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REPORT FROM THE COMMISSION

CONVERGENCE REPORT 2004

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

[SEC(2004) 1268]

1. PURPOSE OF THE REPORT

In accordance with Article 122(2) of the Treaty, the Commission and the European Central Bank (ECB) are required to report to the Council on the progress made by the "Member States with a derogation" with respect to the compliance of their national legislation with the Treaty, as well as the achievement of a high degree of sustainable convergence. "Member States with a derogation" have not yet adopted the euro with the exception of Denmark and the United Kingdom which are Member States with a special status[1]. Such convergence reports must be prepared at least once every two years, or at the request of a Member State with a derogation. Sweden, being one such Member State, is now due for a convergence report as two years have elapsed since the last one. This provides an opportunity to also assess, for the first time, the ten countries that joined the European Union (EU) on 1 May 2004, which are automatically "Member States with a derogation" by virtue of Article 4 of the Treaty of Accession. It will contribute to the preparation in these countries of the requirements for euro adoption. This report therefore covers the following eleven Member States with a derogation: the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, Slovakia and Sweden.

The content of the reports[2] prepared by the Commission and the ECB is governed by Article 121(1) of the Treaty, which requires that the reports include an examination of (i) the compatibility of national legislation with the Treaty as well as with the Statute of the European System of Central Banks (ESCB) and of the European Central Bank. The reports must also examine whether a high degree of sustainable convergence has been achieved, by reference to the four convergence criteria relating to (ii) price stability, (iii) the government budgetary position, (iv) exchange rate stability and (v) the long-term interest rate as well as a number of additional factors[3]. The four convergence criteria and the periods over which they are to be respected are further developed in a Protocol annexed to the Treaty ("Protocol on the convergence criteria referred to in Article 121").

2. OVERVIEW: COMPATIBILITY OF LEGISLATION AND ACHIEVEMENT OF ECONOMIC CONVERGENCE

(i) Compatibility of national legislation, including the statutes of the national central banks, with Articles 108 and 109 of the Treaty and the Statute of the ESCB/ECB must be ensured. As far as the new Member States are concerned, the independence of their respective national central banks and the latter's compliance with the ESCB's objectives have been taken care of as part of the pre-accession requirements. However, in order to ensure the full integration of the different national central banks

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1 Denmark and the United Kingdom have a special status since they have opt-out arrangements. They are not examined because they have not indicated that they wish to adopt the euro (Article 4 on the Protocol on certain provisions related to Denmark and Article 10(a) of the Protocol on certain provisions related to the UK).

2 Convergence Report 2002 on Sweden, COM(2002) 243 final, 22 May 2002; Convergence Report 2000 on Sweden and Greece, COM(2000) 277 final, 3 May 2000; Convergence Report 1998 (on all the 15 Member States at that time), COM(1998) 1999 final, 25 March 1998; Convergence Report 1996, COM(1996) 560 final, 6 November 1996.

3 These additional factors are not necessary conditions for adopting the euro and are therefore not examined here. For a technical analysis of all factors affecting convergence, see SEC(2004) 1268.

into the ESCB before the countries concerned join the euro area, incompatibilities need to be resolved in the legislation of all countries.

(ii) The assessment of the price stability criterion is based on the observance of an average inflation rate over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-performing Member States in terms of price stability. The reference value was calculated to be 2.4% in August 2004, with Finland, Denmark and Sweden as the three best-performing Member States. Of the eleven Member States analysed in this report, five fulfil this criterion, namely the Czech Republic, Estonia, Cyprus, Lithuania and Sweden.

(iii) The criterion on the government budgetary position is linked to the decisions made in accordance with the excessive deficit procedure in Article 104 of the Treaty. At present, five of the eleven Member States examined are not the subject of a Council decision under Article 104(6) on the existence of an excessive deficit, namely Estonia, Latvia, Lithuania, Slovenia and Sweden, which therefore fulfil the criterion.

(iv) The exchange rate criterion requires the observance of the normal fluctuation margins of the exchange rate mechanism (ERM II) for at least two years without severe tensions. On 28 June 2004, the Estonian kroon, Lithuanian litas and Slovenian tolar joined ERM II. The Czech koruna, Hungarian forint, Cyprus pound, Latvian lats, Maltese lira, Polish zloty, Slovak koruna and Swedish krona have not yet joined ERM II. While the three currencies participating in ERM II since 28 June 2004 have been stable vis-à-vis the euro, no country examined has participated in ERM II for the required period. None of the eleven countries fulfils the exchange rate criterion.

