COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 22.5.2002
COM(2002) 243 final

REPORT FROM THE COMMISSION

CONVERGENCE REPORT 2002
SWEDEN

(prepared in accordance with Article 122(2) of the Treaty)

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1. INTRODUCTION AND MAIN FINDINGS

1.1.Introduction

The move into the third stage of economic and monetary union (EMU) and the introduction of the single currency, the euro, on 1 January 1999 was a major step forward in European economic integration. It followed several years of successful but often difficult adjustment efforts by the Member States during the second stage of EMU to achieve the high degree of sustainable convergence required for EMU participation and needed for the stability and success of the new currency. The decision[1] by the Council (of Heads of State or Government) on 3 May 1998 in Brussels on the 11 Member States ready to participate in the single currency from the beginning had, in accordance with the Treaty (Article 121(4)), been prepared by the Ecofin Council on a recommendation from the Commission. The decision was based on the two convergence reports made by the Commission[2] and the European Monetary Institute (EMI).[3] These reports, prepared in accordance with Article 121(1) of the Treaty, examined in considerable detail whether the Member States satisfied the convergence criteria and met the legal requirements[4].

Those Member States which were assessed in 1998 as not fulfilling the necessary conditions for the adoption of the single currency were referred to as "Member States with a derogation". Two Member States fell into this category, Greece and Sweden. Article 122(2) of the Treaty lays down provisions and procedures for re-examining the situation of Member States with a derogation (see Box: Article 122(2)). At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank (ECB) are required to prepare new convergence reports on such Member States.

Greece submitted a request on 9 March 2000 for its convergence situation to be re-examined. The Ecofin Council adopted the decision[5] that Greece fulfilled the necessary conditions for adoption of the single currency on 19 June 2000 in Santa Maria da Feira. The decision was taken, having regard to the discussion of the Council, meeting in the composition of Heads of State or Government, and had, in accordance with the Treaty (Article 122(2)), been prepared on a proposal from the Commission. The decision was based on the two convergence reports made by the Commission[6] and the ECB[7].Greece adopted the single currency with effect from 1 January 2001.

Sweden was again assessed by the Commission[8] in 2000 as not fulfilling the necessary conditions for the adoption of the single currency and –continued to be referred to as a "Member State with a derogation". Two years have elapsed since the

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1 OJ L 139, 11.5.1998, pp. 30-35.

2 Report on progress towards convergence and recommendation with a view to the transition to the third stage of economic and monetary union, COM(1998)1999 final, 25 March 1998.

3 Convergence Report, European Monetary Institute, March 1998.

4 Denmark and the United Kingdom were not the subject of a formal assessment because of their opt-out arrangements.

5 OJ L 167, 7.7.2000, pp. 19-21.

6 Convergence report 2000, COM(2000) 277 final, 3 May 2000.

7 Convergence Report, European Central Bank, May 2000.

8 See footnote 6.

last reports were made by the Commission and ECB (3 May 2000) and so Sweden is due for re-examination, in accordance with Article 122(2).

BOX: Article 122(2) of the Treaty

At least once every two years, or at the request of a Member State with a derogation, the Commission and the ECB shall report to the Council in accordance with the procedure laid down in Article 121(1). After consulting the European Parliament and after discussion in the Council, meeting in the composition of the Heads of State or Government, the Council shall, acting by a qualified majority on a proposal from the Commission, decide which Member States with a derogation fulfil the necessary conditions on the basis of the criteria set out in Article 121(1), and abrogate the derogations of the Member States concerned.

Two other Member States do not participate in the euro. Denmark and the United Kingdom negotiated opt-out arrangements before the adoption of the Maastricht Treaty (Protocols No 26 and No 25, respectively). Until these Member States indicate that they wish to participate in the third stage and join the single currency, they are not the subject of an assessment by the Council as to whether they fulfil the necessary conditions. Although the 1998 convergence report gave a considerable amount of information about the convergence situation in these two countries, the Commission made no judgement on whether they fulfilled the criteria and achieved a high degree of sustainable convergence. The 2000 convergence report was limited to Greece and Sweden and did not deal with Denmark and the United Kingdom. The present report by the Commission is limited to Sweden and does not deal with Denmark and the United Kingdom.

The reports to be prepared by the Commission and the ECB are, like the earlier reports, governed by Article 121(1) (see Box). This requires that the reports shall examine the compatibility of national legislation with the Treaty and the Statute of the European System of Central Banks (ESCB) and shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment of the four convergence criteria dealing with price stability, the government budgetary position, exchange rate stability and the long-term interest rate as well as in the light of some additional factors.[9]

The four convergence criteria and the relevant periods over which they are to be respected are developed further in a Protocol annexed to the Treaty (see Box: Protocol (No 21) on the convergence criteria).

[9] Among the factors of which the reports also have to take account is "the development of the ECU". On 1 January 1999, every reference to the ECU was replaced by a reference to the euro at a rate of one euro to one ECU. Since there are no country-specific elements of this factor, it is not examined further in this report.

BOX: Article 121(1) of the Treaty

1. The Commission and the EMI shall report to the Council on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of economic and monetary union. These reports shall include an examination of the compatibility between each Member State's national legislation, including the statutes of its national central bank, and Articles 108 and 109 of this Treaty and the Statute of the ESCB. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criteria:

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

– *the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104(6);*

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

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

The four criteria mentioned in this paragraph and the relevant periods over which they are to be respected are developed further in a Protocol annexed to this Treaty. The reports of the Commission and the EMI shall also take account of the development of the ECU, the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices.

One of the principles which has been followed in the preparation of this report is that a Member State with a derogation not yet participating in the euro area is to be assessed as far as practicable in the same way as the first wave of euro area participants as well as subsequent participants. This is the principle of equal treatment which implies that, wherever possible, the Treaty provisions on the convergence criteria should be interpreted and applied in the same way as in 1998 and in 2000. However, the assessment of some of the convergence criteria has to take into account the introduction of the euro. This is particularly the case for the exchange rate criterion, where, with the establishing of the euro in place of the ECU and the replacement of the original exchange rate mechanism by the new ERM II at the beginning of 1999, there is a changed frame of reference. Similarly, the existence of a single monetary policy in the euro area may have implications for the assessment of inflation developments.

BOX: Protocol (No 21) on the convergence criteria referred to in Article 121 of the Treaty establishing the European Community

THE HIGH CONTRACTING PARTIES,

DESIRING to lay down the details of the convergence criteria which shall guide the Community in taking decisions on the passage to the third stage of economic and monetary union, referred to in Article 121(1) of this Treaty.

HAVE AGREED upon the following provisions, which shall be annexed to the Treaty establishing the European Community.

Article 1

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.

Article 2

The criterion on the government budgetary position referred to in the second indent of Article 121(1) of this Treaty shall mean that at the time of the examination the Member State is not the subject of a Council decision under Article 104(6) of this Treaty that an excessive deficit exists.

Article 3

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.

Article 4

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.

Article 5

The statistical data to be used for the application of this Protocol shall be provided by the Commission.

Article 6

The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament, the EMI or the ECB as the case may be, and the Committee referred to in Article 114, adopt appropriate provisions to lay down the details of the convergence criteria referred to in Article 121 of this Treaty, which shall then replace this Protocol.

The introductory section of this chapter is followed by a summary of the main findings about convergence in Sweden. The report then continues with the detailed examination of the fulfilment of each of the convergence criteria and other requirements in the order that they appear in Article 121(1). A set of annexes dealing with the way the criteria are applied and other background information not specific to Sweden but relevant to the assessment completes the report.

1.2.Main findings

In the 2000 convergence report the Commission assessment was that Sweden already fulfilled three of the convergence criteria (on price stability, the government budgetary position and the convergence of interest rates) but that it did not fulfil the exchange rate criterion. The assessment on legal convergence made in the 2000 convergence report concluded that legislation in Sweden was not compatible with the Treaty and the ESCB Statute.

The relevant legislation in Sweden has remained unchanged since the last convergence report in May 2000. Developments in 2001 and 2002 have made evident the absence of detailed legislation on profit allocation and extraordinary payments of the Riksbank to the Treasury, safeguarding that the Riksbank retains the financial means necessary for implementing all ESCB-related tasks. In the view of the assessment in the 2000 convergence report and the new developments, the legislation in this field in Sweden is assessed not to be compatible with the Treaty and the ESCB Statute.

The average inflation rate in Sweden during the 12 months to April 2002 was 2.9%, below the reference value of 3.3%. The Swedish 12-month average inflation rate has been below the reference value throughout the period from December 1996. Sweden continues to fulfil the criterion on price stability.

The Council decision of 10 July 1995 on the existence of an excessive deficit in Sweden was abrogated in 1998 (Council decision of 1 May 1998). The government finances were turned around from a deficit of 1.6% of GDP in 1997 to a surplus of 1.9% in 1998 and have been in surplus each year since then. In 2001, a government surplus of 4.8% of GDP was achieved. The government debt ratio peaked in 1994 and it fell below the 60% of GDP reference value in 2000. It was 55.9% of GDP in 2001. Sweden continues to fulfil the criterion on the government budgetary position.

The Swedish krona has not participated in the ERM II during the review period and it has fluctuated quite markedly against the euro and the Danish krone. Hence, as was the case at the time of the 2000 assessment of convergence, Sweden does not fulfil the exchange rate criterion.

The average yield on ten-year Swedish benchmark bonds during the 12 months to April 2002 was 5.3%, below the reference value of 7.0%. The Swedish long-term interest rate has been below the reference value throughout the period from December 1996. Sweden continues to fulfil the criterion on long-term interest rate convergence.

In the light of this assessment the Commission concludes that there should be no change in the status of Sweden as a Member State with a derogation.

