of approval of the volume of issuance of coins.

### 4.3 Foreign reserve management

One of the main tasks of the ESCB is to hold and manage the official foreign reserves of the Member States (Article 105 (2), third indent, of the Treaty). Member States which do not transfer their official foreign reserves to their NCB are in breach of this requirement of the Treaty (with the exception of foreign exchange working balances, which the governments of the Member States may keep under Article 105 (3) of the Treaty). In addition, the right of a third party – for example, the government or parliament – to influence decisions of an NCB with regard to the management of the official foreign reserves would (under Article 105 (2), third indent, of the Treaty) not be in conformity with the Treaty. Furthermore, NCBs have to provide the ECB with foreign reserve assets in proportion to their shares in the subscribed capital of the ECB. This means that there must be no statutory obstacles to the NCBs transferring foreign reserve assets to the ECB.

### 4.4 Exchange rate policy

National legislation of a Member State with a derogation may provide that the government be responsible for the exchange rate policy of that Member State, with a consultative and/or executive role being granted to the respective NCB. The statutory provisions have to reflect, however, the fact that the responsibility for the euro area’s exchange rate policy has been transferred to the Community level in accordance with

Article 111 of the Treaty, which assigns the responsibility for such policy to the EU Council in close co-operation with the ECB.

#### 4.5 Miscellaneous

There are many other areas in which legislation may have an impact on an NCB's performance of ESCB-related tasks. For example, Member States are free to organise their respective NCBs under public or private law, but provisions governing the legal status

of an NCB – in the latter case, for instance, company law – may not infringe on the requirements of the Treaty and the Statute of the ESCB for full participation in Stage Three of EMU. Furthermore, the confidentiality regime of the ESCB is governed by Article 38 of the Statute of the ESCB. The supremacy of Community law and rules adopted thereunder implies that national laws on access of third parties to public documents may not lead to infringements of the ESCB's confidentiality regime.

## 5 Country assessments

The above-mentioned listing of areas of particular importance in respect of the adaptation of statutes of the NCBs and other legislation with a view to the requirements of the Treaty and the Statute of the ESCB for full participation of a Member State in Stage Three of EMU may serve as a basis for an assessment of the state of affairs in Greece and Sweden in this respect.

### 5.1 Greece

#### 5.1.1 Introduction

The Statute of the Bank of Greece was amended to meet the requirements of the Treaty and the Statute of the ESCB for Stage Three of EMU, which were introduced with Law 2548 dated 12 December 1997, published in the Government Gazette on 19 December 1997. Law 2548/1997 was incorporated into the Bank's Statute through a decision of the Bank's Extraordinary Meeting of Shareholders held on 22 December 1997. In accordance with Article 7 of the Bank's Statute, this decision was later ratified by Parliament through Law 2609/1998, which was published in the Government Gazette on 11 May 1998. The EMI concluded in its March 1998 Convergence Report that, with the adoption and entry into force of Law 2548/1997, there were no remaining incompatibilities with the requirements of the Treaty and the Statute

of the ESCB concerning central bank independence in the Statute of the Bank of Greece. The law addressed both the period during which the Bank of Greece is not an integral part of the ESCB as well as the situation in which Greece will have adopted the euro. The EMI also concluded, however, that there were still two imperfections in the Statute of the Bank of Greece, as meanwhile contained in Law 2609/1998 (see above), which required adaptation before Greece adopts the euro. Some of the provisions of the law will become obsolete upon the adoption by Greece of the euro. This applies to the following provisions:

- Article 2.4 on the Bank's participation in international monetary and economic organisations does not refer to the ECB's power of approval;
- Article 7.4 on the imposition of minimum reserves and penalties in the case of non-compliance does not recognise the ECB's powers in this field.