(v) The long-term interest rate criterion is based on the observance, over a period of one year before the examination, of an average nominal interest rate that does not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability. The reference value was calculated to be 6.4% in August 2004. Long-term interest rates were below the reference value in the Czech Republic, Cyprus, Latvia, Lithuania, Malta, Slovenia, Slovakia and Sweden. These eight countries were found to meet the interest rate criterion. For Estonia, where no long-term government bonds or comparable securities are available, there are no reasons to conclude that Estonia would not fulfil the interest rate criterion.

Compatibility of legislation and fulfilment of convergence criteria

	Legal compatibility	Price stability	Government budgetary position	Exchange rates	Long-term interest rate convergence
Czech Republic	no	yes	no	no	yes
Estonia	no	yes	yes	no	--
Cyprus	no	yes	no	no	yes
Latvia	no	no	yes	no	yes
Lithuania	no	yes	yes	no	yes
Hungary	no	no	no	no	no
Malta	no	no	no	no	yes
Poland	no	no	no	no	no
Slovenia	no	no	yes	no	yes
Slovakia	no	no	no	no	yes
Sweden	no	yes	yes	no	yes

Source: Commission services

3. ASSESSMENT BY MEMBER STATE

3.1. The Czech Republic

As regards the central bank integration into the ESCB at the time of euro adoption, legislation in the Czech Republic, in particular the Czech National Bank Act, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute .

The average inflation rate in the Czech Republic during the 12 months to August 2004 was 1.8%. The Czech Republic fulfils the criterion on price stability.

The Czech Republic is at present the subject of a decision on the existence of an excessive deficit (Council decision of 5 July 2004). The general government deficit was 12.6% of GDP in 2003, while government debt was 37.8 % of GDP. The Czech Republic does not fulfil the criterion on the government budgetary position.

The Czech koruna is not participating in ERM II and is subject to a managed floating regime with occasional interventions by the central bank. The Czech Republic does not fulfil the exchange rate criterion.

The average long-term interest rate in the Czech Republic in the year to August 2004 was 4.7% and the Czech Republic fulfils the criterion on the convergence of long-term interest rates. Against a background of low inflationary pressures, long-term interest rates in the Czech Republic dropped temporarily below euro area levels between mid-2002 and mid-2003, but long-term interest rate spreads have since become positive.

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

3.2. Estonia

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Estonia, in particular the Eesti Pank Act, the Constitution of the Republic of Estonia as well as the currency law and the law on the security for Estonian kroon, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute

The average inflation rate in Estonia during the 12 months to August 2004 was 2.0%. Estonia fulfils the criterion on price stability.

Estonia is not the subject of a decision on the existence of an excessive deficit. The general government surplus was 3.1% of GDP in 2003 and government debt was 5.3% of GDP. Estonia fulfils the criterion on the government budgetary position.

Since 28 June 2004, Estonia has participated in ERM II and the Estonian authorities have committed to unilaterally maintaining their currency board arrangement within ERM II. The Estonian kroon has not deviated from its central parity. At the time of this examination, ERM II participation was less than two years. Estonia does not fulfil the exchange rate criterion.

Due to the absence, partially linked to the low level of government debt, of a harmonised benchmark long-term government bond or comparable security, an interest rate indicator has been identified, based on bank lending rates. This interest rate indicator in the year to August 2004 was on average 4.6%. On the basis of developments in the interest rate indicator and taking into account, inter alia, the low government debt level, there are no reasons to conclude that Estonia would not fulfil the long-term interest criterion.

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

3.3. Cyprus

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Cyprus, in particular the Central Bank of Cyprus Law, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute .

The average inflation rate in Cyprus during the 12 months to August 2004 was 2.1%. Cyprus fulfils the criterion on price stability.

Cyprus is at present the subject of a decision on the existence of an excessive deficit (Council decision of 5 July 2004). The general government deficit was 6.4% of GDP in 2003 and government debt was 70.9% of GDP. Cyprus does not fulfil the criterion on the government budgetary position.