2. ASSESSMENT OF SUSTAINABLE CONVERGENCE IN SWEDEN

2.1. Compatibility of national legislation with the Treaty and the Statute of the European System of Central Banks[10]

2.1.1. Situation in the 2000 convergence report

The 2000 convergence report concluded that legislation in Sweden was not compatible with the requirements of the EC Treaty and the ESCB Statute. In particular, the Commission noted that an incompatibility existed as regards the full integration of the central bank in the ESCB. Indeed, while according to the Constitution Act and the Riksbank Act, as amended in 1998, the competence for monetary policy is attributed to the Riksbank[11], there is however no reference to the competence of the ESCB in this field. Further, the right of the Riksbank to impose minimum reserves for monetary purposes is also defined without such a reference[12].

Furthermore a few imperfections were identified in the 2000 convergence report.

Firstly, an imperfection in the definition of the objectives of the Riksbank was identified. The Riksbank Act[13] included price stability as an objective, but omitted a reference to supporting the general economic policies in the Community, an objective which according to Article 105.1 of the EC Treaty and Article 2 of the ESCB Statute, the ESCB shall pursue, without prejudice to the objective of price stability.[14]

Secondly, it was identified in the report that according to the Constitution Act and the Riksbank Act, the Riksbank had an exclusive right to issue banknotes[15] without recognising the ESCB's competence in this field[16].

Thirdly, the fact that the prohibition of public authorities to give and of the members of the Riksbank's decision-making bodies to seek or take instructions in the Riksbank Act itself only covered monetary policy issues[17] and did not include all ESCB-related tasks as provided for in Article 108 of the EC Treaty, was identified as a further imperfection.[18]

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10 See Annex A for brief description of the Treaty requirements in this area, in particular for central bank independence.

11 Constitution Act, Chapter 9, Article 12 and Riksbank Act, Chapter 1, Article 2

12 Riksbank Act, Chapter 6, Article 6

13 Riksbank Act, Chapter 1, Article 2

14 In the Riksbank Act, Chapter 1, Article 2, the objectives of the Riksbank are defined as follows: "*The objective of the Riksbank's operations shall be to maintain price stability. In addition, the Riksbank shall promote a safe and efficient payment system*."

15 Constitution Act Chapter 9, Article 13 and Riksbank Act, Chapter 5, Article 1

16 EC Treaty Article 106.1 and ESCB Statute Article 16

17 Riksbank Act, Chapter 3, Article 2

18 The application of this rule to all ESCB-related tasks is only mentioned in the Explanatory Memorandum to the Riksbank Act.

2.1.2. Assessment of compatibility in 2002

The assessment of incompatibility still stands in relation to the provisions mentioned above, as the relevant legislation in Sweden has remained unchanged since the last convergence report in May 2000.

However, an additional issue has been identified. Developments in Sweden in 2001 and 2002 have made evident the absence of detailed legislation on profit allocation and extraordinary payments of the Riksbank to the Treasury, in particular the absence of legislation ensuring that the Riksbank retains the financial means necessary for the implementation of all ESCB-related tasks. On both occasions the General Council of the Riksbank, a body not involved in ESCB-related tasks, submitted for adoption by the Riksdag, the Swedish Parliament, a proposal for the Riksbank to make extraordinary payments to the Swedish state, amounting to 20 billion kronor, in addition to the allocation of profit of the previous financial year. The absence of legislation in this procedure safeguarding that the Riksbank retains the financial means necessary for implementing all ESCB-related tasks is incompatible with the principle of financial independence.

In view of the assessment in the 2000 convergence report and the new developments, the relevant legislation in Sweden is assessed not to be compatible with the EC Treaty and the ESCB Statute.

2.2. Price stability[19]

2.2.1. *Situation in 2000 convergence report*

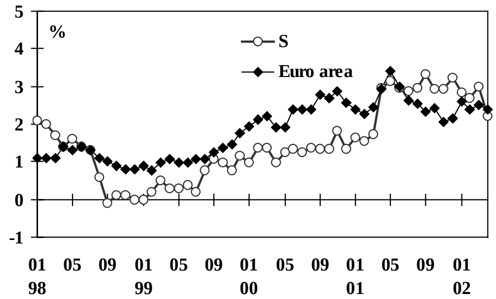
Sweden fulfilled the criterion on price stability when assessed in the 2000 convergence report. The average inflation rate in Sweden during the 12 months to March 2000 was well below the reference value. The Swedish 12-month average inflation rate had been below the reference value throughout the period from December 1996.

2.2.2. Assessment of convergence in 2002

– *Recent trends*

The annual inflation rate in Sweden (as measured by the change in the monthly HICP index from 12 months earlier (see Graph 1)) remained around 1.5% from the beginning of 2000 until March 2001. However, in April 2001, the annual inflation rate rose to 3% and has remained relatively high since then. It was 2.2% in April 2002.

Graph 1 Sweden - annual inflation rate (HICP)
(percentage change of monthly index on a year earlier,M/(M-12))



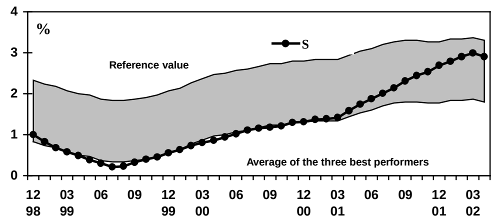
Source **: Eurostat.**

– *Respect of the reference value*

19 See Annex B for the calculation of the reference value, a discussion of other inflation standards, and a short description of improvements in the harmonised indices of consumer prices (HICP).

The 12-month average inflation rate which is used for the convergence assessment has fluctuated in Sweden but has continued to be below the reference value. Sweden was one of the three best-performing Member States in terms of price stability between March 1999 and September 2001. While inflation rose in Spring 2001 and has remained relatively high since then, which has resulted in an increase in the 12-month average inflation rate, Sweden continues to be below the reference value. (see Graph 2).

Graph 2 Sweden - comparison of 12-month average inflation rate (HICP) with reference value (%)



Note: The grey band represents 1.5 percentage points interval between the average rate in the three best performers in terms of price stability (bottom of the band) and the reference value (top of the band).

Source: Eurostat , Commission services .

In April 2002 the three best-performing Member States in terms of price stability were the United Kingdom, France and Luxembourg and the simple arithmetic average of the 12-month average inflation rates in these three countries was 1.8%. The reference value was 3.3%. The 12-month average inflation rate in Sweden in April 2002 was 2.9%, below the reference value (see Table 1 and Graph 2).

– *Performance relative to other inflation standards*

The relatively good inflation performance in Sweden is also apparent when comparison is made with other possible standards for inflation (see Annex Table B.1). Using the three best performers in the euro area gives a slightly higher reference value in April of 3.6%.

However, in April 2002 Sweden's annual inflation rate was 2.2%, above the 2% upper limit of the ECB's definition of price stability, as was the 12-month average inflation rate.

Table 1

Sweden : 12-month average inflation rate (HICP) and the reference value [a)]

(% change)

	1997	1998	1999	2000	2001	April 2002
S	1.8	1.0	0.6	1.3	2.7	2.9
Euro area	1.6	1.1	1.1	2.3	2.5	2.5
EU	1.7	1.3	1.2	2.1	2.3	2.3
Reference value [b)]	2.7	2.2	2.1	2.8	3.3	3.3

a) Measured by the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period.

b) Unweighted arithmetic average of the three best performers in terms of inflation plus 1.5 percentage points ; same method as used in the 2000 convergence report , see tables in Annex B.

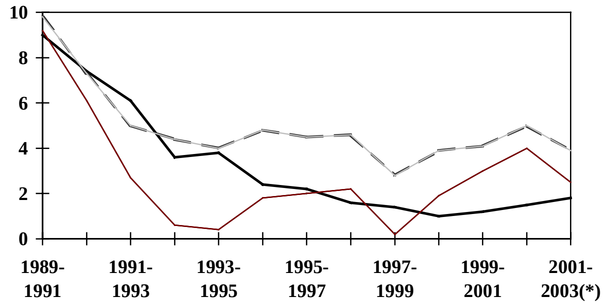
Source: Eurostat, Commission services.

A successful reduction in the inflation rate was achieved in Sweden during the first half of the 1990s, and between 1995 and 2000 inflation was maintained at a low level. The favourable evolution of the private consumption deflator also aided this achievement. The disinflation process was helped by the slow increase in unit labour costs, particularly until 1995 (see Graph 3). Since then, compensation per employee[20] has increased at a moderate pace and, since 2000, productivity growth has slowed, resulting in slightly higher unit labour costs (see also Table 2). The economic downturn in 2001 coincided with continued strong employment growth and a slight increase in compensation per employee, which resulted in poor productivity growth and high unit labour costs. Import prices accelerated somewhat in 2000 and 2001, coinciding with the depreciation of the currency. These factors have contributed to some upward pressure on inflation recently.

Graph 3

Sweden - inflation and wage trends

(3-year moving average of annual percentage change)



(*) Spring 2002 economic forecasts.

Source **: Commission services.**

Inflation is expected by the Commission services to be lower in 2002 compared with 2001, partly because some temporary factors pushing inflation up in 2001 should subdue.

Since 1992 Sweden has had an explicit inflation target for monetary policy and a flexible exchange rate regime. Commitment to price stability as the objective of monetary policy was further underlined by the new legislation on the status of the Riksbank that came into force in 1999. The Riksbank's inflation target is 2% with a tolerance interval of ±1 percentage point. Since October 1999 the Riksbank has specified that it bases its current monetary policy on the assessment of underlying inflation as measured by UND1X[21]. The Swedish target indicators are also different from the HICP, being either the CPI or, as at present, the UND1X.

The underlying inflation rate (UND1X) has, for most of the time, remained within the Riksbank's tolerance interval for the inflation target. However, underlying inflation rose in April 2001 and has remained relatively high since. In April 2002, the UND1X stood at 2.8% year-on-year.

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20 The figures for nominal compensation per employee for 1999 and 2000 in Sweden are distorted due to the fact that ESA 1995 treated payroll taxes for employees as a tax on production. If treated as a wage tax, labour costs would have increased by 3.4% in 1999 and 3.8% in 2000.