#### 5.1.2 Legal integration into the ESCB

Following the findings of the 1998 EMI Convergence Report, the Statute of the Bank of Greece was amended on 25 April 2000 to meet the requirements of the Treaty and the Statute of the ESCB for the full legal

integration of the Bank of Greece into the ESCB. On 24 March 2000 the Bank of Greece submitted a draft proposal to the ECB for consultation under Article 105 (4), second indent, of the Treaty as repeated in Article 4 (a), second indent, of the Statute of the ESCB. On 12 April 2000 the Bank of Greece submitted amendments to the above draft proposal to the ECB for inclusion in the consultation procedure. The draft proposal aimed to amend the Statute of the Bank of Greece. On 26 April 2000 the Bank of Greece confirmed that its General Assembly of Shareholders had endorsed the amendments to the Statute at its meeting on 25 April 2000. The new Statute of the Bank of Greece will, again (as in the case of Law 2548/1997; see paragraph 5.1.1 above), have to be ratified by Parliament through a law. It is expected that the new Statute of the Bank of Greece will be ratified by the Greek Parliament shortly after 25 April 2000 and published well in advance of 31 December 2000 in the Government Gazette. The envisaged date of entry into force is 1 January 2001.

The amendments to the Statute of the Bank of Greece are aimed at removing the two above imperfections as well as at a further fine-tuning of the Bank of Greece's legal integration into the Eurosystem. The imperfection in Article 2.4 is remedied in Article 2, last indent, of the new Statute, through explicit recognition of the fact that, in accordance with Article 6.2 of the Statute of the ESCB, participation in international monetary institutions is subject to approval of the ECB. The imperfection in Article 7.4 is remedied in Article 55, No. 21 (2), of the new Statute, which explicitly recognises that, after the adoption of the euro by Greece, the competence to impose minimum reserves and related matters is governed exclusively by the ESCB's regulatory framework.

Furthermore, the amendments to the Statute also address other issues of importance to the Bank of Greece and update core provisions of its Statute in view of full participation of the Bank of Greece in the ESCB. First, the amendments to the Statute

emphasise the Bank of Greece's future status as an integral part of the ESCB by recognising that all ESCB-related tasks are performed in accordance with the provisions of the Statute of the ESCB. Second, the amendments have improved the legal status of collateral taken for central bank purposes by the Bank of Greece on its own behalf or on behalf of other NCBs or the ECB, since they codify provisions stipulating prerogatives in the establishment and realisation of collateral taken by the Bank of Greece.

The ECB notes that Law 2548/1997 became obsolete after the adoption of Law 2609/1998 with regard to provisions which are incompatible with the amended Statute as currently contained in Law 2609/1998. While, in accordance with the principle "lex posterior derogat priori" and under Article 28 of the Greek Constitution, Law 2609/1998 (as amended in the future) would prevail over Law 2548/1997, the ECB notes that Article 109 of the Treaty nevertheless requires, for reasons of legal clarity and certainty, the removal of obsolete provisions. The ECB has been informed by the Bank of Greece that the Greek legislative authorities intend to do so in the law ratifying the new Statute of the Bank of Greece, on which the ECB will also have to be consulted under Article 105 (4), second indent, of the Treaty as repeated in Article 4 (a), second indent, of the Statute of the ESCB. In this connection, the ECB notes that, in its view, the legislative procedures to repeal the relevant provisions of Law 2548/1997 need to be accomplished as a matter of urgency.

Assuming that the new Statute of the Bank of Greece will be ratified by Parliament and that it will enter into force on time, as it was presented to the ECB in the above consultation procedure, and assuming that Law 2548/1997 will be adapted accordingly (which in the ECB's view, needs to be accomplished as a matter of urgency), there will be no remaining imperfections in the Statute of the Bank of Greece relating into the requirements of the Treaty and the Statute of the ESCB for the full legal integration of the Bank of Greece into the ESCB.