The Cyprus pound is not participating in ERM II and is pegged to the euro with a ± 15% fluctuation margin. Cyprus does not fulfil the exchange rate criterion.

The average long-term interest rate in Cyprus in the year to August 2004 was 5.2% and Cyprus fulfils the criterion on the convergence of long-term interest rates. Long-term interest rates converged considerably towards euro area levels in early 2002 and the spread remained within 1 percentage point for most of 2003. Recently, long-term interest rates have increased to well above euro area levels.

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

3.4. Latvia

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Latvia, in particular the Law on the Bank of Latvia, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute .

The average inflation rate in Latvia during the 12 months to August 2004 was 4.9%. Latvia does not fulfil the criterion on price stability.

Latvia is not the subject of a decision on the existence of an excessive deficit. The general government deficit was 1.5% of GDP in 2003 and government debt was 14.4% of GDP. Latvia fulfils the criterion on the government budgetary position.

The Latvian lats is not participating in ERM II and is pegged to the SDR basket of currencies with a normal fluctuation margin of ± 1%. Latvia does not fulfil the exchange rate criterion.

The average long-term interest rate in Latvia in the year to August 2004 was 5.0% and Latvia fulfils the criterion on the convergence of long-term interest rates. Long-term interest rate differentials with the euro area have increased slightly in Latvia since mid-2002 to ½-1 percentage points.

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

3.5. Lithuania

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Lithuania, in particular the Law on the Bank of Lithuania, the Constitution of Lithuania as well as the law on currency and the law on the credibility of the litas, is not fully compatible with Articles 109 of the Treaty and the ESCB/ECB Statute

The average inflation rate in Lithuania during the 12 months to August 2004 was -0.2%. Lithuania fulfils the criterion on price stability.

Lithuania is not the subject of a decision on the existence of an excessive deficit. The general government deficit was 1.9% of GDP in 2003 and government debt was 21.4% of GDP. Lithuania fulfils the criterion on the government budgetary position.

Since 28 June 2004, Lithuania has participated in ERM II and the Lithuanian authorities have committed to unilaterally maintaining their currency board arrangement within ERM II. The litas has not deviated from its central parity. At the time of this examination, ERM II participation was less than two years. Lithuania does not fulfil the exchange rate criterion.

The average long-term interest rate in Lithuania in the year to August 2004 was 4.7% and Lithuania fulfils the criterion on the convergence of long-term interest rates. Long-term interest rates in Lithuania, still at 10% at the beginning of 2001, have declined considerably and the interest rate differential with the euro area narrowed to 0.4 percentage points in the period January-August 2004.

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

3.6. Hungary

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Hungary, in particular the Magyar Nemzeti Bank Act and the Constitution Act, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute

The average inflation rate in Hungary during the 12 months to August 2004 was 6.5%. Hungary does not fulfil the criterion on price stability.

Hungary is at present the subject of a decision on the existence of an excessive deficit (Council decision of 5 July 2004). The general government deficit was 6.2% of GDP in 2003, while government debt was 59.1% of GDP. Hungary does not fulfil the criterion on the government budgetary position.

The Hungarian forint, which is pegged to the euro with a ± 15% fluctuation margin, is not participating in ERM II. Hungary does not fulfil the exchange rate criterion.

The average long-term interest rate in Hungary in the year to August 2004 was 8.1% and Hungary does not fulfil the criterion on the convergence of long-term interest rates. Long-term interest rates in Hungary diverged from developments in the euro area which can be associated with an increased foreign exchange risk premium and higher inflation expectations.

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

3.7. Malta

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Malta, in particular the Central Bank of Malta Act, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute

The average inflation rate in Malta during the 12 months to August 2004 was 2.6%. Malta does not fulfil the criterion on price stability.

Malta is at present the subject of a decision on the existence of an excessive deficit (Council decision of 5 July 2004). The general government deficit was 9.7% of GDP in 2003 and government debt was 71.1% of GDP. Malta does not fulfil the criterion on the government budgetary position.

The Maltese lira, which is pegged to a basket of currencies in which the euro has a weight of 70%, is not participating in ERM II. Malta does not fulfil the exchange rate criterion.