21 UND1X is defined as the CPI excluding interest expenditure and direct effects of altered indirect taxes and subsidies.

Sweden has respected the reference value for inflation throughout the period from December 1996. Sweden therefore continues to fulfil the criterion on price stability.

Table 2

Sweden : other inflation and cost indicators
(annual % change)

	1997	1998	1999	2000	2001	2002*
Private consumption deflator						
S	2.3	1.0	1.0	1.0	1.6	1.9
Euro area	2.1	1.6	1.2	2.2	2.3	2.1
EU	2.2	1.7	1.3	1.9	2.1	2.1
Labour costs: Nominal compensation per employee						
S	3.8	3.3	1.3	7.3	3.8	3.9
Euro area	2.3	1.5	2.3	2.5	2.7	2.9
EU	2.7	2.2	2.8	3.0	3.2	3.3
Labour productivity						
S	3.2	2.3	2.3	1.5	-0.6	2.1
Euro area	1.6	1.1	0.9	1.4	0.3	1.1
EU	1.6	1.2	1.0	1.5	0.5	1.2
Nominal unit labour costs						
S	0.6	0.9	-1.0	5.8	4.4	1.8
Euro area	0.7	0.3	1.3	1.1	2.4	1.8
EU	1.1	0.9	1.8	1.4	2.7	2.0
**Import prices ** **						
S	0.8	-0.5	1.0	4.6	4.2	1.7
Euro area	2.6	-1.3	0.0	8.4	1.1	0.7
EU	0.9	-2.1	-0.4	7.2	1.1	0.8

* Spring 2002 economic forecasts.
** Deflator of imports of goods and services .

Source: Commission services.

2.3. Government budgetary position

2.3.1. Situation in the 2000 convergence report

In the 1998 convergence report the Commission considered that the excessive deficit situation in Sweden had been corrected. In the light of this assessment and in parallel with the adoption of the report, the Commission made a recommendation to the Council that the decision on the existence of an excessive deficit in Sweden (Council decision of 10 July 1995) should be abrogated. Acting on this recommendation the Council adopted on 1 May 1998 a decision abrogating the decision on the existence of an excessive deficit in Sweden.[22]

In the 2000 convergence report the Commission considered that Sweden continued to fulfil the criterion on the government budgetary position.

2.3.2. Assessment of public finances in 2002[23]

Swedish public finances have been in surplus each year since 1998 and in 2001 a surplus of 4.8% of GDP was recorded. A surplus of 1.7% of GDP is forecast by the Commission services for 2002 (see Table 3 and Graph 4). After rising strongly in the early 1990s the government debt ratio in Sweden reached a peak in 1994 and has since been on a declining trend. There was a sharp fall in the ratio between 1998 and 2000, from 70.5% of GDP to 55.3% of GDP. In 2001, the debt ratio was almost unchanged at 55.9% of GDP[24]. A further decline in 2002 is

Table 3

Sweden : government surplus/deficit , debt and investment expenditure
(as % of GDP)

	1997	1998	1999	2000	2001	2002*
General government net lending (+) / net borrowing (-)						
S	-1.6	1.9	1.5	3.7	4.8	1.7
Euro area	-2.6	-2.2	-1.3	0.2	-1.3	-1.4
EU	-2.5	-1.6	-0.7	1.1	-0.6	-1.1
General government gross debt						
S	73.1	70.5	65.0	55.3	55.9	52.6
Euro area	75.3	73.7	72.6	70.2	69.1	68.6
EU	71.0	68.9	67.3	64.2	62.8	61.9
General government investment expenditure **						
S	2.7	2.7	2.7	2.5	2.6	2.6
Euro area	2.4	2.5	2.5	2.5	2.5	2.4
EU	2.2	2.2	2.3	2.2	2.3	2.3

* Spring 2002 economic forecasts.
** General government gross fixed capital formation.

Source: Commission services.

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22 OJ L 139, 11.5.1998, p. 19.

23 For the purposes of the present report and for the assessment of the government budgetary position, the definition of 'deficit' is in accordance with the excessive deficit procedure, as was the case in the Commission's convergence report 2000. The issue of the reclassification of settlements under swap arrangements concerning interest payments and forward rate arrangements in the ESA 95 system of accounts is dealt with in Annex C.

24 The general government debt ratio was 55.9% of GDP in 2001, virtually unchanged from 2000, despite the large surplus in 2001 noted above. This can be attributed to a substantial – and larger-than-expected - reduction in the public pension funds' (AP fonder) holdings of government debt, from 13% of GDP in 2000 to 4% of GDP in 2001.

forecast by the Commission services to 52.6% of GDP, (see Table 3 and Graph 4).

During the consolidation phase that was initiated in the early 1990s, almost all of the improvement in the public finances was structural in nature until 1998, and the influence of the cycle was relatively limited. Since then, the cyclical influence has been greater. Between 1997 and 2001, the cyclically adjusted government balance (as measured by the Commission) improved by 4.5 percentage points of GDP (see Table 4). About two thirds of the improvement was due to declining interest payments and one third was due to an increase in the primary balance. The substantial budgetary consolidation in recent years has thus been based on determined debt reduction and on lower expenditure, but has also relied on increases in tax pressure, although to a lesser extent in the latter years. In particular, tax cuts have been introduced each year between 2000 and 2002. The cyclically-adjusted surplus suggests that the Swedish public finances are in a robust position.

Table 4

Sweden : composition of budgetary consolidation between 1997 and 2001

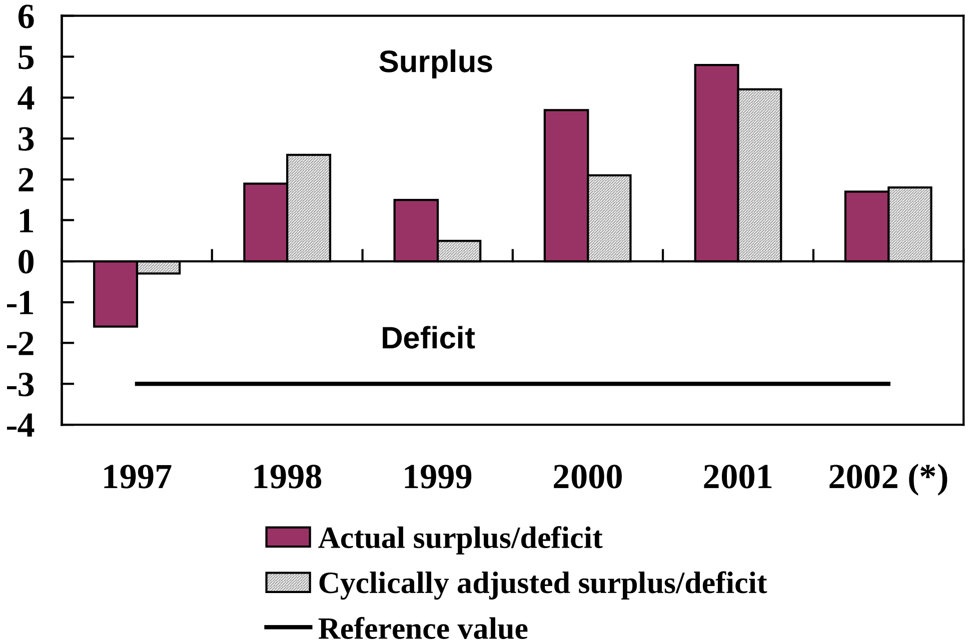
(Cyclically adjusted, as % of trend GDP)

		of which :		of which :	
	Change in Overall Balance (1)=(3)-(2)	Change in interest payments (2)	Change in primary balance (3)=(4)-(5)	Change in revenue (4)	Change in primary expenditure (5)
S	4.5	-2.9	1.6	0.9	-0.7
Euro area	0.6	-1.1	-0.5	-0.7	-0.2
EU	1.2	-1.2	0.0	-0.3	-0.3

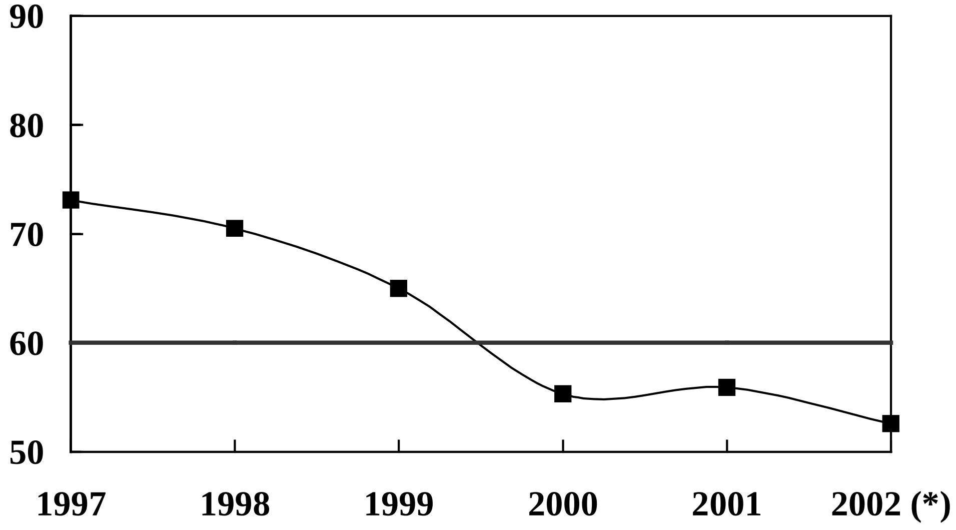
Source: Commission services.