### **5.1.3 Adaptation of other legislation**

As far as legislation other than the Statute of the Bank of Greece is concerned, the ECB was informed by the Bank of Greece on 24 March 2000 that adaptation of legislation is envisaged in the following areas: laws on currency and foreign exchange, law on coins, issuing of bonds, company law, taxation and agriculture. A co-ordinating drafting committee under the auspices of the Ministry of the National Economy will finalise an umbrella law on the introduction of the euro in accordance with lists of necessary amendments and suggestions submitted by the ministries and other institutions concerned. Such law will be submitted to the new Parliament after the April 2000 elections.

### **5.1.4 Assessment of compatibility**

On the assumption that the new Statute of the Bank of Greece will be ratified by Parliament and that it will enter into force on time, as it was presented to the ECB in a consultation procedure, and assuming that Law 2548/1997 will be adapted accordingly (which, in the ECB's view, needs to be accomplished as a matter of urgency), there will be no remaining imperfections in the Statute of the Bank of Greece relating to the requirements of the Treaty and the Statute of the ESCB for the full legal integration of the Bank of Greece into the ESCB.

As far as legislation other than the Statute of the Bank of Greece is concerned, the ECB takes note that such other legislation will be adapted in a law introducing the euro, on which the ECB will have to be consulted in accordance with Article 105 (4), second indent, of the Treaty, as repeated in Article 4 (a), second indent, of the Statute of the ESCB.

## **5.2 Sweden**

### **5.2.1 Introduction**

The following Acts were identified in the 1998 EMI Convergence Report as requiring adaptation under Article 109 of the Treaty:

- the Constitution Act;
- the Riksdag Act; and
- the Sveriges Riksbank Act (1988:1385), as amended.

The Constitution Act, the Riksdag Act and the Sveriges Riksbank Act have been adapted to meet the requirements of the Treaty and the Statute of the ESCB for the independence of Sveriges Riksbank. These adaptations entered into force on 1 January 1999. When the EMI prepared its Convergence Report in March 1998, it based its assessment of legal convergence in Sweden on the assumption that the draft legislation would be adopted as it stood at that time. The ECB has now reviewed current Swedish legislation and the country assessment for Sweden can, therefore, be restricted to the mention of any divergence in the current Swedish legislation from the assumption made by the EMI and the areas of incompatibility referred to by the EMI in 1998 which have not yet been addressed by Swedish law. Some further remarks are made in order to clarify the ECB's assessment.

The 1998 EMI Convergence Report stated that the timetable for adaptation was incompatible with Treaty requirements, since the adaptations in the area of central bank independence had to become effective on the date of the establishment of the ESCB at the latest (i.e. on 1 June 1998). This statement has now become obsolete, since the necessary amendments on central bank independence entered into force on 1 January 1999. However, further amendments will be required for the integration of Sveriges Riksbank into the ESCB (see below). It should be noted that some time will be required for the necessary further legislative amendments

for the adoption of the euro to be enacted, considering the relevant internal procedures to effectuate such changes in Swedish law.

The adaptations with regard to Sveriges Riksbank's independence introduced a new legal regime which meets the requirements of the Treaty and the Statute of the ESCB on central bank independence identified in the 1998 EMI Convergence Report. Only one divergence from the EMI's assumption in March 1998 in relation to Sveriges Riksbank's independence may be noted. The presentation of matters to be decided by the General Council of Sveriges Riksbank has changed slightly, compared with the initial proposal of the Swedish Government as it stood in March 1998. However, this change is not incompatible with the requirements of the Treaty and the Statute of the ESCB, since it is still clear that the General Council of Sveriges Riksbank (whose members do not fulfil the requirements of the Treaty and the Statute of the ESCB on central bank independence) cannot be involved in the performance of ESCB-related tasks.