The average long-term interest rate in Malta in the year to August 2004 was 4.7% and Malta fulfils the criterion on the convergence of long-term interest rates. Long-term interest rate differentials with the euro area were around 0.4 percentage points in the period January-August 2004.

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

3.8. Poland

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Poland, in particular the Act on the National Bank of Poland and the Constitution of Poland, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

The average inflation rate in Poland during the 12 months to August 2004 was 2.5%. Poland does not fulfil the criterion on price stability.

Poland is at present the subject of a decision on the existence of an excessive deficit (Council decision of 5 July 2004). The general government deficit was 3.9% of GDP in 2003, while government debt was 45.4% of GDP. Poland does not fulfil the criterion on the government budgetary position.

The Polish zloty is not participating in ERM II and is left floating with the central bank abstaining from currency interventions. Poland does not fulfil the exchange rate criterion.

The average long-term interest rate in Poland in the year to August 2004 was 6.9% and Poland does not fulfil the criterion on the convergence of long-term interest rates. Long-term interest rates in Poland diverged from developments in the euro area which may be associated with concerns about fiscal policy and inflation.

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

3.9. Slovenia

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Slovenia, in particular the Bank of Slovenia Act, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

The average inflation rate in Slovenia during the 12 months to August 2004 was 4.1%. Slovenia does not fulfil the criterion on price stability.

Slovenia is not the subject of a decision on the existence of an excessive deficit. The general government deficit was 2.0% of GDP in 2003 and government debt was 29.4% of GDP. Slovenia fulfils the criterion on the government budgetary position.

Since 28 June 2004, the Slovenian tolar has participated in ERM II and has been trading close to its central parity since that date. At the time of this examination, ERM II participation was less than two years. Slovenia does not fulfil the exchange rate criterion.

The average long-term interest rate in Slovenia in the year to August 2004 was 5.2% and Slovenia fulfils the criterion on the convergence of long-term interest rates. Since mid-2002, long-term interest rates in Slovenia have declined sharply toward the euro area level with differentials narrowing to 0.6 percentage points in the period January-August 2004.

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

3.10. Slovakia

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Slovakia, in particular the Act on the National Bank of Slovakia, is not fully compatible with Articles 108 and 109 of the Treaty and the ESCB/ECB Statute.

The average inflation rate in Slovakia during the 12 months to August 2004 was 8.4%. Slovakia does not fulfil the criterion on price stability.

Slovakia is at present the subject of a decision on the existence of an excessive deficit (Council decision of 5 July 2004). The general government deficit was 3.7% of GDP in 2003, while government debt was 42.6 % of GDP. Slovakia does not fulfil the criterion on the government budgetary position.

The Slovak koruna is not participating in ERM II and is subject to a managed floating regime with occasional interventions by the central bank. Slovakia does not fulfil the exchange rate criterion.

The average long-term interest rate in Slovakia in the year to August 2004 was 5.1% and Slovakia fulfils the criterion on the convergence of long-term interest rates. Since mid-2002, long-term interest rates in Slovakia have declined sharply toward the euro-area level, with differentials narrowing to 0.9 percentage points in the period January-August 2004.

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

3.11. Sweden

In the 2002 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. It also concluded that legislation in Sweden was not compatible with the Treaty and the ESCB/ECB Statute.

As regards central bank financial independence as well as central bank integration into the ESCB at the time of euro adoption, legislation in Sweden, in particular the Sveriges Riksbank Act and the Instrument of Government (the country’s Constitution), continues not to be fully compatible with Articles 108 and 109 of the Treaty and the ESCB/ECB Statute.

The average inflation rate in Sweden during the 12 months to August 2004 was 1.3%. Sweden continues to fulfil the criterion on price stability.

Sweden is not the subject of a decision on the existence of an excessive deficit. The general government surplus was 0.3% of GDP in 2003 and government debt was 52.0% of GDP. Sweden continues to fulfil the criterion on the government budgetary position.

The Swedish krona is not participating in ERM II and is floating. Sweden continues not to fulfil the exchange rate criterion.

The average long-term interest rate in Sweden in the year to August 2004 was 4.7% and Sweden continues to fulfil the criterion on the convergence of long-term interest rates. Swedish long-term interest rates have been close to euro-area levels and occasionally below them.

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”.