Graph 4
Sweden - government surplus/deficit and debt

Actual and cyclically adjusted surplus/deficit
(% of GDP)



Government debt
(% of GDP)



(*) Spring 2002 economic forecasts.
Source **: Commission services**

The 2001 updated convergence programme for Sweden was adopted by the government in November 2001 and assessed by the Ecofin Council in January 2002[25]. It covers the years to 2004 and foresees government surpluses of about 2% of GDP in each year, thus respecting Stability and Growth Pact requirements (see Table 5). The budgetary strategy continues to be based on strict control of government spending with a further decline in the expenditure-to-GDP ratio. At the same time cuts in taxes are being introduced – extended to 2002 in the latest budget - reversing the trend in the years up to 1998. Budgetary discipline is reinforced by the continuation of nominal ceilings for central government expenditure adopted by the Swedish Parliament for three years ahead, and by a legal obligation on local authorities from 2000 onwards to balance their budgets. Furthermore, the recently introduced pension reform - which involves a higher degree of individual funding - will enable the pension system to cope better, in the medium term, with business cycle fluctuations and, in the long term, with the ageing of the population. With the government balance remaining in surplus, the 2001 updated convergence programme projects a further decline in the debt ratio to 45.2% by 2004.

Table 5

Sweden: updated convergence programme projections for GDP growth, government surplus/deficit and debt

	2001	2002	2003	2004
GDP-growth , annual % change				
S	1.7	2.4	2.6	2.3
General government net lending (+)/borrowing (-) , as % of GDP				
S	4.6	2.1	2.2	2.3
General government debt , as % of GDP				
S	52.3	49.7	47.3	45.2

Source: 2001 updated convergence programme of Sweden; see also Annex table C.3.

In the Spring Fiscal Policy Bill presented by the Swedish government on 15 April, the surplus in government finances is expected to be 1.8% of GDP in 2002 and to remain close to 2% of GDP in the years to 2004. The debt-to-GDP ratio is projected to decline to 48.3% of GDP by 2004.

From the information presented in this section, it can be seen that the budgetary position of Sweden, which is not at present the subject of an excessive deficit decision, has remained strong in 2001 and is likely to remain robust in 2002. Therefore Sweden continues to fulfil the budgetary criterion.

25 OJ C 33, 6.2.2002, p. 4.

2.4. Exchange rate stability

2.4.1. Situation in the 2000 convergence report

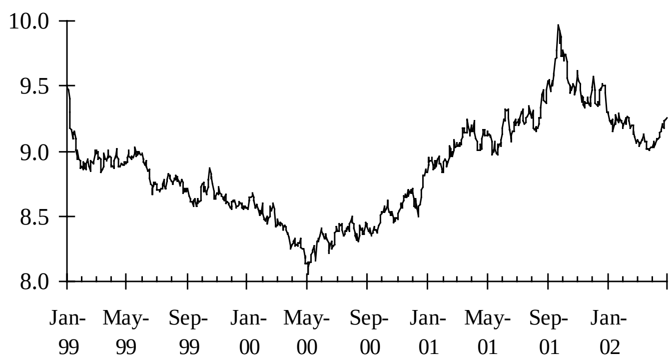
In the 2000 convergence report Sweden was assessed not to fulfil the exchange rate criterion. The Swedish krona had not participated in the ERM II, and in the two years under review (up to March 2000) the krona had fluctuated against the euro reflecting, among other factors, the absence of an exchange rate target.

2.4.2. Assessment of convergence in 2002

Sweden has continued not to participate in the ERMII during the current review period (up to April 2002). The monetary framework of explicit inflation targeting implies that the Swedish krona is left floating freely in the exchange rate market. The absence of an explicit exchange rate commitment means that the stability of the exchange rate of the krona cannot be assessed on the basis of deviations from such a commitment.

From the beginning of 1999 through to April 2000, the krona was on an appreciating trend, rising by 15% from 9.47 SEK to 8.06 SEK against the euro. Thereafter the krona depreciated considerably as the crisis in the telecom sector hit Sweden particularly hard. In September 2001, it reached its lowest level ever in trade-weighted terms and fell to almost 10 SEK/euro. Since then the krona has appreciated, possibly attributable to the prospects of a referendum on EMU in 2003, and is now close to 9.20 SEK/euro (see Graph 5).

Graph 5. SEK/EUR exchange rate



Source : Commission services.

The volatility of the krona exchange rate diminished in the second half of the 1990s as credible and sustainable fiscal and monetary policy provided the preconditions necessary for a stable exchange rate in the medium run. However, during the review period, volatility increased again as e.g. the global slowdown and financial market uncertainty had a relatively large impact on the Swedish economy. Both the depreciation and later the appreciation of the krona exchange rate over the last two years have been pronounced, also reflecting the absence of an exchange rate commitment.

The Swedish krona has not participated in the ERM II during the review period and it has fluctuated quite markedly against the euro and the Danish krone. Hence, as was the case at the time of the 2000 assessment of convergence, Sweden does not fulfil the exchange rate criterion.

2.5. Long-term interest rate[26]

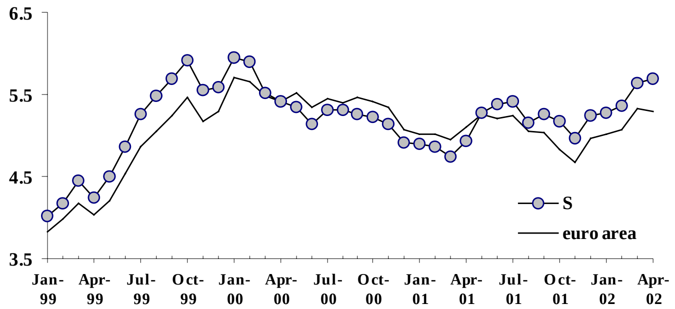
2.5.1. Situation in the 2000 convergence report

Sweden fulfilled the criterion on the convergence of interest rates in the 2000 convergence report. The average long-term interest rate in Sweden during the 12 months to March 2000 was well below the reference value.

2.5.2. Assessment of convergence in 2002

Sweden's good inflation record and impressive consolidation of public finances during the second half of the 1990s were reflected in declining long-term interest rates. During the period under review, Swedish long-term interest rates (the yield on the 10-year benchmark bond) have followed the trend in international bond markets: they decreased until March 2001 and have thereafter edged upwards (see Graph 6), to stand at around 5.7%. Over the last year, the spread over euro area long-term yields has fluctuated between 5 and 50 basis points. The main contributing factors to the variation in the spread may have been the cyclical position of Sweden relative to the euro area economy and inflation differentials.

Graph 6 Long-term interest rates
Sweden and euro area (monthly averages)



Source: Commission services

Sweden has continued to have a twelve-month average long-term interest rate below the reference value. In fact, Sweden has had long-term interest rates below the reference value ever since December 1996, the first date for which this comparison can be provided.

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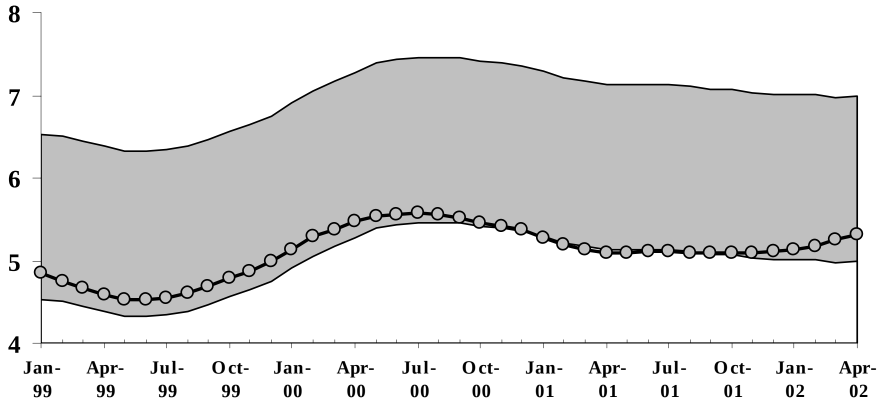
26 See Annex E for information on the calculation of the reference value and on the data employed.

Graph 7 Sweden - comparison of average long-term interest rate with reference value



Note: The grey band represents a 2 percentage points interval between the average interest rate in the three best performers in terms of price stability (bottom of the band) and the reference value (top of the band) *Source: ECB, Commission services*

Table 6

Sweden: long-term interest rates
(12-month averages)

	1999	2000	2001	2002 [a)]
S	5.0	5.4	5.1	5.3
Reference value [b)]	6.8	7.4	7.0	7.0

a) Average of May 2001 – April 2002
b) Average of interest rates of the three best performing Member States in terms of price stability plus 2 percentage points; see Annex table E1

Source: ECB, Commission services

The average yield on ten-year Swedish benchmark bonds during the 12 months to April 2002 was 5.3%. The reference value, derived from the average interest rates in the United Kingdom, France and Luxembourg, the three best performing EU Member States in terms of price stability, was 7.0%. Hence, Sweden continues to fulfil the criterion on long-term interest rate convergence.

2.6. Additional factors

2.6.1. Results of the integration of markets

– *Development of product markets*

Sweden is increasingly integrated into the EU economy. Sweden's intra-EU trade to GDP ratio for the period 1999-2001 of 20.2% was 0.6 percentage points higher than in 1997-99. This ratio is similar to that of Denmark and Finland, although considerably below the average for the other smaller EU Member States. The intra-EU FDI to GDP ratio for the period 1997-99 was above the average for the smaller Member States. Sweden's share in EU cross-border mergers and acquisitions (M&As) is well above what one would expect for a country of its size.

In recent years, a number of structural policy reforms have been introduced which have promoted the integration of Sweden into EU product markets:

- Sweden has an excellent record in transposing and applying Single Market legislation.

- Measures have been taken to open up public procurement including the promotion of on-line procurement.

- Liberalisation of the network industries has continued and is among the most advanced in the EU. Telecoms prices are amongst the lowest in the EU. Nevertheless, consolidation of firms in some of these industries has created a highly concentrated supply structure.

- Sweden is one of the most advanced EU Member States in terms of the knowledge-based society. R&D expenditure and patent applications are the highest in the EU and internet and computer use are well above the EU average.