### **5.2.2 Integration into the ESCB**

As referred to in the 1998 EMI Convergence Report, one area in which Swedish law, and the Sveriges Riksbank Act, remains incompatible with the requirements of the Treaty and the Statute of the ESCB for Stage Three of EMU and the adoption of the euro is the full integration of Sveriges Riksbank into the ESCB. No date for the adoption of the euro and the necessary legal adjustments is anticipated at present, although Sweden is not a Member State with a special status and must, therefore, comply with all adaptation requirements under Article 109 of the Treaty. The fact that Swedish law does not as yet anticipate Sveriges Riksbank's full integration into the ESCB implies that Sweden's legislation is still not compatible with Treaty requirements. This affects a number of provisions in Sveriges Riksbank's Statute, and will require a further thorough legislative review in Sweden before the adoption of the euro.

In this context, the ECB, first of all, notes and welcomes the new Chapter 1, Article 2, third paragraph, of the present Sveriges Riksbank Act, which contains the Bank's statutory objective and unambiguously reflects the primacy of maintaining price stability.

It may also be noted that the former Article 42 in the Sveriges Riksbank Act has now been replaced by a new provision in Chapter 6, Article 3, of the Act whereby, prior to Sveriges Riksbank making a monetary policy decision of major importance, the minister appointed by the Government shall be informed. Upon Sweden's adoption of the single currency, such an arrangement would not be appropriate, since important monetary policy decisions will not be taken by Sveriges Riksbank, but rather by the Governing Council of the ECB, which will include the Governor of Sveriges Riksbank.

In addition, the following areas of Swedish law, as already stated in the 1998 EMI Convergence Report, are incompatible with the Treaty and the Statute of the ESCB and are still to be addressed.

#### *(a) Tasks*

##### *Monetary policy*

Chapter 9, Article 12, of the Constitution Act and Chapter 1, Article 2, of the present Sveriges Riksbank Act, which establish Sveriges Riksbank's powers in the field of monetary policy, do not recognise the ECB's powers in this field.

##### *Issuance of banknotes*

Chapter 9, Article 13, of the Constitution Act and Chapter 5, Article 1, of the present Sveriges Riksbank Act, which establish the Bank's exclusive right to issue banknotes and coins, do not recognise the ECB's competence in this field.

(b) *Instruments*

Chapter 6, Article 6, and Chapter 11, Article 1, of the current Sveriges Riksbank Act, concerning the imposition of minimum reserves on financial institutions and the payment of a special fee to the State in the case of non-compliance with this requirement, do not respect the ECB's competence in this field.

(c) *Exchange rate policy*

Chapter 9, Article 11, of the Constitution Act and Chapter 7, Article 1, of the present Sveriges Riksbank Act, together with the new Act on Foreign Exchange Policy, provide a new regime for the Government's and Sveriges Riksbank's respective powers in the area of exchange rate policy. These provisions do not, however, acknowledge the competence of the EU Council and the ECB in this field under Article 111 of the Treaty.

**5.2.3 Adaptation of other legislation**

As stated above, Sweden is not a Member State with a special status. Thus, Article 109 of the Treaty is applicable to Sweden and also requires, since 1 June 1998, the

adaptation of other Swedish legislation, which should enter into force on the date of adoption of the euro by Sweden. This applies in particular to legislation on access to public documents and to the law on secrecy, which need to be reviewed in the light of the confidentiality regime under Article 38 of the Statute of the ESCB.

**5.2.4 Assessment of compatibility**

Swedish legislation, and in particular the Statute of Sveriges Riksbank, does not anticipate the Bank's legal integration into the ESCB, although Sweden is not a Member State with a special status and must, therefore, comply with all adaptation requirements under Article 109 of the Treaty. This affects a number of provisions in the Bank's Statute.

As far as legislation other than the Statute of Sveriges Riksbank is concerned, the ECB notes that legislation on access to public documents and the law on secrecy need to be reviewed in the light of the confidentiality regime under Article 38 of the Statute of the ESCB. The ECB is not aware of any other statutory provisions which would require adaptation under Article 109 of the Treaty.





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