In spite of the significant progress made in opening up the product markets to competition, both from within and from outside the country, Sweden's price level remained high at around 28% above the EU average in 2000. This high relative price level may be attributed in part to the high levels of indirect taxation in Sweden, but more importantly to a lack of competition in certain sectors such as the retail and distribution of pharmaceuticals and food retailing. In addition the relatively large size of the public sector in Sweden means that open public procurement rules and competition in public services provision are particularly important.

Table 7 Sweden : product markets

PRODUCT MARKETS IN SWEDEN	SWEDEN				EU			
	1998	1999	2000	2001	1998	1999	2000	2001
Labour productivity[1]	93.9	93.0	93.0	91.1	100	100	100	100
Relative price levels[2]	122.0	125.0	128.0		100	100	100	100
Intra-EU trade to GDP ratio (%)[3]	20.1	19.9	21.0	19.7	28.5	28.7	31.0	30.5
Intra-EU FDI inflows (% of GDP)[4]	7.5	20.2			4.7	6.1		
Cross-border M&A share[5]	5.9(3.0)	7.6(2.8)	6.3(2.9)		100	100	100	
Single Market Directives[6]	1.5	2.1	1.2	0.9	3.9	3.6	3.0	2.0
Value of tenders in the O.J.[7]	2.5	2.7	3.7		1.8	1.8	2.4	
Sectoral and ad hoc State aids[8]	0.7	0.6			1.0	0.9		
Prices in telecommunications[9]								
Local	0.29	0.29	0.30	0.30	0.41	0.41	0.41	0.41
National	0.58	0.45	0.30	0.30	2.16	1.69	1.34	1.15
Call to USA	4.90	4.90	1.11	1.11	5.07	4.09	3.39	2.65
Market share fixed telecom. (%)[10]								
Local		93.0	82.0					
Long Distance		76.0	82.0					
International		62.0	59.0					
Electricity prices[11]								
Households	7.01	6.24	6.52	6.83	10.57	10.48	10.40	10.33
Industry users	3.68	3.52	3.88	3.75	6.44	6.32	6.44	6.33
Market share electricity (%)[12]		53.0						
Education expenditure[7]	8.0	7.7	8.4	8.3	5.0	5.0	5.1	
New S&T graduates[13]	7.9	9.7	11.6					
R&D expenditure[7]	3.75	3.80			1.87	1.92	1.90	
Internet access at home[14]	39.6	51.0	53.8	60.7	8.3	12.0	28.4	37.7
Patent applications[15]	307.0	308.5	346.4		129.9	140.9	152.7	

All figures for 2001 are estimates. [1] Per person in PPS, EU=100; [2] EU=100, private final consumption; [3] (Intra-EU exports + intra-EU imports)/(2*GDP). EU average for small Member States (B, DK, EL, IRL, L, NL, A, P, FIN and S);[4] Intra-EU FDI inflows as a % of GDP; [5] % of EU total (GDP share). EU average for small Member States; [6] % not yet implemented; [7] % of GDP; [8] % of GDP (avg. 96-98&97-99); [9] Price in euro of 10 minute call at 11 am on a weekday, VAT included; [10] Market share of the incumbent; [11] Prices in euro per Kwh; [12] Market share of the largest generator; [13] Per 1000 inhabitants aged 20-29; [14] % of households; [15] Per million inhabitants, EPO.

– *Developments in financial markets*

The Swedish bond market is characterised by high liquidity and the active participation of both domestic and foreign financial intermediaries. The largest issuer in the Swedish krona (SEK) fixed income market is the central government. Although declining since 1999, the stock of (central) government debt still accounts for approximately for half of the outstanding volume[27]. The mortgage institutions are the other major issuer in the market. Foreign currency instruments, including swaps, account for more than one third of total central government debt[28], with the benchmark distribution for foreign currency debt in 2002 biased towards the euro (59%) and the USD (20%). Of the remaining SEK-denominated debt, 8% is in the form of index-linked bonds. The corporate bond market has grown significantly in recent years, but fulfils still only a minor part of companies financing needs. Government issues also dominate the SEK money market, which has a volume of approximately one third of the bond market. The Swedish equity market is integrated with several neighbouring markets. Equity trading via the Norex alliance (comprising the Stockholm, Copenhagen, Reykjavik and Oslo stock exchanges) now accounts for about 70% of the total Nordic equity market.

A number of legislative initiatives were taken in 2001 to improve conditions in the securities markets. The Financial Supervisory Authority (FSA) is developing a refined internal risk assessment system, while the co-operation agreement signed in 2000 with its counterparts in Denmark, Finland and Norway was broadened during 2001.

The financial structure has been characterised by a continued transformation of the banking sector, legislative and taxation reform and technological development. The transformation of the banking system continued in 2001 with new players receiving permits to establish banking business. Also, large retail-chains have started offering banking services to their customers. Swedish banks continue to focus strongly on “home banking”, with the use of the Internet as a central feature.

2.6.2. Balance of payments on current account

In the 1970s and 1980s Sweden emerged as a significant international net debtor as a combination of low private and public saving and recurring competitiveness problems created substantial current account deficits. Sweden’s position changed after the deep recession at the beginning of the 1990s. The large depreciation in November 1992 and continued depressed private domestic demand, in combination with consolidation of public finances, generated large current account surpluses. The current account remained substantial at 3¼% of GDP in 2001 despite the global slowdown. Sustained external surpluses in combination with favourable growth prospects suggest that the competitiveness of the Swedish economy is strong.

2.6.3. Unit labour costs and other price indices

The examination of the development of unit labour costs and other price indices, required by Article 121(1), is included in the section on price stability (see 2.2.2.).

[27] about 53,5% of GDP at the end of 2001
[28] End-February 2002

ANNEX A: COMPATIBILITY OF NATIONAL LEGISLATION

According to the second sentence of Article 121 of the Treaty, the report drawn up under this article "shall include an examination of the compatibility between each Member State's national legislation, including the statutes of its national central bank, and Articles 108 and 109 of this Treaty and the Statute of the ESCB".

According to Article 109 of the Treaty, each Member State shall ensure, at the latest at the date of the establishment of the ESCB, that its national legislation including the statute of its national central bank is compatible with this Treaty and the Statute of the ESCB.

Following the approach chosen in the convergence report of 2000, the examination is divided into three areas:

– objectives of national central banks;

– independence;

– integration in the ESCB and other legislation.

Objectives of national central banks

The objective of a national central bank must be compatible with the objectives of the ECB as formulated in Article 105(1) of the Treaty (and Article 2 of the Statute of the ESCB):

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

References in national law to the policy of the government or to specific macroeconomic objectives are not incompatible provided that the primacy of the first and second objectives of Article 105 of the Treaty is respected.

Independence

Article 108 of the Treaty ensures that the ESCB will operate free from instructions from third parties:

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

The various aspects of independence are described in more detail in the convergence report of 1998.

Integration of national central banks in the ESCB and other legislation

According to Article 9.2 of the Statute of the ESCB, the ECB shall ensure that the tasks conferred upon the ESCB are implemented either by its own activities or through the national central banks. Furthermore, according to Article 14.3, the national central banks are an integral part of the ESCB and shall act in accordance with the guidelines and instructions of the ECB. Therefore, provisions in the statutes of the central banks, which stand in the way of the national central banks assuming their role, need to be adapted under Article 109.

The examination in this report recalls the result of the examination in 2000, describes legislative action since the earlier examination, summarises the essential elements of central bank legislation in force and concludes with an assessment of compatibility. The statement on compatibility concludes that a country's legislation either is or is not compatible with the Treaty and the ESCB Statute. Legislation is not compatible where incompatibilities exist which infringe upon principles of the Treaty. In some cases, imperfections have been identified which are either of a technical nature or are ambiguities rather than obvious inconsistencies. The judgement on compatibility is not affected by the reference to such imperfections.

ANNEX B: INFLATION CRITERION

This Annex presents the evolution of the reference value for assessing the inflation criterion and describes recent methodological developments in the harmonised indices of consumer price.

B.1. Reference value for inflation

Article 121(1) and Article 1 of Protocol N° 21 are the relevant Treaty provisions for assessing the inflation criterion (see pages 7 and 8). Article 1 of Protocol No 21 specifies that *"Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions"*. To meet this requirement, Harmonised Indices of Consumer Prices (HICP) have been produced in each Member State since January 1997 using a harmonised methodology developed by Eurostat in collaboration with national statistical offices.

The assessment of the price convergence criterion as laid down in Protocol No 21 of the Treaty requires an operational definition of the reference value against which the price performance of Member States with a derogation will be assessed. In the Commission's Convergence Reports of March 1998 and May 2000, the reference value was calculated as the arithmetic average of the inflation rates of the three best performing Member States plus 1.5 percentage points.

Since the start of the third stage of EMU, price stability in the participating Member States is pursued at euro area level by means of the monetary policy of the Eurosystem. Moreover, the ECB has provided its interpretation of price stability: "price stability shall be defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%".[29] The implications

Table B.1

Development of 12-month average inflation rates and the reference value

	0104	0105	0106	0107	0108	0109	0110	0111	0112	0201	0202	0203	0204
B	2.9	3.0	3.0	3.1	3.0	2.8	2.7	2.5	2.4	2.4	2.4	2.5	2.4
DK	2.6	2.6	2.5	2.5	2.5	2.4	2.4	2.3	2.3	2.3	2.3	2.3	2.3
D	2.3	2.5	2.5	2.6	2.7	2.6	2.6	2.5	2.4	2.4	2.3	2.3	2.2
EL	3.2	3.3	3.5	3.6	3.7	3.8	3.8	3.7	3.7	3.8	3.8	3.9	3.9
E	3.5	3.5	3.6	3.5	3.3	3.2	3.1	2.9	2.8	2.8	2.9	2.9	2.9
F	1.8	1.9	1.9	2.0	2.0	1.9	1.9	1.8	1.8	1.9	1.9	2.0	2.0
IRL	5.0	4.9	4.8	4.7	4.5	4.4	4.2	4.0	4.0	4.1	4.2	4.3	4.3
I	2.5	2.6	2.6	2.6	2.5	2.5	2.4	2.4	2.3	2.3	2.4	2.5	2.4
L	3.7	3.8	3.6	3.5	3.4	3.2	2.9	2.7	2.4	2.3	2.3	2.2	2.1
NL	3.5	3.8	4.0	4.2	4.4	4.6	4.8	4.9	5.1	5.1	5.1	5.0	4.9
A	2.1	2.2	2.2	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.2	2.2
P	3.8	4.0	4.2	4.2	4.3	4.3	4.4	4.4	4.4	4.3	4.2	4.1	4.0
FIN	3.0	3.0	3.0	3.0	3.0	2.9	2.8	2.7	2.7	2.7	2.6	2.6	2.6
S	1.6	1.7	1.9	2.0	2.1	2.3	2.4	2.5	2.7	2.8	2.9	3.0	2.9
UK	0.9	1.0	1.0	1.1	1.2	1.2	1.2	1.2	1.2	1.3	1.3	1.4	1.4
Euro area	2.5	2.6	2.6	2.7	2.7	2.6	2.6	2.5	2.5	2.5	2.5	2.6	2.5
EU-15	2.2	2.3	2.4	2.4	2.4	2.4	2.4	2.3	2.3	2.3	2.4	2.4	2.3
reference value [b)]	2.9	3.0	3.1	3.2	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.4	3.3

a) Measured by the percentage change in the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period.
b) Average of the three best performers plus 1.5 percentage points; same method as used in the 1998 and 2000 convergence reports.
Source: Eurostat , Commission services.

arising from the third stage of EMU for the operational definition of the price convergence criterion were discussed in the 2000 Convergence Report.

[29] The ECB has made it clear that negative inflation rates, should they occur, would not be consistent with price stability. Price stability in the euro area is to be maintained over the medium term.

Table B.1 shows how the 12-month average inflation rates have evolved in the Member States since the beginning of 2001, and the derivation of the reference value, calculated using the same method as in the 1998 and 2000 Convergence Reports. Table B.2 shows for the period since the beginning of the third stage of EMU in January 1999 the three best performers (in the EU) in terms of price stability, the 12-month average inflation rate in these three best performers and the corresponding reference value. Finally, Graph B1 and table B3 compare the evolution of the reference value and the 12-month average inflation in Sweden with other possible standards for price stability.

As shown in those tables, the three best-performing Member States in the EU in April 2002 were the United Kingdom (1.4%), France (2.0%) and Luxembourg (2.1%). The unweighted arithmetic average of the 12-month average inflation rates in these three countries was 1.8%. The resulting reference value, calculated according to the operational definition used in the March 1998 and May 2000 convergence reports, was therefore 3.3%.

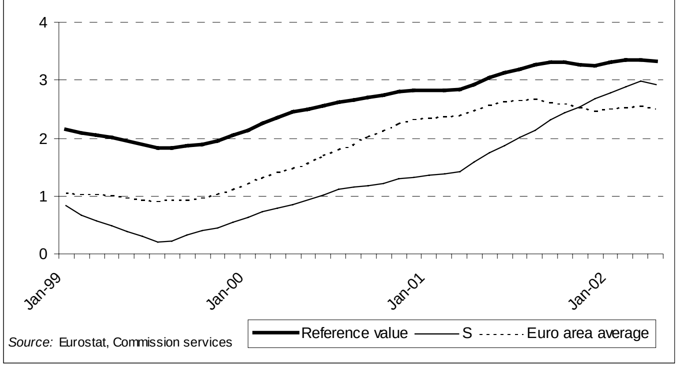
On the basis of a definition which excludes non-euro Member States from the group of reference countries, the 12-month average inflation rate of the three best-performing euro area Member States in April 2002 was 2.1%, giving a reference value of 3.6%.

Table B.2
Evolution of the inflation reference value and the three best performers

	Three best EU performers	Average of 3 best	**Reference value**
Jan-99	D, F, L	0.6	**2.1**
Feb-99	D, F, S	0.6	**2.1**
Mar-99	D, F, S	0.6	**2.1**
Apr-99	S, D, A	0.5	**2.0**
May-99	S, D, A	0.4	**1.9**
Jun-99	S, F, A	0.4	**1.9**
Jul-99	S, F, A	0.3	**1.8**
Aug-99	S, A, F	0.3	**1.8**
Sep-99	S, A, F	0.4	**1.9**
Oct-99	A, S, F	0.4	**1.9**
Nov-99	A, S, F	0.4	**1.9**
Dec-99	A, S, F	0.6	**2.1**
Jan-00	A, S, F	0.6	**2.1**
Feb-00	S, A, F	0.8	**2.3**
Mar-00	S, F, A	0.9	**2.4**
Apr-00	S, F, A	1.0	**2.5**
May-00	S, UK, F	1.0	**2.5**
Jun-00	UK, S, F	1.1	**2.6**
Jul-00	UK, S, F	1.1	**2.6**
Aug-00	UK, S, F	1.2	**2.7**
Sep-00	UK, S, F	1.2	**2.7**
Oct-00	UK, S, F	1.2	**2.7**
Nov-00	UK, S, F	1.3	**2.8**
Dec-00	UK, S, F	1.3	**2.8**
Jan-01	UK, S, F	1.3	**2.8**
Feb-01	UK, S, F	1.3	**2.8**
Mar-01	UK, S, F	1.3	**2.8**
Apr-01	UK, S, F	1.4	**2.9**
May-01	UK, S, F	1.5	**3.0**
Jun-01	UK, S, F	1.6	**3.1**
Jul-01	UK, F, S	1.7	**3.2**
Aug-01	UK, F, S	1.8	**3.3**
Sep-01	UK, F, S	1.8	**3.3**
Oct-01	UK, F, A	1.8	**3.3**
Nov-01	UK, F, DK	1.8	**3.3**
Dec-01	UK, F, DK	1.8	**3.3**
Jan-02	UK, F, A	1.8	**3.3**
Feb-02	UK, F, A	1.8	**3.3**
Mar-02	UK, F, L	1.9	**3.4**
Apr-02	UK, F, L	1.8	**3.3**

a) Measured by the percentage change in the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period.
b) Unweighted arithmetic average of the three best performing Member States in terms of inflation plus 1.5 percentage points.
Source: Eurostat , Commission services.

Graph B.1 Evolution of average inflation and reference value since start of EMU



Source: Eurostat, Commission services

Given the relatively moderate inflation in the EU and a 12-month average inflation rate of 2.5% in April 2002 in the euro area, none of the three best-performing EU Member States is considered to have a non-representative inflation performance.

Table B.3

Inflation convergence -HICP

(April 2002) a)

NL	4.9		
IRL	4.3		
P	4.0		
EL	3.9		
		3.6	reference value 3 best Euro area MS
		3.3	reference value 3 best EU MS
S	2.9		
E	2.9		
FIN	2.6		
		2.5	Euro area average
I	2.4		
B	2.4		
		2.3	EU average
DK	2.3		
D	2.2		
A	2.2		
L	2.1		
		2.1	average value of 3 best Euro area MS
		2.0	Upper limit of ECB definition of price stability
F	2.0		
		1.8	average value of 3 best EU MS
UK	1.4		

[a] Percentage change in the arithmetic average of the latest 12 months harmonised indices of consumer prices (HICP) relative to the arithmetic average of the previous 12 months.

Source : Eurostat , Commission services.

B.2. Recent methodological developments in HICP

The HICPs provide comparable measures of consumer price inflation in the Member States. The HICPs are used for the assessment of convergence in inflation across the EU and they form the main measure of price stability in the euro area. Since the Commission undertook its previous convergence assessment in May 2000, Eurostat and the statistical offices of the Member States have continued to refine the measurement of inflation provided by the HICPs.

HICPs are intended to cover all forms of household expenditure ("household final monetary consumption expenditure"). At the launch of the HICP in 1997, certain technically difficult areas were excluded because Member States did not yet agree on comparable methodologies. The initial product coverage included approximately 95% of all household final monetary consumption expenditure (this concept does not include imputed rents of owner-occupied housing). The product coverage of the HICPs has been extended since to include additional goods and services, and there have been further harmonisation to full population and geographic coverage.[30] These extensions were implemented with the January 2000 and January 2001 indices and were discussed in the 2000 Convergence Report.

Further harmonisation rules were implemented starting with the January 2001 index. These concerned the treatment of price reductions (e.g. seasonal sales) in national HICPs, the time of entering prices into the index, additional harmonisation on the coverage of services prices (e.g. proportional charges for financial and legal services) and the treatment of revisions in the HICP.[31] On account of the small weights, the changes for services prices is expected to have only a minimal effect on the overall index. However, the changes concerning the treatment of sales and revisions are likely to have a stronger impact and can vary across Member States (e.g. depending on the nature and timing of price reductions introduced by a Member State and the collection period within the month).

Given that the data used for the price convergence criterion is the 12-month average inflation rate , the practical implications of the changes in methodology for the assessment of inflation convergence in this examination are small.

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30 The extension takes place under the legal umbrella of Council Regulations (EC) Nos 1687/98 and 1688/98.

31 These further harmonisation rules resulted from implementing Commission Regulation (EC) N° 2601/2000, Commission Regulation (EC) N° 2602/2000, Commission Regulation (EC) N° 1920/2000 and Commission Regulation (EC) N° 1921/2001.

B.3. Additional tables on other price and cost indicators

Table B.4

Price deflator of private final consumption expenditure in EU Member States
(national currency, annual percentage change)

	1997	1998	1999	2000	2001	2002*
B	1.8	1.2	1.0	2.2	2.3	1.7
D	2.0	1.1	0.4	1.4	1.8	1.7
EL	5.6	4.5	2.1	3.1	3.0	3.3
E	2.6	2.2	2.4	3.2	3.2	2.9
F	1.4	0.7	0.4	1.5	1.2	1.4
IRL	2.7	3.5	3.4	4.6	4.5	4.4
I	2.2	2.1	2.1	2.8	2.9	2.3
L	1.4	1.3	1.4	2.8	2.8	1.9
NL	2.0	1.7	1.9	2.8	4.5	3.3
A	1.5	0.5	0.7	1.5	2.3	2.2
P	3.0	2.9	2.3	2.8	4.4	3.1
FIN	1.3	1.7	1.0	3.8	2.7	1.9
Euro area	2.1	1.6	1.2	2.2	2.3	2.1
DK	2.2	1.3	2.6	3.0	2.1	2.4
S	2.3	1.0	1.0	1.0	1.6	1.9
UK	2.3	2.7	1.5	0.6	1.5	2.0
EU	2.2	1.7	1.3	1.9	2.1	2.1
Standard deviation						
Euro area	1.2	1.2	0.9	1.0	1.1	0.9
EU	1.0	1.1	0.9	1.1	1.1	0.8

***** Spring 2002 economic forecasts.

Source: Commission services.

Table B.5

Labour costs in EU Member States

(percentage change, total economy)

	Nominal compensation per employee				Labour productivity				Nominal unit labour costs			
	1993 -96 a)	1997 -00 a)	2001	2002*	1993 -96 a)	1997 -00 a)	2001	2002*	1993 -96 a)	1997 -00 a)	2001	2002*
B	3.0	2.8	2.6	3.2	1.3	1.9	-0.1	1.0	1.7	0.8	2.7	2.2
D	3.0	1.1	1.6	2.4	1.3	1.1	0.4	1.2	1.6	0.0	1.2	1.2
EL	10.6	7.6	6.2	6.6	0.4	3.0	4.2	3.4	10.2	4.4	1.9	3.1
E	4.8	2.8	4.3	3.5	1.7	0.7	0.3	0.9	3.0	2.1	4.0	2.5
F	2.6	2.2	2.0	2.5	1.4	1.5	0.1	1.1	1.1	0.7	1.9	1.4
IRL	3.7	5.7	9.2	8.1	3.3	4.0	3.7	2.4	0.3	1.6	5.3	5.5
I	4.5	2.0	2.8	2.7	2.3	1.1	0.2	0.6	2.2	0.9	2.6	2.1
L	3.4	3.3	5.3	3.7	1.3	2.4	-0.6	0.9	2.0	0.8	5.9	2.9
NL	2.2	3.4	4.6	5.2	1.3	1.1	-1.0	0.9	0.9	2.3	5.6	4.3
A	3.5	2.2	2.8	2.4	2.1	1.8	0.8	1.6	1.4	0.4	2.0	0.8
P	6.8	4.5	5.8	4.4	4.3	1.8	0.1	1.2	2.4	2.6	5.6	3.2
FIN	2.6	3.0	4.5	3.5	3.8	2.8	-0.5	1.7	-1.1	0.2	5.0	1.8
Euro area	3.5	2.1	2.7	2.9	1.7	1.3	0.3	1.1	1.7	0.8	2.4	1.8
DK	2.9	3.5	4.2	3.6	2.4	1.4	0.4	1.6	0.5	2.1	3.8	2.0
S	4.7	3.9	3.8	3.9	3.1	2.3	-0.6	2.1	1.5	1.6	4.4	1.8
UK	3.5	4.7	5.2	4.3	2.7	1.5	1.4	1.8	0.8	3.1	3.7	2.5
EU	3.5	2.6	3.2	3.3	1.9	1.4	0.5	1.3	1.6	1.3	2.7	2.0

a) Average annual percentage change.
***** Spring 2002 economic forecasts.

Source: Commission services.

Table B.6

Import prices in EU Member States
(percentage change in the deflator of imports of goods and services, in national currency)

	1997	1998	1999	2000	2001	2002*
B	5.5	-2.3	0.7	11.8	2.6	0.9
D	3.1	-1.7	-1.2	7.7	1.0	0.1
EL	2.8	3.8	1.9	10.5	3.1	1.7
E	3.5	-0.3	0.5	9.8	0.4	0.2
F	1.5	-2.5	-0.6	5.1	0.4	0.6
IRL	0.7	2.5	2.7	7.4	2.7	1.8
I	1.4	-1.3	0.4	12.0	1.6	1.2
L	4.2	1.9	3.7	7.4	-1.1	-0.1
NL	2.2	-1.5	0.6	8.7	0.6	1.3
A	1.8	0.0	0.1	3.1	2.2	1.1
P	2.7	-1.2	-0.6	8.6	2.0	0.9
FIN	0.5	-3.0	-1.9	6.9	-2.2	-0.1
Euro area	2.6	-1.3	0.0	8.4	1.1	0.7
DK	2.2	-2.5	-0.2	9.9	2.5	0.1
S	0.8	-0.5	1.0	4.6	4.2	1.7
UK	-7.1	-6.2	-2.5	0.6	0.0	1.4
EU	0.9	-2.1	-0.4	7.2	1.1	0.8

***** Spring 2002 economic forecasts.

Source : Commission services.

ANNEX C: GOVERNMENT BUDGETARY DATA

C.1. Developments in the national accounts system ESA 95

The government budgetary data used in the excessive deficit procedure, and hence for the assessment of convergence, are on a national accounts basis. From the year 2000 a new system of accounts, ESA 95[32], was brought into use for these purposes. Annex C in the Commission's 2000 convergence report described the main features of the system, ESA 95, and key differences from the earlier system of accounts, ESA 79, which was used in the excessive deficit procedure until the end of 1999 and in the 1998 convergence report.

Since the Commission's 2000 convergence report was adopted, some further changes to ESA 95 have been introduced.

First, in November 2000, a Regulation[33] was adopted, modifying the common principles of ESA 95 as concerns the recording of taxes and social contributions. The purpose of this Regulation is to ensure comparability and transparency among the Member States and, in particular, that the impact on the net lending/borrowing of general government of taxes and social contributions recorded in the system do not include amounts unlikely to be collected.

Second, in December 2001, an amended Regulation was adopted concerning the ESA 95 definition of flows between two counterparts under any kinds of swaps and under forward rate agreements. These flows that were previously considered to be interest (non-financial transactions), are now considered to be financial transactions and are therefore excluded from the calculation of general government balances[34]. However, this amendment does not apply to the definition of general government balances to be used for the purpose of the Excessive Deficit Procedure (EDP), which therefore continues to consider these flows as interest.

Therefore, as regards Council Regulation 3605/93[35], which defines the EDP, the reclassification in ESA 95 referring to swaps and forward rate agreements is not carried over and in February 2002 an amendment to the EDP regulation was adopted for this purpose[36].

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32 The ESA 95 accounting methodology and the transmission programme of national accounts data are specified by Council Regulation (EC) No 2223/96 of 25 June 1996 on the European system of national and regional accounts in the Community, OJ L 310, 30.11.1996, p.1.

33 Regulation (EC) No 2516/2000 of the European Parliament and of the Council of 7 November 2000, OJ L 290, 17.11.2000, pp. 1-2. Commission Regulation (EC) No 995/2001 of 22 May, OJ L 139, 23.5.2001, pp. 3-8, implements Regulation (EC) No 2516/2000 mentioned above.

34 Regulation (EC) No 2558/2001 of the European Parliament and of the Council of 3 December 2001 amending Council Regulation (EC) No 2223/96 as regards the reclassification of settlements under swaps arrangements and under forward rate arrangements, OJ L 344, 28.12.2001, pp. 1-4.

35 Council Regulation (EC) No 3605/93 of 22 November 1993 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community OJ L 332, 31.12.1993, as amended by Regulation (EC) No 475/2000, OJ L 58, 3.3.2000.

36 Commission Regulation (EC) No 351/2002 of 25 February 2002, OJ L 55, 26.2.2002, amending Council Regulation (EC) No 3605/93 as regards references to ESA95.

For the purposes of the present report and for the assessment of the government budgetary position, the definition of ‘deficit’ is in accordance with the one used in the EDP.

C.2. Additional tables on the public finances

Table C.1

Government surplus / deficit in EU Member States

(General government net lending (+) / net borrowing (-) , as % of GDP)

	1997	1998	1999	2000	2001	2002*
B	-2.0	-0.8	-0.6	0.1	0.2	-0.2
D	-2.7	-2.2	-1.6	1.2	-2.7	-2.8
EL	-4.7	-2.4	-1.7	-0.8	0.1	0.3
E	-3.2	-2.6	-1.1	-0.3	0.0	-0.2
F	-3.0	-2.7	-1.6	-1.3	-1.4	-1.9
IRL	1.2	2.3	2.3	4.5	1.7	0.6
I	-2.7	-2.8	-1.8	-0.5	-1.4	-1.3
L	2.8	3.2	3.8	5.8	5.0	2.0
NL	-1.1	-0.8	0.4	2.2	0.2	0.0
A	-2.0	-2.4	-2.2	-1.5	0.1	-0.1
P	-2.6	-2.3	-2.2	-1.5	-2.7	-2.6
FIN	-1.5	1.3	1.9	7.0	4.9	3.3
Euro area	-2.6	-2.2	-1.3	0.2	-1.3	-1.4
DK	0.4	1.1	3.1	2.5	3.1	2.1
S	-1.6	1.9	1.5	3.7	4.8	1.7
UK	-2.2	0.4	1.1	4.1	0.9	-0.2
EU	-2.5	-1.6	-0.7	1.1	-0.6	-1.1

Note: Data according to the EDP definition.
***** Spring 2002 economic forecasts.

Source: Commission services.

Table C.2

Government debt in EU Member States
(General government consolidated gross debt , as % of GDP)

	1997	1998	1999	2000	2001	2002*
B	124.7	119.3	115.0	109.3	107.5	104.3
D	61.0	60.9	61.3	60.3	59.8	60.8
EL	108.2	105.0	103.8	102.8	99.7	97.9
E	66.6	64.6	63.1	60.4	57.2	55.5
F	59.3	59.5	58.5	57.4	57.2	57.4
IRL	65.1	55.1	49.6	39.0	36.3	33.6
I	120.2	116.4	114.5	110.6	109.4	107.8
L	6.0	6.3	6.0	5.6	5.5	5.2
NL	69.9	66.8	63.1	56.0	52.9	50.1
A	64.7	63.9	64.9	63.6	61.8	60.2
P	58.9	54.8	54.2	53.4	55.4	56.5
FIN	54.1	48.8	46.8	44.0	43.6	43.1
Euro area	75.3	73.7	72.6	70.2	69.1	68.6
DK	61.2	56.2	52.7	46.8	44.7	43.2
S	73.1	70.5	65.0	55.3	55.9	52.6
UK	50.8	47.6	45.2	42.4	39.0	37.6
EU	71.0	68.9	67.3	64.2	62.8	61.9

***** Spring 2000 economic forecasts.

Source: Commission services.

Table C.3

Updated stability/convergence programme projections for government surplus/deficit in EU Member States

(General government net lending (+) / net borrowing (-) , as % of GDP)

	Date submitted (a)	2000 (b)	2001 (b)	2002	2003	2004	2005
B	Dec.'01	-0.1	0.0	0.0	0.5	0.6	0.7
D	Dec.'01	1.2(-1.3)	2½	-2.0	1.0	-0.0	-0.0
EL	Dec.'01	-1.1	0.1	0.8	1.0	1.2	n.a
E	Dec.'01	-0.3	0.0	0.0	0.0	0.1	0.2
F (e)	Dec.'01	-1.4	-1.4(-1.5)	-1.4(-1.5)	-1.3/-1.0	-0.5/0.0	0.0/0.3
IRL	Dec.'01	4.5	1.4	0.7	-0.5	-0.6	n.a
I	Nov.'01	-1.5	-1.1	-0.5	0.0	0.0	0.2
L	Nov.'01	6.2	4.1	2.8	3.1	3.4	n.a
NL	Oct '01	2.2(1.5)	1.0	1.0	1.0	1.0	n.a
A	Nov.'01	-1.1	0.0	0.0	0.0	0.2	0.5
P	Dec.'01	-1.5	-2.2	-1.8	-1.0	0.0	0.4
FIN	Nov.'01	6.9	4.7	2.6	2.1	2.6	n.a
Euro area		-0.8	-1.1	-0.9	-0.5	0.0	0.1
DK	Jan '02	2.5	1.9	1.9	2.1	2.1	2.1
S	Nov.'01	4.1	4.6	2.1	2.2	2.3	n.a
UK (d)	Dec.'01	2.0	-0.2	-1.1	-1.3	-1.1	-1.0(c)
EU		-0.1	-0.8	-0.9	-0.6	-0.1	-0.1

(a) Dates of adoption by Member State government of updated stability or convergence programme.

(b) Government balances in 2000 or 2001 are affected by receipts from the sale of UMTS licences in several countries. Where information is available in the programmes, two figures are shown: the first includes the proceeds from UMTS licences and the second (in brackets) excludes these proceeds.

(c) Government deficit of 1.0% of GDP also projected for 2006-07.

(d) Financial years.

(e) In 2003 – 2005 the first figure refers to a low growth scenario, the latter to a high growth scenario.

Source: Updated stability/convergence programmes.

ANNEX D: EXCHANGE RATE CRITERION

D.1. Treaty provisions and ERM II

The relevant period for assessing exchange rate stability in this report extends over two years of Stage 3 of EMU. This implies that the application of the exchange rate criterion must reflect the situation after the introduction of the euro and the establishment of the ERM II. Accordingly, the assessment of exchange rate stability in this examination will be based on the Treaty provisions, as elaborated by the relevant protocol, and by the Council Resolution establishing the ERM II with effect from 1 January 1999.

The relevant Treaty provisions are:

- The *third indent of Article 121(1)*, which refers to the exchange rate criterion as:

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

- *Article 3 of Protocol No 21* which states that:

"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".

- *The Council Resolution on the establishment of the ERM II* (97/C 236/03 of 16 June 1997)[37] which states that:

"With the start of the third stage of economic and monetary union, the European Monetary System will be replaced by the exchange rate mechanism as defined in this Resolution….The exchange-rate mechanism will link currencies of Member States outside the euro area to the euro".

D.2. Application of the exchange rate criterion

In the convergence examination of April 2000, the application of the exchange rate criterion had already to be extended to the first 15 months of Stage 3 of EMU bringing ERM II into focus. Unlike the original ERM, the ERM II is based on a bilateral exchange rate commitment between the euro and the other participant currencies. A "standard" fluctuation band of ±15% has been established and this, in

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[37] OJ C 236, 2.8.1997, p. 5.

principle, corresponds to the "normal fluctuation margins" referred to in the Treaty. The standard fluctuation band of ±15% implies the possibility of a 30% appreciation/depreciation of a currency against the euro while remaining within the band, making it a very accommodative benchmark for assessing exchange rate stability.

There exists the possibility of establishing narrower fluctuation bands within the ERM II to reflect progress in economic convergence, but there is no requirement to do so. The assessment of exchange rate stability can be made in the context of a fluctuation band of ±2.25% around a currency's central parity against the euro. Continuity between the approaches used in earlier assessments (when ERM still was in place) and the current one is enhanced by the fact that the median currency in the original ERM on the final day of Stage 2 was fixed irrevocably against the euro from the first day of Stage 3. The "euro-based approach" would also imply that an appreciation/depreciation of 4.5% would be tolerated, although, once again, a breach of the band would not necessarily correspond to severe tensions but would be assessed by reference to the same range of elements as in previous examinations.

D.3. Fulfilling the exchange rate criterion in the current examination

The principle of equal treatment requires that the exchange rate criterion should be applied as consistently as possible over time. For the purposes of this examination the criterion will be applied using the euro-based approach. In summary, the conditions to be respected in fulfilling the exchange rate criterion would be as follows:

- Participation in the ERM II at the time of the assessment is mandatory.

- Participation in the ERM II for at least two years is expected, although exchange rate stability during a period of non-participation before entering ERM II can be taken into account.

- No downward realignment of the central parity in the ERM II within the two-year examination period.

- Exchange rate to have been maintained within a fluctuation band of ±2.25% around the currency's central parity against the euro in the context of the ERM II. However, the extent to which a breach of the ±2.25% fluctuation band would correspond to severe tensions would take account of a range of relevant considerations. A distinction is to be made between exchange rate movements above the 2.25% upper margin and movements below the 2.25% lower margin.

ANNEX E: LONG-TERM INTEREST RATE CRITERION

Table E.1
Long-term interest rates in EU Member States
(12-month averages)

	1999	2000	2001	April 2002 a)
B	4.7	5.6	5.1	5.2
D	4.5	5.3	4.8	4.9
EL	6.3	6.1	5.3	5.3
E	4.7	5.5	5.1	5.2
F	4.6	5.4	4.9	5.0
IRL	4.7	5.5	5.0	5.1
I	4.7	5.6	5.2	5.2
L	4.7	5.5	4.9	4.9
NL	4.6	5.4	5.0	5.0
A	4.7	5.6	5.1	5.1
P	4.8	5.6	5.2	5.2
FIN	4.7	5.5	5.0	5.1
Euro area	*4.7*	*5.4*	*5.0*	*5.1*
DK	4.9	5.6	5.1	5.1
S	5.0	5.4	5.1	5.3
UK	5.0	5.3	5.0	5.1
EU	*4.7*	*5.4*	*5.0*	*5.1*
Average of 3 best performers	4.8	5.4	5.0	5.0
Reference value b)	6.8	7.4	7.0	7.0

a) Average of May 2001-April 2002.
b) Average of interest rates of the 3 best performing Member States (underlined) in terms of price stability plus 2%-points.
Source: Commission services.

The application of the interest rate criterion in this report is on the same basis as in the 1998 and the 2000 convergence reports.

For the operational assessment of the criterion on the convergence of interest rates the yield on benchmark ten-year bonds has been used; details about the interest rates used for the Member States are given in the box. The long-term interest rates are averaged over periods of twelve months. The reference value is calculated from the simple average of the average long-term interest rates of the three best performing Member States in terms of price stability as measured by harmonised indices of consumer prices (see Annex B) plus 2 percentage points.

Table E.1 reports the annual averages for long-term interest rates in the years 1999-2001 and in April 2002, the latest date for which monthly data are available. Average long-term interest rates for the 12-month period from May 2001 to April 2002 are shown in the final column of the table. In April 2002, the reference value, derived from the average interest rates in the United Kingdom, France and Luxembourg, the three best performing Member States in terms of price stability, was 7.0%.

BOX: Data for the interest rate convergence criterion

The fourth indent of Article 121(l) of the Treaty requires that the durability of nominal convergence and exchange rate stability in Member States should be assessed by reference to long-term interest rates. Article 4 of Protocol No 21 on the convergence criteria adds that these "*Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions*".

Article 5 of Protocol No 21 requires that the Commission should provide the statistical data used for the application of the convergence criteria. However, in the context of the interest rate criterion, the European Monetary Institute developed the criteria for harmonising the series of yields on benchmark 10-year bonds on behalf of Eurostat and started collecting the data from the central banks, a task which has then been transferred to the European Central Bank. The selection of bonds for inclusion in this series has the following characteristics: a residual maturity close to 10 years; issued by central government; adequate liquidity, which is the main selection criterion; the choice between a single benchmark or the simple average of a sample is based on this requirement; yield gross of tax; and fixed coupon.

For all the Member States, the representative interest rates used in this examination incorporate all of the above characteristics. This ensures cross-country comparability. Since December 1997, 11 Member States have been using a single benchmark bond and four a sample of bonds (Germany, Spain, Portugal, Sweden). The harmonised series for Greece starts in mid-1997, as a 10-year benchmark bond has been available only since June 1997.